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The Coming Oil Windfall in the Gulf

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Dubai buys a share of Sony. Qatar and Dubai compete to acquire global stock exchanges. Abu Dhabi injects billions into Citigroup. Almost daily, we see new signs of how surging oil prices have transformed the six nations of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—into major players on the world financial stage.

But the coming oil windfall will dwarf anything we have seen yet. At an oil price of $70 per barrel, new research by the McKinsey Global Institute finds that Gulf[1] oil export revenues will add up to $6.2 trillion over the next 14 years—more than triple the amount they earned over the past 14 years. At $100 oil, this will rise to almost $9 trillion.

Decisions by Gulf leaders on how to use this wealth will have global repercussions for decades. Their foreign-investment choices will affect interest rates, liquidity, and financial markets around the world. Their domestic investments will determine which of their local industries and cities thrive, whether the region's economies diversify beyond oil, and whether they generate enough jobs to employ their young people.

This new fortune also comes with risks. A flood of liquidity into global markets could cause asset price bubbles, fuel profligate lending, and result in a poor use of global capital. Gulf states could repeat the mistakes made in past oil booms, squandering wealth on bad investments and wasteful spending while piling up debt. Failure to productively employ the region's youth would have geopolitical ramifications for generations.

1 Throughout this paper, "Gulf" and "GCC" are used synonymously.

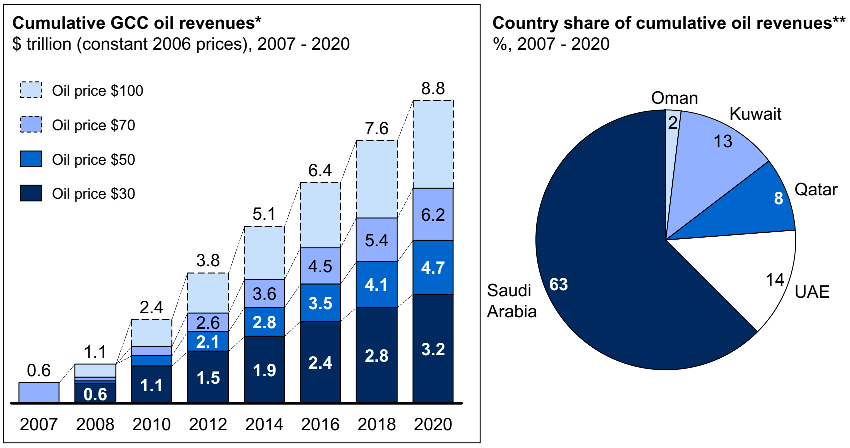
Global policy makers, as well as Gulf citizens, have a stake in how these petrodollars are used. This paper seeks to inform the discussion by laying out the potential scale of the windfall, shedding light on the diversity and investment strategies of Gulf players, and noting some of the opportunities, challenges, and policy issues raised by the new oil boom.

GROWING WEALTH

In any plausible oil-price scenario, Gulf nations' wealth will continue to grow significantly between now and 2020. Their oil revenues are soaring now at around $100 a barrel. But even at $50 per barrel, the GCC states would earn a cumulative $4.7 trillion by 2020, or 2.5 times their earnings over the past 14 years (Exhibit 1). And this wave comes on top of the riches already reaped from the run-up of oil prices since 2002.

Exhibit 1

GULF COUNTRIES WILL EARN OIL REVENUES OF ALMOST $9 TRILLION BY 2020 IF OIL PRICES REMAIN AT $100 PER BARREL



* Based on spot prices. Realized prices may vary by producer.
** Assumes $50 barrel of oil; Bahrain has negligible net oil supply, but does get allocated reserves from Saudi Arabia's Abu Saafa offshore field and also purchases discounted oil from Saudi Arabia's Dammam field.
Source: BP World Energy Report; Global Insight; Business Monitor International; McKinsey Global Institute Energy Demand Model; McKinsey Global Institute Capital Flows Database; McKinsey Global Institute analysis

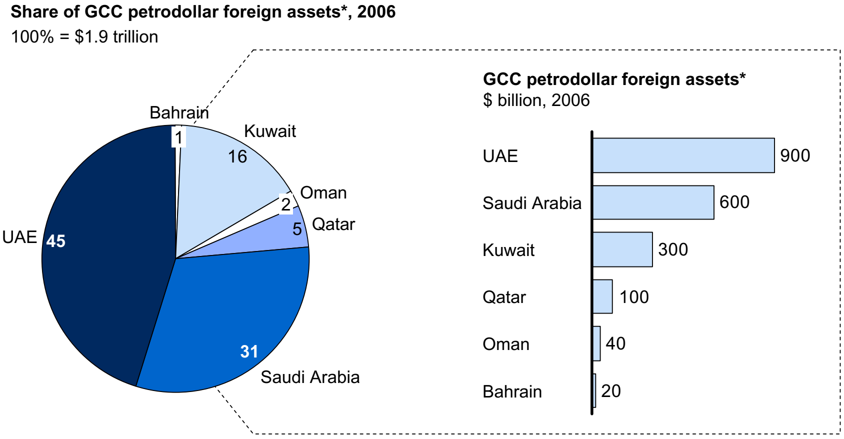
We estimate that the total value of the Gulf states' foreign assets reached $1.9 trillion by the end of 2006[2]—more than double their level in 2003 and nearly equal to the GDP of India and Brazil combined or the market value of the top ten Fortune 500 companies. Saudi Arabia, the world's largest oil exporter and owner of 55 percent of the GCC's proven oil reserves, accounts for around $600 billion

2 See *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets*, McKinsey Global Institute, October 2007. The report can be downloaded at www.mckinsey.com/mgi.

of the total (Exhibit 2). The United Arab Emirates, with a far smaller population, has around $900 billion in foreign assets (representing roughly 46 percent of Gulf offshore wealth).

Exhibit 2

UAE AND SAUDI ARABIA TOGETHER CONTROL ROUGHLY THREE-QUARTERS OF GCC PETRODOLLAR FOREIGN ASSETS



* Does not include foreign assets of GCC companies and charitable foundations/development organizations. Sum of foreign assets for GCC countries will differ slightly from overall total due to rounding.

Source: McKinsey Global Institute analysis

And this vast wealth is swelling daily. Even if the GCC never invests another penny, the returns on their current foreign assets would add up to more than $1.6 trillion over the next 14 years under conservative assumptions,[3] or more than $70,000 for every GCC citizen today.

In fact, their future wealth will likely be far larger, because the Gulf will almost certainly have additional funds to invest abroad in coming years. In 2006, the GCC states together had net capital outflows of $202 billion, joining China to become the world's largest sources of surplus capital. This feat is especially remarkable given that GCC surpluses were negligible as recently as 2001. The exact amount invested abroad by the GCC states in coming years will depend on both future oil prices and the scale of their domestic spending.

3 This assumes a nominal return of 6.5 percent annually on all GCC foreign assets. Based on forecast long-run US inflation of 2 percent, this yields a real annual return of 4.4 percent. We assume that interest income is reinvested.

WHERE THE NEW MONEY WILL GO

Surging oil prices present the Gulf states with a historic opportunity to accelerate development of their local economies. To this end, Abu Dhabi is building its industrial sector and aiming to become the region's preeminent cultural center as well. Dubai and Qatar are vying to become the key financial hub for the region, and Saudi Arabia is building six new cities with industrial and manufacturing zones. The portion of oil profits not spent within the Gulf will flow into global capital markets. By 2020, we estimate that new foreign investments from the GCC could amount to more than $3.5 trillion.

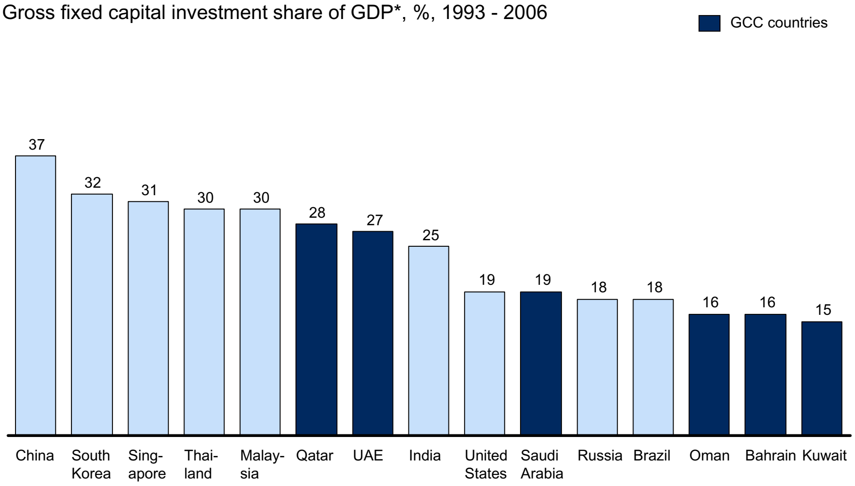
Domestic investment could exceed $3 trillion by 2020

In the past, Gulf states have invested relatively little in building their economies. Since 1993, GCC domestic investment rates have averaged 20 percent of GDP[4]—on par with the United States and Europe but almost one-quarter lower than the 24 percent average investment rate of China, India, Brazil, and Russia combined (Exhibit 3).

Exhibit 3

INVESTMENT RATES IN THE GULF HAVE LAGGED MOST HIGH-GROWTH ASIAN ECONOMIES

Gross fixed capital investment share of GDP*, %, 1993 - 2006



* Simple average of investment rates.

Source: Global Insight; McKinsey Global Institute analysis

4 This figure is for gross fixed capital formation, which represents net new investment by enterprises in the domestic economy in fixed capital assets, such as machinery and buildings. The source of this data is Global Insight, which is based on International Monetary Fund (IMF) figures.

The new generation of Gulf leaders has already announced plans to boost domestic investment. A primary goal is to create more jobs. The GCC today has one of the youngest, fastest-growing populations in the world. More than 40 percent of the population is younger than age 15, roughly twice the level found in China, the United States, or the European Union. Prior McKinsey research has calculated that the GCC will need to create more than 4 million new jobs for its citizens over the next decade alone (more than 80 percent of them in Saudi Arabia). Although this may not sound like much, it will be a major challenge for a region that employs just 4.8 million locals today. It will require major investments in industry and services, as well as in infrastructure, transportation, communication, utilities, health care, and education.

But even with vast amounts of funds to invest, there are limits to how fast the Gulf will be able to effectively increase domestic investment and create new jobs. The rate will depend on the availability of equipment and raw materials to build the projects, skilled managers to plan and oversee them, and financial systems that efficiently allocate capital to its most productive uses—what economists call "absorptive capacity." Today the Gulf is lacking in many of these areas, which may limit its ability to substantially accelerate investment rates (see sidebar at the end of the paper, *A Snapshot of the GCC economies today*).

So how much of the oil windfall could the Gulf plausibly invest locally? As a lower estimate, the GCC nations could continue to grow domestic investments by the same rates seen since 1993—6.1 percent annually. This would imply cumulative investments of $3.2 trillion by 2020, or $230 billion annually. Although this is almost three times the amount invested over the past 14 years, it would still not raise GCC investment rates to the levels seen in other fast-growing economies.

A more ambitious goal would be for the GCC countries to raise their investment rate to the average that Qatar has achieved since 1993, or 28 percent of GDP—faster than the average of China, India, Russia, and Brazil. In this scenario, GCC domestic investments would total $4.2 trillion over the next 14 years, or $300 billion per year. This would imply growing investment by 7.4 percent annually—a very high rate but still within the experience of what other fast-growing economies have achieved. Whether or not the Gulf can achieve this is an open question, and the answer depends on its ability to effectively expand its absorption capacity.

New foreign investments could exceed $3.5 trillion by 2020

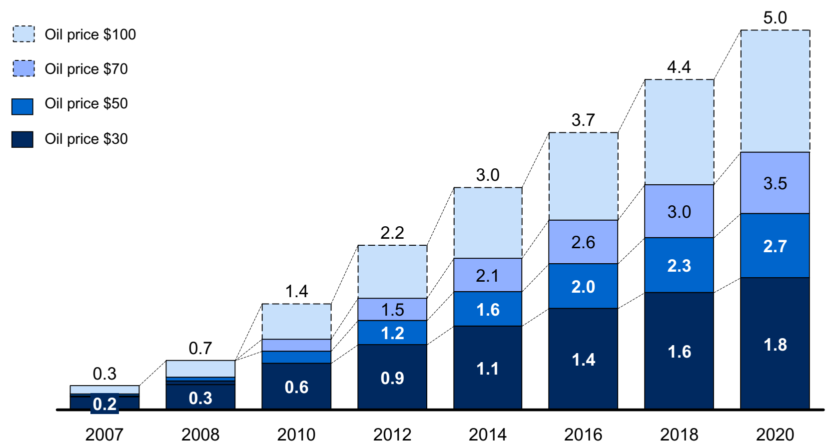
The petrodollars not invested locally will spill over into global capital markets. The exact amount will depend on the combination of oil prices and domestic investment levels. But the total will be enormous.

In our base case, the GCC would have $3.5 trillion of new funds to invest in global capital markets between now and 2020—almost twice as much as their foreign wealth today (Exhibit 4).[5] Including asset appreciation, the added investment would raise their total foreign wealth to $8.3 trillion. The resulting nest egg would amount to roughly $270,000 for every GCC citizen at that time.

Exhibit 4

GULF CAPITAL OUTFLOWS WILL TOTAL $3.5 TRILLION WITH $70 BARREL OF OIL PRICE

GCC cumulative net capital outflows, $ trillion, 2007 - 2020, 2006 prices*



* Assumes GCC countries match their historical growth rates of investment from 1993 to 2006.

Source: BP World Energy Report; Global Insight; McKinsey Global Institute Energy Demand Model; McKinsey Global Institute Capital Flows Database; McKinsey Global Institute analysis

This scenario assumes that Gulf nations continue to increase their domestic investments at the same rate they have over the past 14 years, or 6.1 percent annually, and oil prices are $70 per barrel over the period. If instead oil stays around $100 per barrel, the GCC would have $5 trillion in new funds flowing into world markets over the next 14 years, boosting their total foreign wealth to $10.3 trillion by 2020. Even if Gulf nations substantially increased investment in their domestic economies to 28 percent of GDP (Qatar's historical investment rate), we project they would still have trillions of dollars more to invest abroad.

Short of a major decline in oil prices—to less than $30 per barrel, by our calculations—combined with a large increase in domestic investment, the GCC will

5 We use a national accounting approach to model capital outflows from the Gulf. We first calculate the total expected savings in the Gulf economies, from oil and non-oil sources, based on McKinsey industry expert interviews and economic forecasts from institutions such as the IMF. These savings can be invested either domestically or abroad; based on our assumptions of domestic investment, capital outflows are then calculated. Our model is not dynamic, however, so GDP forecasts to 2020 remain constant regardless of the investment rate.

pump significant extra liquidity into global capital markets in future years, with effects that will be felt around the world.

UNDERSTANDING GULF INVESTORS IN GLOBAL FINANCIAL MARKETS

The growing wave of Gulf money flowing into the world's financial markets is causing concern in some other nations, prompting discussion of a variety of policy responses. But there remains considerable confusion about the players' identities, aims, and investment strategies.

The Gulf's sovereign wealth funds have grabbed world attention recently with a series of high-profile deals—but they are not the only GCC investors in global markets. Also important are private wealthy individuals, new types of government funds, and state-owned and private companies. Overall, we estimate that about two-thirds of the GCC's foreign wealth in 2006 was held by various types of government investment funds and that nearly a third was owned by private investors.

Among various players, there also is a diversity of investment styles: some prefer passive, highly diversified portfolios, focusing largely on fixed-income and equity investments; the more adventurous seek larger stakes in companies and more active management of acquisitions. And some employ a mix of strategies. Focusing exclusively on traditional sovereign wealth funds misses a large part of the GCC investor landscape. There are at least six distinct types of Gulf investors active in global financial markets, four related to the government and two in the private sector:

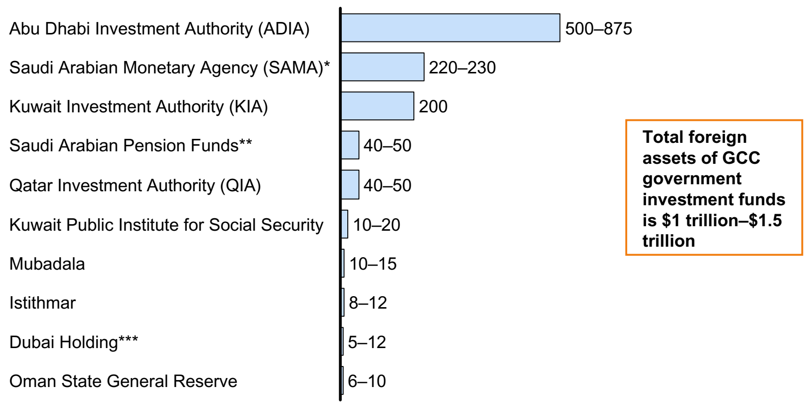
Central banks. Some petrodollars end up as reserves held by central banks, which invest in foreign assets with the objective of stabilizing their currencies against balance of payment fluctuations. Their primary objective is stability, not the maximization of returns. They hold foreign reserves mainly in the form of cash and long-term government debt (largely US Treasury bills). We calculate that the GCC has roughly $80 billion in foreign reserve assets in 2006.

Traditional sovereign wealth funds. A large share of Gulf foreign wealth is in traditional sovereign wealth funds. These funds have diversified portfolios of foreign financial assets, including equity, fixed income, real estate, debt securities, and alternative investments, and have traditionally been passive investors. More recently, some have begun taking direct equity stakes in companies, although without seeking to exert management control. The largest and oldest sovereign wealth fund in the GCC is the Abu Dhabi Investment Authority (ADIA), established in 1976, with up to $875 billion in assets in 2006 (Exhibit 5).[6] It is followed by the Saudi Arabian Monetary Agency (SAMA), which has $220 billion to $230 billion in foreign assets (in addition to roughly $20 billion of official reserves).[7] Third largest is the Kuwait Investment Authority (KIA), with around $200 billion in assets in 2006, which may have reached $250 billion by the end of 2007. In total, we estimate that traditional sovereign wealth funds in the Gulf had between $1 trillion and $1.4 trillion in foreign assets at the end of 2006.

Exhibit 5

SIZE OF GCC GOVERNMENT INVESTMENT FUNDS

Estimated foreign assets of major GCC government investment funds
$ billion; 2006



* Excludes the stated reserve assets of SAMA.
** Includes the General Organisation for Social Insurance (GOSI) and the Public Pension Agency. Total assets of these funds is significantly higher (~$130 billion to $150 billion) due to large value of domestic investments.
*** Includes Dubai International Capital (DIC) and Dubai Investment Group (DIG).
Source: Interviews; McKinsey Global Institute analysis

Sovereign wealth funds, however, pursue different investment approaches. Some, such as SAMA, have been conservative investors that hold a large share of their portfolios in fixed-income assets. Others, such as ADIA and KIA, are also passive investors but nonetheless pursue more aggressive risk-return strategies in their asset allocations. ADIA, for example, recently injected $7.5 billion into Citgroup. They are estimated to have 50 to 60 percent of their portfolios in equities worldwide, 20 to 25 percent in fixed income, 5 to 8 percent in real estate, and up to 10 percent each in private equity and other alternative asset classes, such as hedge funds (Exhibit 6).

6 Our interviews with industry experts suggest ADIA's foreign assets may have reached up to $1 trillion by the end of 2007.

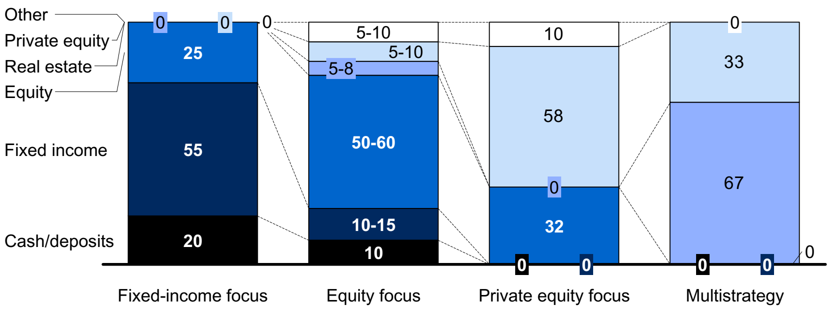
7 Although SAMA is a central bank, we include it on our list of sovereign wealth funds given its substantial investment activities and diversification beyond traditional reserve assets. Saudi Arabia is reportedly planning to establish its own government investment fund, which is expected to adopt similar investment allocations to funds such as ADIA and KIA.

Exhibit 6

DIVERSE INVESTMENT STYLES OF GULF INVESTORS

Estimated asset allocations of government investment funds, 2006

%



Examples

- Fixed-income focus:
  - Saudi Arabia Monetary Agency (SAMA)
  - General Organisation for Social Insurance (GOSI)
- Equity focus:
  - Abu Dhabi Investment Authority (ADIA)
  - Kuwait Investment Authority (KIA)
- Private equity focus:
  - Dubai International Capital (DIC)
  - Mubadala
  - Qatar Investment Authority (QIA)
- Multistrategy:
  - Istithmar

Source: Press search; interviews; Institute for International Finance; Setser and Ziemba (2007); Morgan Stanley; Cap Gemini/Merill Lynch; McKinsey Global Institute analysis

New-generation government investment funds. The Gulf also has seen a proliferation of smaller, newer state-controlled investment funds with more activist investment approaches. These funds often seek direct investments in domestic and foreign corporate assets, shunning the passive portfolio investment approach of sovereign wealth funds. Some operate like private-equity funds, actively buying and managing companies, including Dubai International Capital (DIC)[8] and Abu Dhabi's Mubadala. Others take a multistrategy approach. Dubai's Istithmar has real estate investments in prime locations in New York and London, as well as several significant private-equity investments, including ownership of the US high-end retailer Barneys, and large stakes in public companies, such as Standard Chartered Bank. Other new government investment funds include the Abu Dhabi Investment Corporation (ADIC) and, most recently, the Emirates Investment Authority (EIA). Altogether, these new government investment funds have an estimated $60 billion to $100 billion in foreign assets in 2006.

Going forward, Gulf states will likely split their oil earnings among a growing number of investment funds. This strategy creates a more competitive environment for the funds, which may enhance returns. In the future, investment

8 DIC has also stated its intention to raise third-party funds to invest, adopting an asset manager role.

funds achieving suboptimal returns face the prospect of losing their share of future oil revenues. In addition, spreading the wealth into smaller investment pools reduces the risk of GCC governments and their citizens being tempted to dip into the growing "pot of gold." It also makes it easier to test new investment approaches.

Government-controlled companies. Some state-owned companies in the GCC receive government funding directly or indirectly and then invest in companies abroad. In 2005 and 2006 alone, GCC companies spent more than $70 billion on international mergers and acquisitions. Recent deals include Saudi Basic Industries' $11.6 billion acquisition of General Electric's plastics unit. However, we do not include the value of these corporate acquisitions in our analysis of the GCC's foreign financial assets because they are not traded in global capital markets and because their value is often difficult to assess. Some GCC company deals have stirred controversy in recent years. Recall, for example, the backlash from some in the US Congress and media that eventually led Dubai Ports World to sell the US operations of one of its acquired companies.

High-net-worth individuals. The Gulf also has many private wealthy individuals that invest abroad. Their fortunes stem either directly from oil or from other industries that thrive on oil's stimulus to the domestic economies. Traditionally, these individuals have had mainly diversified foreign asset allocations, similar to the more aggressive, equity-oriented sovereign wealth funds, but often with more money in real estate. We estimate that private wealthy investors in the Gulf had roughly $600 billion in foreign assets in 2006 (Exhibit 7).[9]

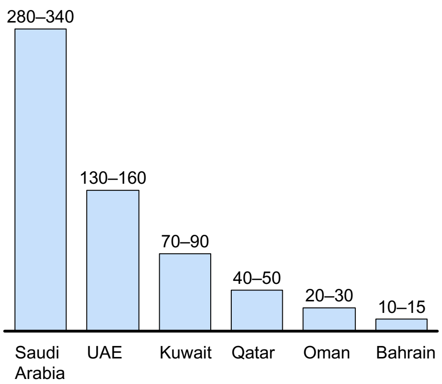
Private companies. A growing number of private GCC companies have also become active buyers of foreign assets. These companies operate like private companies anywhere, using retained earnings and external funding to finance investments overseas. Examples include Kuwait's Mobile Telecommunications Company (MTC), which acquired African mobile operator Celtel in 2005 for $3.4 billion and the National Bank of Kuwait's (NBK) acquisition of AlWatany Bank of Egypt in 2007. As with government-controlled companies, we do not include the foreign acquisitions of private companies in our estimates of GCC foreign wealth.

9 We have excluded middle-class and mass-affluent households (which collectively have an estimated $200 billion to $250 billion in assets) from this analysis because they generally keep their wealth in the domestic financial system, and our focus here is on the impact of petrodollars on global financial markets.

Exhibit 7

GCC PRIVATE INVESTOR FOREIGN ASSETS TOTAL ~$600 BILLION

Estimated foreign assets of GCC investors*, 2006
$ billion



GCC wealth list**	
• Prince Alwaleed Bin Talal Alsaud (Saudi Arabia)	29.5
• Al Rajhi family (Saudi Arabia)	24.0
• Nasser Al-Kharafi (Kuwait)	12.0
• Maan Al-Sanea (Saudi Arabia)	10.0
• Mohammed Al Amoudi (Saudi Arabia)	9.2
• Bin Laden family (Saudi Arabia)	8.5
• Abdul Aziz Al Ghurair (UAE)	8.0
• Olayan family (Saudi Arabia)	7.2
• Kanoo family (Bahrain)	6.1
• Sheikh Saleh Kamel (Saudi Arabia)	5.1
• Gargash family (UAE)	5.0
Top 10	**124.6**

* Represents foreign assets of high-net-worth individuals only (greater than $1 million liquid financial investments).
** Net worth estimated by *Arabian Business* as of December 2007.
Source: *Arabian Business*; Merrill Lynch; McKinsey Global Institute analysis

The importance of each of these players varies across countries. For example, in the UAE, government funds of all types hold a dominant position, controlling roughly 80 percent of the country's total foreign wealth. In contrast, most wealth in Saudi Arabia is in private hands (Exhibit 8). Saudi Prince Alwaleed Bin Talal Alsaud, for example, is one of the largest shareholders in Citigroup.[10] Overall, Saudi Arabia accounts for roughly half of the GCC's private foreign wealth.

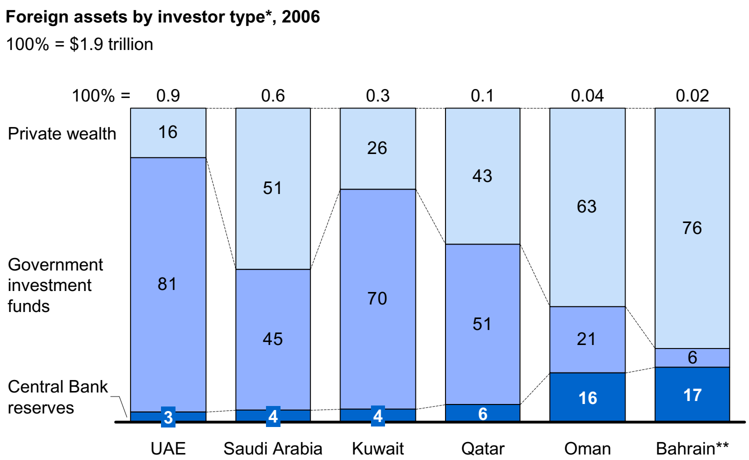
SHIFT IN INVESTMENT STRATEGIES GOING FORWARD

Gulf investments in global financial markets have already had tangible effects far from home. They have provided significant liquidity to global markets, increasing the availability of capital to borrowers worldwide. We estimate that Gulf investors today have almost $1 trillion of international equities, corresponding to roughly 2 percent of global equity market capitalization, and an additional $300 billion in hedge funds and private-equity funds. In late 2007, petrodollar investors emerged as lenders of last resort for several global banks that suffered heavy

10 Estimates for GCC private wealth held in foreign assets were derived using a top-down approach, using a combination of sources including the Merrill Lynch/Cap Gemini World Wealth reports, expert opinions, and private wealth estimates in publications such as *Forbes* and *Arabian Investor*. The methodology is described in *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets*, McKinsey Global Institute, October 2007. The report can be downloaded at www.mckinsey.com/mgi.

Exhibit 8

UAE WEALTH IS MAINLY IN THE GOVERNMENT, WHILE SAUDI ARABIA HAS A LARGER SHARE OF PRIVATE WEALTH



* Does not include foreign assets of GCC companies and charitable foundations/development organizations.
** Does not add up to 100% due to rounding.
Source: McKinsey Global Institute analysis

losses stemming from the US subprime mortgage debacle, demonstrating the GCC's long-term investment horizon. And they have provided permanent equity capital for several private-equity firms and hedge funds.

Interviews with asset managers and financial experts in the Gulf reveal the GCC states will invest their new wealth somewhat differently in the future than they have in the past. Their strategies have already begun to shift in several ways.

First, a growing share of petrodollar wealth will be invested in local financial markets rather than abroad, spurring development of the region's financial markets. Already, wealthy private Gulf investors hold an estimated 25 percent of their portfolios in local financial products, up from 15 percent in 2002. This has helped boost growth in domestic financial markets, where total assets reached $1.2 trillion at the end of 2006—up from just $360 billion five years earlier. As local financial markets offer new products and become deeper and more liquid, we expect they will attract a growing share of Gulf wealth, creating a virtuous development cycle. In addition, the market for Islamic financial products is growing rapidly in the GCC—albeit from a small base. This largely reflects the growing mass of affluent and middle-class households.

Second, Gulf investors will also increasingly seek foreign investments that not only offer good returns but also boost their own skills, transfer technology, and help diversify their local industries. For example, by investing directly in, or partnering with, leading private-equity firms, GCC investors gain insight into how to make private-equity deals work. A key reason for Bahrain's government-owned Mumtalakat Holdings to take a 30 percent stake in the McLaren Group was to help develop the kingdom's aluminum industry, leveraging the UK conglomerate's expertise in building automotive components. Among Mubadala's motives in acquiring a 5 percent stake in Ferrari was the desire to build a Ferrari theme park in Abu Dhabi, thereby boosting tourism. Dubai Bourse is seeking a stake in Nasdaq to gain access to its expertise and brand.

Gulf investors will also look for new investment platforms that will give them more direct access to foreign investment opportunities. Traditionally, sovereign wealth funds have relied heavily on external asset managers and "funds of funds" to allocate their assets broadly across asset classes (ADIA, for instance, reportedly invests more than half of its funds through external asset managers). This approach provided Gulf investors with both investment expertise and the ability to "fly under the radar" in their global investments. Over the past year, however, we have seen a move into more direct investments that give sovereign wealth funds and other Gulf investors access to different forms of wealth creation—and without the fees charged by intermediaries. Going forward, we may see a greater portion of assets of traditional sovereign wealth funds managed internally. At the same time, we are already seeing new Gulf investment funds that invest directly in companies in the style of private-equity firms, as noted above. These shifts reduce the role of external asset managers and could amplify capital allocation and geopolitical concerns.

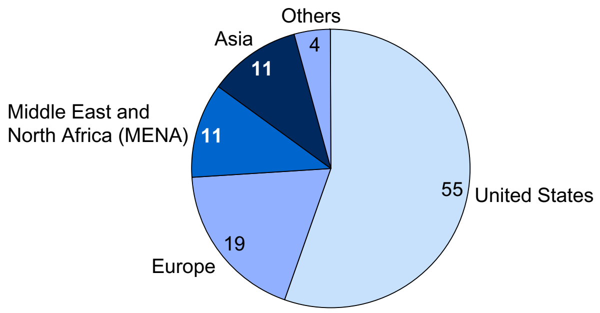
Finally, Gulf investors will have a growing focus on emerging markets. While existing wealth will likely continue to be predominantly held in the United States and Europe (due to their superior investment opportunities and relative safety), an increasing share of new investments will be in emerging markets, particularly those in the rest of the Middle East, North Africa, and Asia. Since 2002, 22 percent of capital outflows from the GCC have gone to these regions (Exhibit 9).[11] According to interviews with financial market experts in the region, the share of incremental new investments going into the United States and Europe could fall from three-quarters today to roughly one-half by 2020. Asia's share of new investment could double, from 10 percent today to 20 percent by 2020.

11 Institute for International Finance, GCC Regional Briefing, December 21, 2007.

Exhibit 9

NEARLY ONE-QUARTER OF GULF FOREIGN INVESTMENTS SINCE 2002 WERE IN ASIA AND MIDDLE EAST/NORTH AFRICA

Distribution of capital outflows from countries of the Gulf Cooperation Council*, 2002 - 2006
100% = $542 billion



* GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE.
Source: Institute of International Finance

QUESTIONS FOR POLICY MAKERS

The Gulf oil boom holds both promise and risk—financial and political—for global capital markets and the world economy. We've noted the benefits of increased liquidity to global financial markets, and the possibility of providing greater stimulus to emerging markets, as well as the opportunity to diversify Gulf economies. But the rise of GCC nations as financial powers creates challenges as well. The last Gulf oil boom of the 1970s helped fuel the Latin American debt crisis of the 1980s. Both Gulf leaders and the world at large have an interest in how the coming oil windfall will be spent. Policy makers in the GCC and elsewhere will have to grapple with several questions:

First, how to ensure that the additional liquidity flowing into global financial markets does not unduly inflate asset prices? To date, we do not see evidence of this effect on equity prices in the developed world. They have risen in recent years primarily because of higher earnings, rather than bubbling price-earnings ratios. But we have seen P/E ratios rise sharply in recent years in several emerging markets, reflecting the flood of money into small equity markets, soaring commodity prices, and the privatization of many state-owned enterprises. There also are signs of bubbles in some illiquid assets such as real estate and art in developed economies. And there are already signs of inflation and financial speculation in some countries flooded with remittances sent by expatriate workers in the Gulf.

Second, how to create enough well-paying jobs for the Gulf's swelling ranks of young people? Failure to do so poses risks to the stability of the region and perhaps the world at large. The challenges are considerable. Whereas most Gulf nationals today work for the government, the new jobs must be created in the private sector of the economy, and in different industries from the past. This will require primary and secondary educational systems that equip future generations with the skills demanded by the job market, along with financial system reforms that channel more funds to the small, dynamic companies and entrepreneurs that drive growth in most economies.

Third, how to ensure that the Gulf states' investment decisions do not distort global capital allocation? Sovereign investors, not only from the GCC but also from Asia and other commodity-producing nations, have for the first time become so big that their actions influence world financial markets. So far, these funds have been prudent, sophisticated investors. But financial markets require the free flow of information to function efficiently. The presence of huge, opaque players could muddy pricing signals that other investors need. And as with other large investors, such as hedge funds and global asset managers, mistakes by sovereign investors could have far-reaching ripple effects. These new investors will also need sophisticated risk-management systems.

Finally, how to allay geopolitical concerns associated with government-controlled investment funds? A particular concern of policy makers in the United States and Europe is that government-controlled investment funds—in the Middle East, Russia, China, and elsewhere—might use their huge wealth for political purposes. These worries are likely to rise as Gulf funds become more active investors. But GCC governments could find themselves caught in a bind: active investments could raise concerns about political motivations, but too much passivity might coddle poorly performing companies and raise questions about adequate corporate governance.

Many Western economists and policy makers have called for the creation of disclosure standards for government investors. But the issue of transparency is complex. For example, should the funds' investment aims and portfolios be publicized to the world, or just to other governments, or just to their own direct shareholders, or to some other audience? Investors in US Treasuries are already committed to certain levels of transparency.

It is clear there is scope for agreement on the issue of transparency that would produce benefits to sovereign investors and the global economy. The key, however, is negotiating in a spirit of reciprocity. For example, if sovereign wealth funds commit to greater disclosure regarding their size, investment objectives, target portfolio allocation, international risk management, and governance procedures, then regulators in markets such as the United States and Europe must ensure that they base their policy responses on a fair and objective appraisal of the facts—not on emotions stirred by the shift of financial power to new players. They must also transparently lay out the types of investments, sectors, and circumstances in which sovereign investments will require any extra regulatory scrutiny.

While a great deal of uncertainty surrounds the implications of the new oil windfall, what is clear is that it will have profound effects both globally and in the Gulf. The world should take note.

Snapshot of the GCC economies today

Today Gulf economies are booming, thanks to the tripling of world oil prices since 2002. Over the past five years, GCC economies have grown at 7.2 percent annually in real terms, faster than Brazil, Russia, Singapore, and South Korea. With projected 2007 GDP of around $773 billion, GCC economies are roughly equivalent to that of Australia or the Netherlands, respectively the 15th- and 16th-largest economies in the world. With 23 million citizens plus 14 million expatriate workers, the GCC's population is equivalent to that of California or Poland.

But growth and prosperity in the oil-rich Gulf is a relatively new phenomenon. In the 1950s, life expectancy in the Gulf was just 46 years, according to the United Nations, and now-booming metropolises like Abu Dhabi were then largely just desert, with fishing and pearl diving the mainstays of the economy.

The region's economies took off during the 1970s, when crude prices soared following the 1973 oil embargo and the 1979 Iranian revolution. But economic gains stalled and government debt rose as oil prices fell throughout most of the 1980s and 1990s. In Saudi Arabia, for example, GDP per capita fell by more than 40 percent from 1980 to 2006. Similar, although less dramatic, falls were seen in other GCC countries. Debt as a percentage of GDP had reached over 100 percent in several GCC countries. Even as recently as 2002, GCC governments were strapped by high debt, rapid population growth, low oil revenue, and growing unemployment.

Oil prices started climbing again in 2002, and today the Gulf economies are on the rebound. Gulf states have cut their debt to an average of 20 percent of

GDP, and investments in industry, infrastructure, and real estate are growing. But there is a long way to go to create modern, diversified economies. Official statistics show that 10 percent of GCC nationals are unemployed, a figure that is probably understated. Oil and mining account for 47 percent of GDP, far higher than other oil producers (oil accounts for 29 percent of Norway's economy, for instance). The question today is whether in this new oil boom, history will repeat itself and nature's bounty will again be frittered away, or whether it will spark a burst of investment and economic activity that transform the Gulf economies for years to come.

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