Prospects and challenges for developing corporate sukuk and bond markets
Lessons from a Kuwait case study

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Abstract

Purpose – This paper aims to present a case study on how to develop financial markets in one of the emerging economies of the MENA region – Kuwait.

Design/methodology/approach – The analysis proceeds in two steps: first, the need for developing and deepening these markets is established; second, the impediments curtailing market development are identified and discussed.

Findings – It is argued that Kuwait currently faces a valuable window of opportunity to build up further its sukuk and bond markets. The paper also assesses the prospects for the emergence of a regional financial market across GCC countries.

Originality/value – Besides the direct policy recommendations provided for Kuwait, given the similarities with other emerging economies, the lessons learned from this study may be relevant to other countries in the MENA region.

Keywords Capital markets, Bonds, Kuwait, Financial markets

1. Introduction

This paper presents a case study on developing sukuk and bond markets in one of the emerging economies of the MENA region – Kuwait. The paper will argue that Kuwait is currently at a crossroad in which it needs to deepen and develop further its financial markets in order to expand the range of financing opportunities for the private sector. Upgrading the country’s financial system should be part of the authorities’ overall strategy for diversifying the Kuwaiti economy away from oil activities. Further, a more diversified financial system – which could also include a wider range of Islamic financial products – is a necessary condition to take full advantage of the large infrastructure projects that the country is planning to undertake in the near future: the wider the range of financing options available, the cheaper it will become to fund these projects.

It will be argued that two areas were substantial progress could be made are the corporate bond and sukuk markets. In particular, private corporations would benefit

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from having access to multiple sources of long-term funding, which would increase their ability to borrow at more competitive terms. Similarly, well developed debt and sukuk markets would also benefit commercial banks, which would be able to issue their own long-term paper. In this manner, banks could reduce their dependence on their depositor base and increase the menu of tools available to balance their maturity mismatches.

The main focus of the paper will be on the developmental aspects of the bond and sukuk markets, with a view to identify the main impediments for their development. Given Kuwait’s similarities with other countries in the region (e.g. large infrastructure projects underway, existence of a mixed financial system, need to further diversify the country’s economic activities), the lessons learned from the study may be applicable to other economies in the MENA region.

The study will proceed as follows: Section II provides a brief overview of the financing sources available to the private sector in Kuwait; Section III reviews the main impediments to the development of the bond and sukuk markets; Section IV discusses the prospects for the emergence of a regional financial market; and Section V concludes.

2. Financing sources for the private sector in Kuwait

The private sector in Kuwait primarily relies on bank loans as its major source of funding. Small- and medium-size enterprises (SMEs) also tend to draw heavily from internal accruals to finance a significant amount of their activities. Currently, SMEs face additional financing constraints due to the existing banking regulations, which impose ceilings on banks’ lending interest rates. These ceilings act to ration out the amount of credit available to small business, as banks are not always able to price their loans according to their risk assessments.

On the other hand, the larger and more established corporations have access to a more varied menu of funding sources, including the local stock market and some foreign sources, such as internationally syndicated loans.

The recourse of local companies to syndicated loans has been growing in recent years, although the amounts involved are still small compared to most GCC economies, or even other emerging markets such as Malaysia or Singapore (Table I). For instance, over the past four years, syndicated loans in Kuwait amounted to a yearly average of

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
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<td>1,188.5</td>
<td>202.0</td>
<td>340.0</td>
<td>1,000.0</td>
<td>1,475.0</td>
<td>1,690.0</td>
<td>2,085.2</td>
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<tr>
<td>Kuwait</td>
<td>250.0</td>
<td>770.0</td>
<td>165.0</td>
<td>782.5</td>
<td>4,283.0</td>
<td>4,226.7</td>
<td></td>
</tr>
<tr>
<td>Lebanon</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>95.0</td>
<td></td>
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<tr>
<td>Qatar</td>
<td>580.0</td>
<td>895.0</td>
<td>1,536.7</td>
<td>880.8</td>
<td>1,377.7</td>
<td>8,168.5</td>
<td>7,252.2</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2,200.9</td>
<td>275.0</td>
<td>280.0</td>
<td>569.5</td>
<td>2,134.0</td>
<td>3,681.0</td>
<td>6,761.7</td>
</tr>
<tr>
<td>UAE</td>
<td>2,045.0</td>
<td>520.7</td>
<td>140.0</td>
<td>1,942.6</td>
<td>1,341.0</td>
<td>7,882.3</td>
<td>16,850.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2,997.2</td>
<td>2,046.7</td>
<td>1,973.6</td>
<td>3,789.4</td>
<td>3,999.2</td>
<td>2,509.7</td>
<td>4,236.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>1,364.2</td>
<td>1,010.6</td>
<td>1,338.8</td>
<td>1,154.1</td>
<td>1,606.1</td>
<td>1,839.2</td>
<td>6,449.7</td>
</tr>
</tbody>
</table>

Note: The figures are represented in millions of US$

Table I.  
External financing: loan syndication, 2000-2006
$2.3 billion (equivalent to 2.3 percent of 2006 GDP), compared to $4.4 billion (or 8.4 percent of 2006 GDP) in Qatar, and $7 billion (or 4.3 percent of 2006 GDP) in UAE.

Within this context, Islamic financial products may emerge as an alternative mode of funding. In fact, the Islamic financial services industry in Kuwait has also been expanding with vigor, to reach a size equivalent to one-third of the total assets of the financial sector’s assets at end-2006. As this industry develops further, it will become easier for local enterprises to tap the expanding pool of foreign investors interested in shariah-compliant investment alternatives.

However, despite the rapid growth of this sector, there remain unexplored opportunities within the Kuwaiti Islamic finance industry. For instance, corporate sukuk issuances in Kuwait have been relatively scarce compared to most other countries in the GCC region (Table II). Kuwait’s companies and banks have not yet been able to fully exploit the growing interest expressed by regional and international investors in these instruments.

Although local corporations are increasingly realizing the potential of sukuk issuances to raise funds, the floating of these instruments often takes place in foreign markets, such as Bahrain or Dubai. These international centers may offer deeper markets – in which it is possible for the issuing company to offer paper at more advantageous prices – as well as more flexible regulatory environments. Such seems to be the case, for instance, of the recent issuances by two Kuwaiti companies: The Investment Dar and Aayan Leasing and Investment Co., in 2005 and 2006, respectively. Both issuances, which amounted to about $100 million, and were partially organized by the Kuwaiti Bobyan Bank, but were also floated in Bahrain.

Looking ahead, Kuwait has a valuable window of opportunity to build up further its financial markets. As the country embarks in large infrastructure projects over the next decade, the scope for bond and sukuk issuances is considerable. Reforming the current environment in order to provide a more inviting environment to international investors would attract large flows of capital, bring in additional foreign expertise, and lower the financing costs of the infrastructure projects.

<table>
<thead>
<tr>
<th>Country</th>
<th>Issuer</th>
<th>Year</th>
<th>Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>Kingdom of Bahrain</td>
<td>2003</td>
<td>Sovereign</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>Kingdom of Bahrain</td>
<td>2004</td>
<td>Sovereign</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>National Central Cooling Co.</td>
<td>2004</td>
<td>Corporate</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Durrat al-Bahrain</td>
<td>2005</td>
<td>Corporate</td>
<td>153</td>
</tr>
<tr>
<td></td>
<td>Bahrain Financial Harbour</td>
<td>2005</td>
<td>Sovereign</td>
<td>270</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Commercial Real Estate Company</td>
<td>2005</td>
<td>Corporate</td>
<td>100</td>
</tr>
<tr>
<td>Qatar</td>
<td>State of Qatar</td>
<td>2003</td>
<td>Sovereign</td>
<td>700</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Solidarity (IsDB)</td>
<td>2003</td>
<td>Corporate</td>
<td>400</td>
</tr>
<tr>
<td></td>
<td>Islamic Development Bank</td>
<td>2005</td>
<td>Corporate</td>
<td>500</td>
</tr>
<tr>
<td>UAE</td>
<td>National Cooling Company</td>
<td>2004</td>
<td>Corporate</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Dubai Metals &amp; Commodities</td>
<td>2005</td>
<td>Corporate</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>Emirate</td>
<td>2005</td>
<td>Corporate</td>
<td>550</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Malaysia Global Sukuk Inc</td>
<td>2002</td>
<td>Sovereign</td>
<td>600</td>
</tr>
</tbody>
</table>

Table II. Sample of large sukuk issuances: 2002-2006

Note: aIn millions of US$  
Source: Various sources, including Islamic Finance and Banking Magazine (several issues) and Euromoney (several issues)
3. Current impediments to further market development

By many standards, Kuwait has a stable and favorable business environment. Nevertheless, there are some features in the legal and regulatory framework that place Kuwait at a disadvantage with respect to its neighbors, and reduces its attractiveness as a destination for foreign investments. This section identifies and discusses some of these deficiencies.

3.1 The legal and regulatory environment

Overall, Kuwait enjoys a prosperous business environment, with the number of investment opportunities progressively increasing as the country continues to develop. Aside from the oil industry, the financial sector has recently emerged as one of the areas with highest growth potential in the country. Having been able to thrive in the competitive local environment, Kuwaiti financial institutions are well poised to seize the opportunity to raise their profile as important regional players.

According to the IFC’s doing business project, Kuwait is the second-ranking country in the region – and 40th in the world – in terms of having a suitable environment for conducting business (Table III)[1].

Similarly, the 2007 Arab World Competitiveness Report showed that Kuwait is, in fact, one of the leading countries in the MENA region in the provision of financial services (Table IV)[2]. Even though Kuwait’s ranking falls below Bahrain’s – a country which to many has established itself as one of the leading financial hubs in the region – it is above other emerging financial centers, such as the UAE and Qatar. Furthermore, Kuwait has also access to a large body of highly qualified professionals with substantial expertise in financial services, as well as a relatively advanced technological infrastructure and network of communications.

<table>
<thead>
<tr>
<th>Country</th>
<th>Ease of doing business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>1</td>
</tr>
<tr>
<td>Kuwait</td>
<td>3</td>
</tr>
<tr>
<td>Oman</td>
<td>4</td>
</tr>
<tr>
<td>UAE</td>
<td>5</td>
</tr>
<tr>
<td>Jordan</td>
<td>6</td>
</tr>
<tr>
<td>Lebanon</td>
<td>7</td>
</tr>
<tr>
<td>Tunisia</td>
<td>8</td>
</tr>
<tr>
<td>Egypt</td>
<td>12</td>
</tr>
</tbody>
</table>

Table III. Ease of doing business in MENA

<table>
<thead>
<tr>
<th>Country</th>
<th>Financial market sophistication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>5.2</td>
</tr>
<tr>
<td>Oman</td>
<td>4.5</td>
</tr>
<tr>
<td>Kuwait</td>
<td>4.5</td>
</tr>
<tr>
<td>UAE</td>
<td>4.3</td>
</tr>
<tr>
<td>Qatar</td>
<td>4.3</td>
</tr>
<tr>
<td>Tunisia</td>
<td>4.1</td>
</tr>
<tr>
<td>Jordan</td>
<td>4.0</td>
</tr>
<tr>
<td>Egypt</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Table IV. Financial market sophistication in MENA

Source: IFC, doing business project, 2008

Note: Ranking: 1 = lowest possible score to 7 = highest possible score
Source: The Arab World Competitiveness Report, 2007
Nevertheless, important shortcomings in the legal and regulatory framework remain that hamper the further expansion of the financial sector. Firstly, a large part of the legislation governing financial transactions is outdated, with some codes dating back to the 1960s and 1970s. Secondly, there is a generalized feeling among investors and financial institutions that the existing legislation does not establish a clear set of rules from which it is always possible for investors to assess _ex-ante_ their tax liabilities and legal requirements.

On top of the uncertainties regarding tax legislation, the tax code also contains some provisions that constitute strong disincentives for foreign investors. In particular, the capital gains tax imposed on foreigners can reach very high levels – of up to 55 percent of the total capital gains[3] and 50 percent of corporate profits. These high rates severely reduce Kuwait’s attractiveness for international investors, especially when compared to the tax rates in other countries in the region.

Adding to this problem, international investors often need to undergo extra legislative hurdles to invest in Kuwait. For instance, in all their business ventures, foreign investors must find a local partner to be the majority share holder in the company (with at least 51 percent of the company’s shares). Another example of an administrative obstacle is the requirement for foreigners to obtain approval from the Central Bank of Kuwait (CBK) in order to acquire each incremental 5 percent of a bank’s capital[4].

Aware of these deficiencies, the Kuwaiti authorities have taken important steps to remedy some of them. There are three important laws being currently considered by parliament and the Council of Ministers. Namely, the Capital Markets Authority Law, the Companies Law, and the revisions to the Tax Code. The passage of this body of legislation would forcefully enhance the legal foundation of the financial sector, by making it more transparent and flexible, and by providing domestic and international investors more attractive incentives.

To improve the general regulatory and legal environment, the authorities should consider:

- securing passage of important legislation such as the Insurance Authority Law, the Companies Law, and revisions to the Tax Code; and
- reducing tax rates on foreign investors in order to make Kuwait more competitive _vis-à-vis_ other markets in the region.

### 3.2 Diversifying the institutional investors base

Kuwait has a narrow institutional investor base. The largest investor class is conformed by commercial banks, followed by investment companies and funds (which mostly concentrate their activities in equity and, to a lesser degree, real estate investments). Other types of schemes, such as hedge funds, money market funds, and bond funds are still inexistent.

The insurance sector constitutes the third investor class, but it is remarkably small (the sector’s assets equal around 1 percent of the assets of the financial system) and has very low-growth prospects, owing to the generous government benefits offered to all citizens. For the same reason, pension funds are very unlikely to appear and thrive in Kuwait.

In order to enhance the variety of institutional investors, less restrictions should be applied to foreign entry. Opening the country further to foreign investors would widen
and deepen the investor base as well as bring in additional expertise. A larger international presence would also make markets more liquid, as different types of investors are less likely to adjust their portfolios in the same direction at the same time. In addition, opening local financial markets to foreign investors would result in increased pressure to constantly modernize the market infrastructure and to maintain high-transparency standards.

### 3.3 Absence of a yield curve and a liquid secondary market for government debt

The well-functioning of financial markets relies on the capability of market participants to price the risks inherent to the different instruments traded. Among the many elements that intervene in the price formation process, the ability to establish a price for riskless assets – such as government bonds – is a crucial ingredient. In most countries, the price of government paper is used as the point of reference upon which other instruments are priced. In order to create a full spectrum of benchmark dates, government debt must be available for a range of maturities, and should be traded in a deep secondary market, where individual investors can change their positions without affecting the market price.

Kuwait has a low level of government debt (amounting to KD 2.3 billion, or 2.4 percent of GDP), which results in a virtually non-existent secondary market for public debt. Additionally, the range of maturities available is very narrow, with most of the outstanding debt being concentrated in paper of one-year maturity. Owing to the high-liquidity requirements imposed on commercial banks (presently set at 20 percent of their assets) banks are induced to hoard government bonds until maturity, preventing the development of a secondary market where these assets would be actively traded. The absence of such a secondary market has prevented the creation of a local yield curve.

In order to build a dinar yield curve, the Kuwaiti Government should expand the volume and range of maturities offered on public debt. Some steps in this direction have been taken by the CBK by issuing central bank notes at several long-term maturities (i.e. three, five, and seven years). While this is a welcome development, government and central bank paper are not close enough substitutes to build a yield curve, as the latter is not accessible to non-bank institutional investors, and thus, the market for CB bills will be mostly driven by the liquidity conditions in the banking system.

An additional element that is forestalling the issuance of government debt is the fact that Kuwait enjoys ample fiscal surpluses (equivalent to an average of 24 percent of GDP in 2001-2006). Hence, it may seem hard to justify for the government to issue debt, when it has a sufficient source of income. However, the decision of whether to issue government debt should also be looked at through the prism of market development. In other words, while the government may not be in need of funds, issuing debt would deepen the financial system, which would eventually benefit the economy as a whole. This was the logic behind Singapore's and Hong-Kong SAR's decision, some years ago, to issue public debt while running fiscal surpluses. Recently, both locations have become thriving international financial centers.

Arguably, other relatively low-default risk and liquid securities could be used as pricing benchmarks instead of government debt. In this sense, and taking advantage of the pegged exchange rate regime with the US dollar, one possibility for Kuwait could...
be to rely on the US yield curve. However, the dollar yield curve presents some limitations as a perfect substitute for the dinar yield curve. The main shortcoming stems from the fact that, despite the currency peg, there will still remain some foreign exchange risk that would pollute the pricing of an otherwise riskless asset.

This drawback could be alleviated if there existed instruments to hedge foreign exchange risk, but the market for these instruments in Kuwait is in the early stages of development. Although a market for foreign exchange swaps exists, the market is mostly limited to instruments with three-month maturities and lacks liquidity[5].

In conclusion, if the Kuwaiti Government decided to increase its debt issuances in order to make the public debt market more liquid, there are a number of steps that should be taken to improve the current market infrastructure. These measures include:

- extending the yield curve by widening the range of debt maturities;
- establishing issuance calendars to enhance transparency and issuing similar debt volumes across issuances;
- ensuring issuances are large enough to satisfy the liquidity needs of commercial banks plus allowing for extra amounts for secondary trading;
- permitting all institutional investors to acquire government debt (presently, only banks and investment companies are entitled to);
- holding regular meetings with market participants and rating agencies; and
- introducing a system of primary dealers in order to enhance the liquidity of the secondary market.

Finally, the establishment of an active government debt market would produce positive spillover effects for other markets. Since the establishment of an active market for sovereign debt would require some upgrades of the current market infrastructure, other financial markets could easily benefit from this infrastructure once it is in place.

3.4 Constraints to the development of a corporate bond market

The possibility of a flourishing corporate bond market is not new to Kuwait. In fact, Kuwait used to have an active corporate debt market from the 1970s to the 1990s. However, the market dried up after the Iraqi invasion in 1991, and has not been able to rebound to its historical activity levels since then (Global Research (2001))

The failure of this market to recover is partly due to certain regulations that restrict companies’ ability to issue debt instruments. For example, the amount of debt that a company can issue is limited not to exceed the company’s paid-up capital. An additional restriction is that only companies with a five year track record are allowed to issue debt.

Regarding the formal procedures for the local issuance of corporate bonds, the approval process in Kuwait is a bit lengthier than in other countries in the region with prosperous financial markets, such as Bahrain. The issuance process starts when a company submits to the CBK a plan detailing the terms of the debt issuance. Once the CBK has approved the issuance conditions, the documentation is transferred to the Ministry of Commerce and Industry, which is in charge of making it public via its publication in the Ministry’s gazette.

This process, which usually takes around eight weeks, could be substantially reduced, at least to a similar length of what it takes in Bahrain (around three to five weeks). By shortening the duration of the approval period, Kuwait could, not only
facilitate debt issuance by local companies, but also increase its competitive edge vis-à-vis other countries in the region to attract international issuances.

Another restraint on market development is the fact that corporate bonds are currently not listed in the Kuwait Stock Exchange (KSE). Listing these bonds in the KSE would accomplish two important goals to promote this market: first, it would provide a valuable safeguard for small investors, and secondly, it would promote the standardization and flow of information through disclosure requirements, which in turn would enhance the price discovery process[6].

To foster the development of a corporate bond market, the authorities should consider:

- increasing the cap on a companies’ permissible amount of outstanding debt (currently set to equal the company’s paid-up capital);
- reducing the time necessary to obtain approval from the CBK and the Ministry of Commerce and Industry to issue corporate debt (at the time of writing, it took around eight weeks, compared, for instance, with three to five weeks in Bahrain);
- reducing the number of track-record years required for a company to be able to issue debt (at the time of writing, a company needed a track record of at least five years); and
- facilitating the listing of corporate bonds in the KSE in order to broaden the bond market, safeguard small investors interests, and promote the standardization and flow of information through disclosure requirements.

3.5 Constraints to the development of a sukuk market

As explained in Section II, there is an increasing interest by local investors and companies alike in the creation of a sukuk market as a potential alternative to conventional bonds. However, the use of sukuk may not be straightforward for entities unfamiliar with the legal underpinnings of these instruments. For instance, the issuance of sukuk certificates must be unequivocally linked to one or more underlying assets. These assets, in turn, are typically transferred to a special purpose vehicle (SPV) for a period equal to the maturity of the sukuk.

Although there is no explicit legal restriction on the creation of SPVs, Kuwait does not possess an unambiguous framework for the establishment, management, and accounting procedures of these vehicles. The absence of a predictable set of rules introduces a serious element of uncertainty in sukuk transactions, and thus severely limits the attractiveness of these Islamic instruments. As an additional limiting factor, Kuwait still lacks a sufficiently large body of professionals with expertise in this field.

Therefore, putting in place an explicit framework governing sukuk issuances and their management would certainly encourage their use by companies and investors alike. In a similar vein, an additional step that could be taken to bolster the sukuk market even further would be the introduction of a framework for the securitization of these instruments.

To foster the development of a corporate sukuk market, the authorities should consider:

- developing a clear legal framework for the establishment, management, and accounting of SPVs, underpinning the issuance of sukuk; and
- developing a legal framework for sukuk securitization (pool/funds of sukuk).
4. Towards a regional bond market? Lessons from Asia and Europe

Beside the positive aspects derived from deeper local financial markets, Kuwait would also benefit from the emergence of large and dynamic regional bond and sukuk markets. In such regional markets, governments and companies from across the region would be able to attract a wide pool of institutional investors, not only from neighboring countries, but also from other parts of the world.

The recent experiences of the Asian Bond Market Initiative and the European Monetary Union can provide valuable lessons that could be applied to the GCC context. The Asian Bond Market Initiative resulted in the launching of the Asian Bond Funds (I and II) in order to promote bond market development in Asia. Similarly, the creation of the European Monetary Union significantly added momentum to the growth of the European bond markets[7].

The Asian Bond Funds were created to respond to the local authorities’ desire to encourage local financial intermediation and to invest the large Asian savings within the region. To a large degree, these two circumstances are also present in the GCC region, and thus, the authorities could be encouraged by the Asian experience to undertake a similar initiative.

Regarding the European Monetary Union, it is now amply recognized that the introduction of the single currency enhanced bond issuances in Europe. As pointed out in Ong and Luengnaruemitchai (2006), the advent of the Euro in January of 1999 was accompanied by a doubling of private debt issuances – from $273 billion in 1998 to 679 billion in 1999. This phenomenon was the reflection of investors’ ability to rely less on bank loans while accessing a wider pool of investors within the same region.

The tremendous growth of the Euro bond market also meant that lower-rated borrowers that before did not have access to the smaller markets, now could find investors that were interested in their paper. In other words, there was a broadening of the range of bonds issued: while the European market was previously dominated by AAA and AA issuers, the amount of single-A rated paper increased substantially after the advent of the single currency.

Similar developments could take place in the GCC region after the creation of the monetary union, now planned for 2010. In fact, the efforts already underway to harmonize several areas of the economy (e.g. some financial regulations, tax codes, accounting conventions, as well as payment systems) which are important from the perspective of the monetary union, are also beneficial for the creation of a regional bond market.

Some pundits (Oh and Park, 2006; Park and Rhee, 2006) have proposed a package of three policy measures to develop regional bond markets. Namely, a regional credit guarantee agency, a regional bond rating facility, and a regional clearing and settlement capacity. Combined together, these elements are seen as the necessary infrastructure components upon which to build a regional bond market.

In this regard, the establishment in July 2005 of the Islamic International Rating Agency (IIRA), based in Bahrain, is a welcome development. The IIRA’s stated mandate is to assist in the development of the regional financial markets by providing an assessment of the risk profile of Islamic entities and instruments.

Finally, the GCC countries should consider strengthening their ties with other thriving Islamic financial centers, such as Kuala Lumpur, Labuan, and Singapore.
Some steps in this direction have already been taken by Bahrain with the listing of a Malaysian sovereign sukuk in the Bahrain Stock Exchange in September of 2003.

5. Concluding thoughts
This note has argued that Kuwait needs to deepen further its financial markets in order to expand the range of financing opportunities for the private sector. Upgrading the country’s financial system should be one of the main ingredients in the authorities’ overall strategy for diversifying the Kuwaiti economy away from oil activities.

Furthermore, a more diversified financial system would facilitate the financing of the upcoming large infrastructure projects. The Kuwaiti authorities should strive to enhance the legislative and institutional environment to support the development of the corporate bond and sukuk markets.

Finally, and regardless of the degree to which a GCC regional market develops, the Kuwaiti authorities should continue taking actions to deepen the country’s financial system. If Kuwait desires to be an active player in the emerging GCC financial markets and not fall behind the rest of countries, it is of paramount importance that it upgrades its current legal framework and undertakes the identified measures to foster the growth of the financial sector.

Notes

1. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business. This index averages the country’s percentile rankings on ten topics, made up of a variety of indicators, giving equal weight to each topic (www.doingbusiness.org).

2. This ranking reflects the average responses in each country to the questions included in the World Economic Forum’s Executive Opinion Survey. In particular, the question on financial sophistications was “The level of sophistication of financial markets in your country is (1 = lower than international norms, 7 = higher than international norms)” (World Economic Forum – www.weforum.org).

3. The draft law now in parliament contemplates reducing the tax rate on capital gains for foreigners to 15 percent.

4. This requirement applies until the foreign investor reaches 49 percent of a bank’s capital, after which limit, the foreign investor needs the explicit approval of the Council of Ministers in order to make further acquisitions.


6. See Ong and Luengnaruenmitchai (2006) and Schinasi and Smith (1998), for a similar argument applied to the USA.

7. For a more detailed account of the Asian Bond Market Initiative, see BIS (2006), and for the effect that the single currency had on European bond markets, see Ong and Luengnaruenmitchai (2006).

References


**About the author**

Juan Solé has worked as an Economist for the International Monetary Fund since 2003, in several of its departments, including the Middle East and Central Asia Department and in the Monetary and Capital Markets Department. Between 1999 and 2002, he was an Associate Analyst in the Research Department of the Federal Reserve Bank of Minneapolis. He holds a PhD and an MA in Economics from the University of Minnesota (obtained in 2003 and 2000, respectively), and an MSc in Economics and Finance from Center for Monetary and Financial Studies, Spain, obtained in 1997. Juan Solé can be contacted at: JSole@imf.org

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