

Near East meets Far East

The rise of Gulf investment in Asia

A report from the Economist Intelligence Unit





Preface

Near East meets Far East: the rise of Gulf investment in Asia is an Economist Intelligence Unit white paper sponsored by Arcapita Bank B.S.C.(c). The Economist Intelligence Unit bears sole responsibility for this report.

The research for this paper was conducted in September 2007. The editor of the paper was Matthew Shinkman. Mike Kenny was responsible for design and layout. Our thanks are due to all interviewees for their time and insights.

The findings and views expressed in this report do not necessarily reflect the views of the sponsors. All forecasts are from the Economist Intelligence Unit (unless otherwise specified) and are accurate as of October 2007.



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Executive Summary

Gulf-based investors have become increasingly active in Asia in recent years, and the trend looks set to continue over the medium term. While claims that a “new Silk Road” is emerging that will trump the Gulf’s relations with the West look overstated, there is little doubt that the small but substantial portion of petrodollar investment going into the region (estimated at around 10-11% of total Gulf outward investment) will increase significantly over the next five years.

Several trends have underpinned the rising interest from investors in the Gulf Co-operation Council (GCC) countries in Asian assets:

- **Changing investment preferences in the Gulf:** In previous oil booms most of the billions of dollars in Gulf capital was parked in the international banking system and US treasuries, and the rest invested cautiously in portfolios that tended to favour capital preservation over yield maximisation. Today the countries of the GCC are increasingly managing their own surpluses directly, rather than outsourcing that process (at a lower return) to the international banks. At the same time, in the last decade the rising sophistication of the GCC banking sector and public and private investors, the deepening integration of emerging markets into the world economy and an increased emphasis on portfolio diversification have underpinned a growing appetite among GCC investors for riskier assets.

- **Changes in Asia making investment in the region more attractive:** Asian countries have made substantial progress in recent years in liberalising their capital accounts, strengthening their business environments and improving conditions for foreign

investors. Real GDP growth in the region has also been robust over the past five years—averaging 5.5% in real terms per annum in 2002-07. This growth has in part been driven by big, long-term public investment programmes, which have opened up a big new array of opportunities for Gulf investors, but also by rapid export growth and corporate profit growth. This means that the pool of investible assets has also deepened substantially.

- **Significant strengthening of links between the GCC and Asia:** In the past five years trade volumes between the GCC and Asia have tripled, and without question much of the incremental demand for Gulf exports going forward—not just oil and gas but also petrochemicals, base metals, and services like finance and tourism—will come from Asia. The GCC region has seen large inflows of migrant labour from the region, creating both a growing source of private capital flows between the regions, but also an increased cultural overlap.

- **Geopolitical trends favour strategic diversification:** Traditionally the Gulf states have aligned themselves closely with the US, for both economic and strategic reasons. This will remain the case over the short term, but over the longer term the region’s increased interest in Asia is a natural strategic extension of its aims to diversify the nature of its economic activity, and a recognition that future relationships with the leading Asian nations will take on major strategic importance, should current economic and consumption trends continue over the medium term.

GCC investors face an array of constraints and barriers to investment, from official obstructionism to weak regulatory and business environments to difficulties in finding quality, investible assets. However, leading investors suggest that taking a cautious approach, working closely with local partners and leveraging the regional demand for Shari’ah compliant investments can make the difference between failure and success.



Overview

Since the current petrodollar surge began around five years ago, investors from the Gulf Co-operation Council (GCC) countries have taken a significantly higher profile on the global financial stage than ever before. Rather than depositing petrodollars in bank accounts—or spending them, as in previous oil shocks—the Gulf investors are increasingly seeking to invest more openly, more aggressively, and into a more diversified portfolio of assets.

This has coincided with the rise of China and India and the increasing integration of the leading Asian markets into the global economy, and unprecedented demand from the region for energy and other exports originating from the Gulf. In turn this has encouraged Gulf-based sovereign wealth funds and private investors to look more closely at Asian assets.

The extreme secrecy with which most of these government-backed agencies operate means it is difficult, if not impossible, to measure accurately the total amount of investment flows from the Gulf to Asia. However, related data suggest that without a doubt investment flows are significant and growing rapidly.

With oil prices holding at sustained high levels for the past five years, the region is flush with liquidity. Over the past five years the GCC's collective annual current-account surplus—a picture of the region's annual net saving—has risen from US\$25bn to over US\$200bn. Official reserves have also mushroomed, and will have doubled from US\$51bn in 2002 to US\$98bn in 2007, and are expected to top US\$100bn by 2008. By 2012 the region's international reserves are forecast to rise to over US\$150bn.

In part this growth in reserves should be seen in the broader context of a rapid accumulation of official

GCC external position
US\$bn



Source: IMF, Economist Intelligence Unit.

assets around the world over the last five years. Median growth in international reserves within the 150 countries covered by the Economist Intelligence Unit in 2002-07 was around 25% (excluding several outlying countries), but this figure obscures a wide variation between countries and rapid accumulation among energy- and commodity-exporting countries. China saw reserves rise by almost fourfold, Russia's reserves grew by more than eightfold, and India's more than doubled.

Most of the countries of the region do not report official figures on international investment positions and asset accumulation. However, taking the cumulative current-account surplus for the 2002-06 period as a proxy for the region's accumulation of net foreign assets, the International Institute of Finance (IIF) estimates that the Gulf countries accumulated some US\$540bn in foreign investment in 2002-06. Of that total, US Treasury data suggests that about one-third was invested in US equities, debt and deposits, while the IIF estimates that inflows into the US via Europe-based counterparties (which are not recorded in Treasury data as emanating from the Gulf) account



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The broader view: trends in global investment into Asia

Global foreign direct investment (FDI) flows will be pushed upwards in the coming five year period by buoyant economic growth, competitive pressures and improvements in business environments in most countries. However, factors such as macroeconomic, regulatory and geopolitical risks will constrain flows. Following a rise in FDI inflows in 2007, albeit at a slower rate than annual average growth in 2004-06, a modest and temporary decline in global FDI inflows is expected in 2008. Global FDI inflows are projected to return to steady growth in 2009-11, at annual rates that are approximately equal to the rate of growth in world GDP, and to reach US\$1.6trn by 2011.

There are a number of reasons to be optimistic about the medium-term prospects for global FDI, including the ongoing global trend towards better business environments, technological change and the search for competitively priced skills; and sharper global competition pushing companies to seek lower-cost destinations. However, downside risks ranging from global macroeconomic imbalances to a range of political factors loom in the background.

In 2007-11, Asia will remain the world's most dynamic region for foreign investment. China and India have been first and second in the world in new FDI projects in the past two years, and will likely remain so this year. The region's economies are being lifted by intra-regional trade, particularly as the Chinese economy continues to boom,

despite some negative trends such as rising protectionism in several Asian countries.

FDI inflows into Asia and Australasia increased in 2006 to almost US\$240bn, after inflows had fallen back sharply to US\$144bn in 2005. Developing Asia (the wider region less Australia, New Zealand, Japan and the Pacific island nations) had attracted a record high of US\$174bn in inflows in 2005, and this climbed to a new record of US\$212bn in 2006, by far the highest emerging-market regional total.

Foreign investment in the broader region will grow substantially this year, and after a dip next year in line with an overall global slowdown in cross-border investment, the region will see inflows rise by around 3.7% per annum in 2009-11. Investment growth will be broad-based, and the weight of China in the region will fall steadily from 2009.

	2004	2005	2006	2007	2008	2009	2010	2011
Asia & Australasia								
Inflows (US\$ bn)	186.0	144.1	238.6	276.5	275.0	287.9	302.7	315.6
% of world total	25.6	14.9	18.3	18.9	19.7	19.7	19.9	19.9
% change, year on year	67.7	-22.5	65.6	15.9	-0.6	4.7	5.2	4.3
% of GDP	2.0	1.4	2.2	2.3	2.0	1.9	1.8	1.7
Developing Asia								
Inflows (US\$ bn)	138.6	174.1	212.4	218.2	224.0	234.8	244.5	254.2
% of world total	19.1	18.0	16.3	14.9	16.0	16.1	16.1	16.0
% change, year on year	47.5	25.6	22.0	2.7	2.7	4.8	4.1	4.0
% of GDP	2.9	3.2	3.3	2.9	2.6	2.4	2.3	2.1
China								
Inflows (US\$ bn)	54.9	79.1	78.1	79.5	84.1	86.5	90.9	92.9
% of regional total	29.5	54.9	32.7	28.8	30.6	30.0	30.0	29.4
% change, year on year	16.7	44.0	-1.3	1.8	5.8	2.8	5.1	2.2
% of GDP	2.8	3.5	2.9	2.4	2.2	1.9	1.7	1.5

Sources: National statistics; IMF; UNCTAD; all forecasts are from the Economist Intelligence Unit.



Gulf investment funds, end-2006

(US\$ bn; estimates)

Abu Dhabi Investment Authority	600
Kuwait Investment Authority	200
Qatar Investment Authority	40
Dubai International Capital	5
Total	845

* Saudi Arabia does not have an official sovereign wealth fund, but is thought to have around US\$300bn in assets among various state-owned agencies and corporations.
Sources: RGE Monitor; Economist Intelligence Unit.

for a further 20-25% of the total, meaning US-based assets still account for the majority of Gulf investment in 2002-06. However, based on anecdotal merger and acquisition (M&A) data, the IIF estimates that US\$60bn in GCC investment, or 11% of the total, was made in Asia in 2002-06.

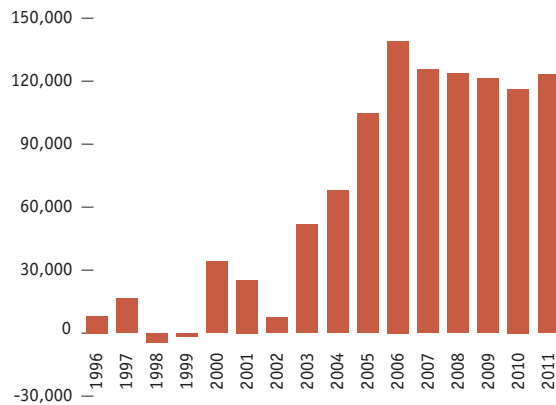
Over the longer term, this figure is expected to rise considerably. Gulf-based investors announced some US\$150bn in long-term infrastructure investments in Asia in 2005-06, and the state investment agencies are all actively scanning the market for quality assets in Asia. The Kuwait Investment Authority (KIA), which holds assets of more than US\$150bn, has said it aims to expand the share of Asian assets in its portfolio from the current 10% to 20%. Dubai Group, a member of Dubai Holding, which has significant stakes in big Asian companies such as Thomas Cook India and Bank Islam in Malaysia, plans to invest at least US\$2.5bn in China and India over the next two years. The Group's

executive chairman suggested in September 2007 that investment in China will be a key driver of its plan to increase the 30% share of its total investments held in emerging markets.

All of the excitement has led to some bold claims: the Dubai International Financial Centre has suggested that the GCC countries could pump as much as US\$250bn into Asia over the next five years. While this figure looks high (it would equate to as much as one-third of capital outflows from the Gulf), there is no doubt that investment into Asia is on the rise, and becoming a core element of portfolio managers' investment strategies in the Gulf.

GCC total outward portfolio investment

US\$m, not including Oman



Source: Economist Intelligence Unit.



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Investment drivers

While it will be some time before the absolute level of Gulf investment into Asia even comes close to rivalling that allocated to US, European, and domestic assets, there is little doubt that the importance of Asia for Gulf investors has increased significantly in recent years. A number of factors help to explain this trend.

At the highest level, rising Gulf interest in Asia is simply part of a larger global trend. With the emergence of China and India and their rapidly progressing integration into the world economy, long-term investors are taking note and looking to diversify into these markets and the rest of Asia. Broadly, the changing preferences of Gulf investors simply mirror the investing world's increased recognition of the opportunities in Asia.

There are, though, four main trends specific to the two regions that have underpinned the growth of capital flows between them.

Changing investment preferences in the Gulf

To a certain degree, the rise in investment flows to Asia is a function of the fact that the countries of the GCC have more cash to invest than they did pre-2002. However, a fundamental difference driving the growth of GCC-Asia capital flows now is the new approach taken by the sovereigns of the region to managing these surpluses.

In previous oil booms, most of the billions of dollars in private capital was invested in the international banking system and US treasuries, with the leading international banks and private banks in London and Switzerland. High-net-worth GCC families have historically preferred cautious investment strategies, and their portfolios have tended to favour

capital preservation over yield maximisation.

However, in the last decade, the rising sophistication of the GCC banking sector and investors (both the sovereign investment agencies and high-net-worth individuals), the rise of Islamic finance, the deepening integration of emerging markets into the world economy, and an increased emphasis on portfolio diversification have together resulted in a sea change in GCC investors' investment strategies.

The countries of the GCC are increasingly managing their own surpluses directly, rather than outsourcing that process (at a lower return) to the international banks, and the typical risk appetite of the leading sovereign wealth funds is now significantly higher than had been the case in previous periods of large petrodollar surpluses.

Even with a higher risk profile, the majority of Gulf capital is still invested in US assets—the International Institute of Finance estimates that some 55% of the GCC's net asset accumulation in 2002-06 was allocated to US-based equities. However, the home region and other emerging markets are gaining in importance. In part this has been driven by an extended period of low interest rates and consequently low yields on US and European assets, which has made emerging market assets more attractive for investors globally, and has led Gulf investors both to invest more heavily in domestic equities (bourses in the region have risen strongly in recent years) and to look more closely at Asia as an investment destination.

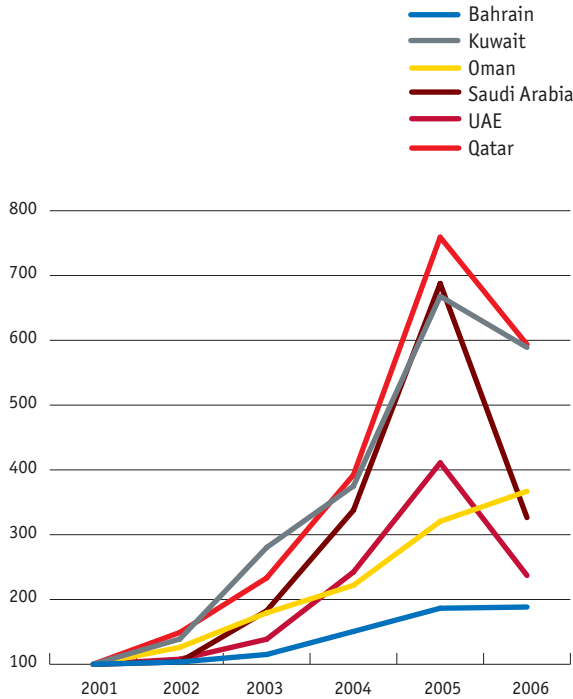
Changes in Asia making investment in the region more attractive

While there is still some way to go, a number of Asian countries have made substantial progress in recent years in liberalising their capital accounts, strengthening their business environments and improving conditions for foreign investors. The government in China has overseen a slow but steady integration of the country into the world economy, authorities in India have begun to relax restrictions



Gulf stock exchanges

% growth, year on year, main index



Source: Economist Intelligence Unit

on foreign investment, and governments around the region are investing in physical, communications, and transport infrastructure. Malaysia, like other countries in the region, has liberalised its financial market considerably, attracting three major GCC banks—Kuwait Finance House (KFH), Alrajhi Bank and Asian Finance Bank (a joint venture between Qatar Islamic Bank, RUSD Investment Bank of Saudi Arabia, and Global Investment House of Kuwait), to apply for licences in the last year.

Meanwhile, growth in the region has also been robust over the past five years. GDP in the region expanded in real terms by an average of 5.5% per year in 2002-07, led by China, which has registered double-digit GDP growth every year since 2003. India's economy grew by 7.8% per year in 2002-07, and will continue to grow at around 8-9% per year over the medium term. Even in the region's more

developed economies, growth has been strong relative to previous periods. Australia and Japan are both this year expected to register the strongest GDP growth since 2004, and growth in Korea and Indonesia has accelerated steadily since 2003.

This growth has in part been driven by large, long-term public investment programmes, which have opened up a new array of opportunities for Gulf investors, but also by rapid export growth and corporate profit growth. This means that the pool of investible assets—good companies, in other words—has deepened substantially. At the same time, increasing financial sector depth and sophistication and the expanding presence of the world's leading financial players in the region means that a wider range of asset classes is on offer for Gulf investors than ever before.

Another important driver is the rapid urbanisation taking place in India, China, Malaysia and Indonesia, which is creating significant opportunities for further investment in infrastructure, housing, retail and other supporting facilities. As of 2003 only some 38% of China's 1.4bn people lived in urban centres, but with China in the midst of a major urbanisation drive, that percentage is expected to rise to over 47% by 2012.

This drive in China and elsewhere has in turn underpinned a heavy policy emphasis on upgrading housing stocks in a number of Asian countries. This links nicely with GCC investor preferences. Sourav Kumar, head of Middle East sales and marketing for Prudential Asset Management, says, "[For Gulf investors] real estate is likely to remain the most important asset class after equities". Real estate, tourism, and energy investments in Asia present Gulf investors with an opportunity to expand into areas in which they already have significant experience at home.



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Significant strengthening of broader economic links between the GCC and Asia

In some sense, the rising interest in Asian assets among Gulf investors is a natural outgrowth of the steadily deepening economic links between the two regions. China and Japan are Saudi Arabia's largest export markets for oil and oil products, and Asia purchases the overwhelming majority of GCC oil exports.

More broadly, without question much of the incremental demand for Gulf exports—not just oil and gas, but also petrochemicals, base metals, and services like finance and tourism—will come from Asia in the near future. In the past five years trade volumes between the GCC and Asia have tripled.

At the same time, high-profile FDI into the region by Gulf investors have been on the rise. State telecommunications firms in Saudi Arabia and Qatar have made large acquisitions in Malaysia and Singapore, respectively, while a number of banks and

energy firms have snapped up regional players.

The ties between the two regions are not just economic, though. The considerable ramping up of construction in the Gulf has spurred large inflows of migrant labour (an estimated 88% of the UAE's workforce—and 95% of Dubai's—is foreign) and much of the new demand has been met by Asian workers, from India, China and Pakistan, creating both a growing source of private capital flows between the regions, but also an increased cultural overlap. Chinese companies operating in Saudi Arabia are providing scholarships for students to study in China. In September 2006 Emirates Airlines started its daily non-stop service to Beijing, thus directly connecting a leading investment destination with one of the Gulf's financial nerve centres.

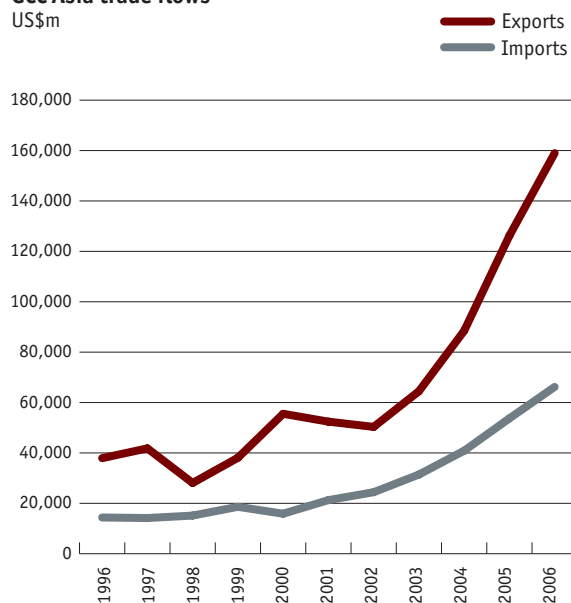
Geopolitical trends favour strategic diversification

Traditionally the Gulf states have aligned themselves closely with the US, for both economic and strategic reasons. This close relationship will undoubtedly remain the centrepiece of foreign and economic policymaking in the region for some time, but there is also little doubt that since the September 11th 2001 attacks in the US, the GCC countries are increasingly seeking to diversify away from their political and economic reliance on the US.

In this respect, observers tend to point to political opposition to Gulf investments in the US—such as the furore over Dubai Ports' acquisition of UK shipping giant, P&O, which managed several ports in the US—as a factor driving government-linked investment agencies to look east. There are also questions raised about the recent role of the US in the Middle East and the Arab world more generally, and its impact on economic relations with the Gulf states.

These arguments have merit largely on the margins of the phenomenon, and over the longer term. In the short term there is little question of the Gulf states withdrawing from or reconsidering economic and

GCC Asia trade flows
US\$m



Source: Economist Intelligence Unit

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political relations with the West. On the contrary, these countries are still purchasing US and European assets in substantial quantities. Rather, the increased interest in Asia is a natural strategic extension of the region's long-term aims to diversify the nature of

its economic activity, and a recognition that future relationships with the leading Asian nations will take on major strategic importance, should current economic and consumption trends continue over the medium term.



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Barriers and constraints

In some sense, portfolio investment in Asia is similar in nature to that in any emerging market around the world. However, there are a number of features particular to the business environment and investment climate in the region that pose challenges for GCC investors.

The essential problem is generating quality deal flow, especially in the major markets of China, India and Indonesia. For example, Shamil China Realty Modaraba (SCRM), a joint venture between Shamil Bank of Bahrain and a subsidiary of CITIC, a major state-owned Chinese conglomerate, is still trying to close its first deal despite having sifted through more than 20 potential investments.

The problem, according to Ahmad Tayara, head of investment banking at Shamil Bank, is simple: “most of the deals failed to meet the investment risk criteria of Shamil Bank and its investors. The deals included greenfield developments of mixed-use residential and commercial properties.”

SCRM’s deal-flow problem is exacerbated by the fact that it is targeting deals in secondary and tertiary cities in China. First-tier cities in China have more fully developed rules, are more transparent and have more fundamentally sound companies, but even in the most advanced cities in China (with the exception of Hong Kong) management, governance, and transparency standards still fall short of those in Singapore, Japan, and Australia.

In the real estate sector—an important area of focus for many Gulf-based investors—the major constraints are around planning approvals and execution. A change in leadership at a municipality can require a complete renegotiation of planning approvals for a project, and more broadly large real estate investments require both a thorough

understanding of on-the-ground regulations (which vary widely) and also a close relationship with the authorities. Gulf banks suggest that these operational risks are greatest in Pakistan, Indonesia and India.

The chief executive officer (CEO) of one leading Gulf-based investment bank agrees that the biggest challenges in markets such as China and India are related to planning and transparency: “many Chinese and Indian cities don’t have master plans. Singapore, on the other hand, has five- and ten-year plans, describing which site can be used for which purpose. We want to have transparent structures for planning applications, joint ventures, capital flows and management of investment vehicles. The better these processes, the easier it will be for foreign investors to be reactive in the market,” he advises.

India and China are considered the most challenging business environments, because of slow bureaucratic processes, relatively high corruption and cumbersome legal systems. In both places, legislative frameworks are evolving at such a rapid pace that new regulations are introduced virtually every quarter.

Malaysia, Singapore, Japan and Australia have far more developed planning, financial, regulatory and legal architectures. The Iskandar Development Region (IDR) in Malaysia, for instance, has a one-stop shop regulatory authority co-chaired by the prime minister and the chief minister of Johor. The Master Plan for IDR clearly defines municipal and planning oversight, investor status and incentives, environmental impact assessment requirements, and land ownership.

The dramatic rise in investment flows between the GCC and Asia will undoubtedly ultimately drive reforms in legal and regulatory framework. However, this can take time to evolve—in both Japan and Hong Kong the process has taken decades. As such, investors will require staying power in the markets of the region—and it is still early to consider any of them as fully fledged regional hubs for investment.

“Hub means investors and issuers use Malaysia to launch their instruments in US dollars. We have not



Investment case study: Iskandar Development Region (IDR)

One of the central pillars of Malaysia's five-year economic development plan (the Ninth Malaysia Plan—9MP) is the launching of the IDR abutting Singapore at the tip of western Malaysia.

The IDR—which will include a range of new industrial clusters, residential and commercial real estate, and new research and development facilities—has become a flagship for Gulf investment in Malaysia, with four Gulf-based investment consortia signing deals to provide funding of around US\$1.2bn for the project—the biggest ever investment commitment from Gulf-based investors in Malaysia.

"If you look at the basic development concept of Iskandar, it is primarily property. That alone should be attractive to GCC investors. The potential is huge," says Badlisyah Abdul Ghani, executive director of CIMB Group, which is structuring some of the financing for the projects.

The IDR lies in the Johor Baru region, just across the Strait of Johor and within a stone's throw of Singapore. Its total area is 2,217 sq km, dwarfing Singapore's 690 sq km.

The managing director of Hong Leong Bank, Khalid Bhaimia, sees a parallel to the rapid development of Shenzhen in China as a supporting region to Hong Kong (Shenzhen

today is also bigger than Hong Kong). "Because real estate in Singapore has become so expensive, Singaporeans who can no longer afford to live there now commute from [the IDR in] Johor over the causeway. Iskandar will develop the same way as Shenzhen in China," he predicts.

Noor Azwa Mohd Noor, senior vice-president of the Iskandar Regional Development Authority (IRDA), which oversees the development of IDR, expects the project, which has a 25-year completion target, to require total financing of about US\$96bn up to 2025. According to the IRDA, in addition to the US\$1.2bn committed by Gulf investors, a further US\$1.2bn has been allocated under 9MP and US\$1.5bn will be injected by Khazanah Nasional Berhad, the investment arm of Malaysia's Ministry of Finance. The IRDA expects to raise the remaining US\$9.5bn in financing required for the first phase of the programme from the private sector.

To encourage investment in IDR, the federal government has introduced a range of additional incentives, which include: a ten-year corporate tax holiday; the sourcing of capital globally without any restrictions and; the ability to employ foreign workers without any restrictions.

Four Gulf-based consortia are involved so far.

- A consortium led by Mubadala Development Company from Abu Dhabi has committed some US\$520m in investments for

a cluster of lifestyle and leisure projects including a golf village, an amusement bay, and a medical and wellness village. Mubadala's CEO, Khaldoon Khalifa AL-Mubarak, suggests that "we believe that the sustainable development approach and solid infrastructure in IDR will attract global brands".

- A second investment of US\$330m has been agreed by Kuwait Finance House (KFH) through its Al Nibras II Limited investment fund. KFH will support the development of a cluster comprising a logistics village, a creative park, and a heritage district. The managing director of KFH in Malaysia, Salman Younis, stresses that "we expect the creative and heritage zones to set new local and international benchmarks for quality of life".

- The third investment is by UAE-based Millennium International Development Company (MDI), a member of Saraya Holdings, which will invest US\$325m in an international financial district. "The international financial district fits well with our objectives and meets the need for a new financial hub to serve expanding markets in Asia and for Islamic banking services," says Ali Kolaghassi, the chairman of MDI.

- Abu Dhabi's Aldar Properties PJSC will be the master development manager for the first phase of IDR. Aldar, according to Mr Noor Azwa, is still finalising its "substantial" investment plans for this phase.

seen much dollar deal flow. That is an aspiration and will remain so unless Malaysian projects are originated out of Malaysia in dollars," says Rafe Haneef, head of Islamic banking for Citibank.



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Overcoming barriers to investment

Meanwhile, the key question for Gulf-based investors is how to overcome the various barriers to investment in a still unfamiliar and challenging environment. Practitioners point to three main risk-mitigation strategies.

Go slow and do the due diligence

Many investors have applied cautious, multi-phased investment strategies. Soud Ba'alawy, executive chairman of Dubai Group, described how his investment company spent several years "familiarising itself" with Asia by building a portfolio of smaller investments, before moving out of what he refers to as the "first stage" and into a mode of more substantial investment in the region. In practice, Gulf investors suggest that this means sticking to your strengths and avoiding the early temptation to venture into unfamiliar business areas—starting with familiar structures and asset classes, and expanding only after getting comfortable with a market.

Proper due diligence is also crucial. "You have to enter the market with your eyes wide open—do your credit and due diligence. Invest once you have attained the knowledge about the risk you are taking. [The level of] risk is not the central issue. If these countries are within your horizons, it implies that you have accepted this. The question is how do you mitigate the risk? I don't think people should not invest in Asia because the risk is different. On the contrary, they should be investing here because it is different," explains Mr Badlisyah of CIMB Bank.

Find a quality partner

There is also a clear consensus among practitioners that the most effective way to mitigate risks in the region is to partner with a quality local company, or

a regional entity with significant experience in the home country. As Max Castelli, senior economist at UBS, puts it, "investing in China is not like investing in the US—you need a vehicle on the ground to enable you to get exposure".

Gulf investors' favoured method thus far has been to establish joint ventures with local partners. For example, Emaar Properties in Dubai has formed a joint venture with MGF Developments of India to carry out a wide range of new projects in several provinces, including more than 50 hotels, with an initial investment of some US\$1bn over three to five years. In June 2007 Emaar-MGF announced plans to invest in the construction of more than 100 shopping malls across India over the next three to four years.

The Global Asia Real Estate Fund of Kuwait's Global Investment House (GIH) has just closed its first investment in China with two joint-venture partners, Titan Capital, a Singapore-based private equity firm, and Pan China, a real estate group in China.

Arcapita Bank launched its first real estate investment in India in July 2007 with Ascendas, a leading Singapore-based real estate entity that pioneered the modern information technology (IT) business park in India in the early 1990s. "Any foreign investor going into a foreign geography must have a seasoned local partner," says Atif Abdulmalik, CEO of Arcapita. "Ascendas has been involved in India for over 13 years and has amassed vast experience in the country. If you do not have a quality local or regional partner, you are just exposing yourself to a high level of risk."

Build on demand for Islamic structures

Another way to strengthen links with local markets is to address the demand for Islamic finance products. Indeed, offering Islamic financing is a competitive advantage in markets such as Malaysia, Indonesia and even Singapore, where proactive governments are encouraging such financing through extra tax and



other incentives.

Sourav Kumar, head of sales and marketing for the Middle East at Prudential Asset Management, confirms: “we have investors who now want to invest in Shari’ah-complaint stocks in India, China and Asia. They are also looking for Shari’ah-compliant real estate assets, funds and projects to invest in. We are in the process of structuring a number of products

geared towards Asian asset allocation.”

Mr Abdulmalik continues this theme. “As long as our partners understand the various structures—what a Murabaha or Ijara is—and they are comfortable that they fit in with their financing and risk criteria, then they are happy. We had this experience when we entered the US and EU markets, and we expect the same in Asia.”



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Conclusion

With big new deals between Gulf and Asian companies being announced on an almost daily basis, breathless references to a “new Silk Road” appear regularly in the western media. A bit of perspective is required, however—Gulf investment into Asia still represents a small portion of total outward flows, at around 10%, and despite the rising importance of the region for GCC leaders, safe western assets will continue to form the core of Gulf portfolios for some time to come (as indeed they do for most large, long-term investors).

At the same time, strengthening relations with Asia is clearly on the long-term agenda for Gulf countries, but this does not mean a wholesale strategic shift to the east is on the cards in any way. The Saudi ambassador to Canada, Abdulaziz Al-Sowayegh, confirms “that turning eastward does not necessarily mean to abandon our relationship with western countries. These relations are long-standing and deeply-rooted, and one cannot imply that strengthening relations with other countries in the East, the North or the South infers that Saudi relations with the West have cooled.”

Nonetheless, there is clearly a relative, if not an absolute, shift, underway that will have significant implications for the economies of both regions and the global economy more broadly as it unfolds.



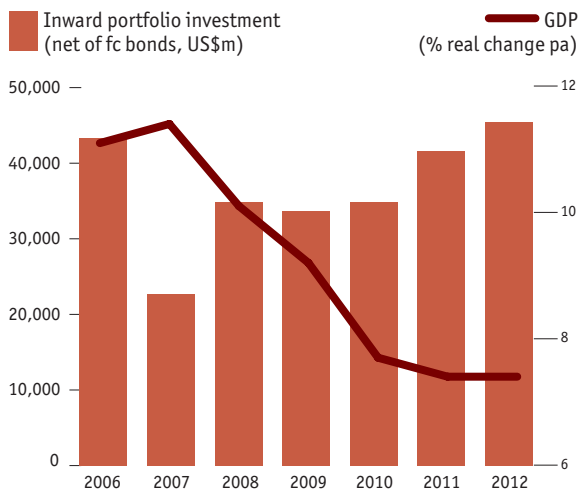
CHINA

Macro/political outlook

Despite the dominant political control exerted by the Chinese Communist Party (CCP), its pursuit of a neo-free-market approach to the economy has underpinned phenomenal GDP growth in recent years. The closed political system is in some sense a boon for economic policymaking, as it allows the government to push through policies that might be difficult to implement in a democracy. However, factionalism within the CCP remains an inherent source of political instability, and secessionist movements in Tibet and Xinjiang present some level of risk for investors.

Economic activity has showed no sign of abating in 2007, with real GDP projected at 10.2% for this year. Growth will slow gradually in 2008-12, but at around 7% per year it will remain one of the world's fastest-growing economies. Gross fixed investment growth, which has been a major driver of economic expansion, will remain in double-digits for the foreseeable future. The renminbi will continue to be held in a floating exchange-rate system, but the Bank of China (the central bank) will allow increasing volatility and sustained appreciation against the US dollar up to 2012.

Investment outlook



Source: Economist Intelligence Unit.

Economic policy outlook

Because of the poor quality of its institutions, lack of transparency, and under-developed legal and regulatory architectures, China faces huge challenges in its aim of catching up with the West. The government wants continuing economic liberalisation and sustainable growth alongside enduring political control. The authorities will likely place greater emphasis on environmental protection in coming years, amid growing concerns about air quality and water pollution.

The government is also belatedly recognising the continuing gap between the main cities and secondary and tertiary cities and its potential long-term drag on growth and stability. The economy should further open up following China's accession to the World Trade Organisation (WTO), with the private sector, comprising local and foreign investors, strongly encouraged to complement the state sector.

Investment trends

China is one of the most attractive foreign direct investment (FDI) destinations in the world, with inflows expected to reach US\$80bn in 2007 and average around US\$90bn per year in 2008-12. China offers huge investment opportunities in manufacturing, real estate, hotel and infrastructure development, retail and financial services, but with important caveats. Language barriers; the lack of suitable local partners; and the dearth of quality deal flows have so far put a drag on Gulf investment.

The major driver of GCC-China investment (and relations more broadly) remains merchandise trade. China is the main export market for Saudi and GCC oil and oil products. The GCC is also a major importer of Chinese goods. This has led to further collaboration. Saudi Aramco is building a joint-venture refinery in China, the national oil company of which has a concession to explore for oil in Saudi Arabia's Empty Quarter.



Near East meets Far East

The rise of Gulf investment in Asia

INDIA

Macro/political outlook

As the world's most populous democracy and an inherently stable, but fast-growing secular country, India represents a major opportunity for Gulf investors.

The country benefits from broad political stability, and recent rapprochement with Pakistan and China has paved the way for greater co-operation in trade and investment with these countries. India's domestic politics, however, remain fractious, with governments tending to be formed of unstable coalitions. Despite the fact that the major Indian political parties all agree that economic reforms are imperative to drive faster investment and growth, there remains a much broader plurality of view than in China, for example, which can tend to delay reform and frustrate investors.

Information technology (IT) and IT-enabled services output will grow rapidly over the near term, thanks to India's cost advantages in these sectors, and along with robust growth in manufacturing and services more generally. This will drive average real GDP growth of around 7.5% in 2008-12. Buoyant consumer demand will lead to a growing trade deficit, although substantial surpluses on services and transfers will keep the current-account deficit below 2% of GDP up to 2010.

Economic policy outlook

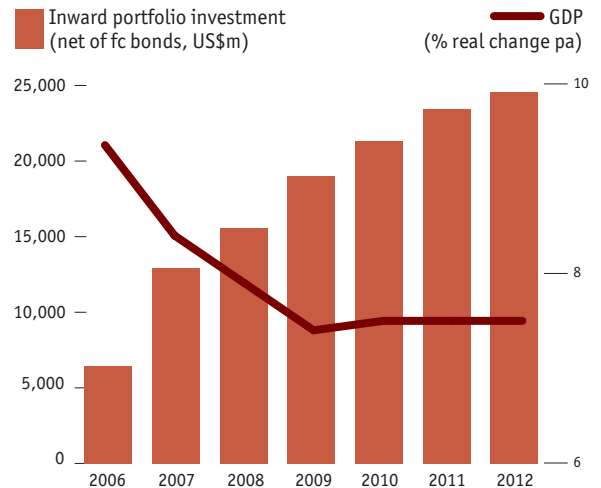
The quality of India's economic policymaking has been patchy, and the result is a current dichotomy between a first world economy operating side-by-side with a third world one. FDI, for instance, has been heavily concentrated in the southern and western states, where more reform-minded administrations are in power. In other parts of the country, opposition to foreign investment remains robust.

The federal government has commissioned Citibank to help it develop a specific strategy for attracting investment from the GCC countries. The government hopes to lure funds into the power, telecommunications, real estate, hotel and ports sectors, and is set to establish specific infrastructure equity funds for each investing country from the region.

Investment trends

India attracted US\$17.5bn in FDI in 2006, well below the global leaders as a percentage of the country's GDP. While

Investment outlook



Source: Economist Intelligence Unit.

the IT and computer software sectors have historically attracted much FDI, in 2006-07 these sectors have been overtaken by services—in particular investment in financial services, construction, telecommunications, and transport.

With India set to become the world's most populous country within the next 30 years, and the middle-class growing particularly strongly, Gulf investors have shown a particular interest in investments targeting the expanding middle-class wallet and the sectors in which they work. These include real estate developments, infrastructure, business parks, gated residential communities, biotechnology and IT. With a huge middle class, the retail sector is emerging as a major investment opportunity, but foreign investment in the sector is limited by an ownership ceiling of 51% for single-brand retailers, and is only allowed with the government's permission. FDI in multi-brand retailing remains prohibited for the time being.

Several GCC institutions have in recent months embarked on major investments in India, primarily in real estate, ports and the financial sector. More generally, GCC-India investment links are underpinned by strong cultural and historical ties. Indian workers have long been active in the energy sectors of the Gulf states, educational exchanges between India and the Gulf are common, and Gulf-based executives often profess a greater ease of doing business in India than in, say, China, given the greater bureaucratic and cultural similarities.



MALAYSIA

Macro/political outlook

Malaysia is a low-risk and well-aligned market for Gulf investors, and has proven to be one of the most popular markets in the region thus far.

Successive Malaysian governments have emphasised the stability and peaceful co-existence of its multi-ethnic and multi-cultural society. Underlying social tensions between ethnic groups do persist; as do some concerns about “creeping Islamisation”, but these have been skilfully managed by Malaysian authorities and have not thus far been a deterrent for foreign investors.

Real GDP growth is expected to be around 6% this year, and with growth averaging around 5.6% in 2008–12 Malaysia will be one of the region’s strongest economic performers. This will be led by continued robust domestic consumption, gathering momentum in the construction sector, and strong FDI inflows, and—of particular interest to Gulf investors—a strengthening of investment and construction activities.

Economic policy outlook

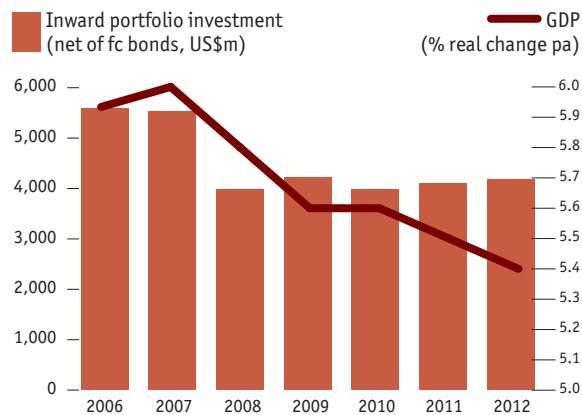
Malaysia’s economic policy is guided by three initiatives—Wawasan (Vision) 2020, which sees Malaysia achieving fully industrialised status by 2020; the Ninth Malaysia Plan (9MP); and The National Mission, which provides the development framework for the next 15 years based on five key objectives: moving the economy up the value chain; raising the capacity for knowledge and innovation; addressing socio-economic inequalities; improving quality of life; and strengthening institutional and delivery capacity.

Investment trends

Real estate; the knowledge-based economy (especially biotechnology); manufacturing; tourism; and services appear to offer the most attractive prospects for Gulf investors.

The real estate sector has clearly already been an area of focus: some 30% of the high-end condominiums in the KLCC area of Kuala Lumpur are now owned by foreigners from the GCC, India, Japan, the EU, Singapore and Hong Kong. The influx of GCC tourists and the presence of Alrajhi Bank, Kuwait Finance House (KFH) and Asian Finance Bank are also fuelling interest in real estate. KFH is a major investor in the Iskandar Development Region (IDR) in South Johor, and Alrajhi Bank is projecting a big uptake of its MM2H

Investment outlook



Source: Economist Intelligence Unit.

(“Malaysia My Second Home”) mortgage scheme.

By far the largest and most high-profile Gulf investment in Malaysia is the US\$1.2bn committed by four Gulf-based investment funds into the IDR. Sitting across the Johor Strait from Singapore, the Malaysian government anticipates that the development region will become a major business and tourism hub for the region, as well as providing more supply for an increasingly strained Singaporean real estate market.

Foreign investors in the financial sector face restrictions following a ceiling imposed by the Bank Negara Malaysia (the central bank, BNM) on new licenses, although the BNM is at the same time actively encouraging GCC investors to buy into the Islamic banking subsidiaries and windows of local and overseas banks. More generally, Malaysia is of interest to Gulf investors specifically because its rules for foreign investors are more lenient than those facing outsiders in other countries of the region—the country has no restrictions on foreign land ownership, for example, at odds with the approach taken by other Asian governments.

Malaysia also has significant advantages as a regional hub, especially for GCC investors who are familiar with its lifestyle and societal values. The country has major cost advantages over Singapore, the primary hub for Gulf investors. Salaries and office space costs are far more reasonable—in Malaysia office space can be found for some RM10 (US\$3) per sq ft whereas in Singapore it is S\$30 (US\$20).



Near East meets Far East

The rise of Gulf investment in Asia

AUSTRALIA

Macro/political outlook

Australia is a dominant player in the Asia-Pacific Rim region. The centre right government, led by the prime minister, John Howard, has aligned itself closely with the US in the global “war on terror”, which poses some risk of terrorist activity, but in general political stability is ensured over the medium term and the economy is healthy. The electorate has become increasingly disgruntled and is resisting efforts to reform labour markets, to the chagrin of the business community.

Real GDP growth is projected at 3.5% in 2007, underpinned by strong domestic demand and export growth. However, this growth rate is well below the emerging economies in the region. Australia is a major commodities and metals producer. As such, the economy is susceptible to dramatic falls in commodity prices. Prices of aluminium, copper and lead are all expected to fall in 2008 and beyond, and this will lead to a mild slowdown in 2008-12 to around 2.8% per year. Should lower commodity prices hit exports and investment harder than expected, growth could slow much more significantly.

Australia’s main source of macroeconomic risk is the large current-account deficit, which reached 5.4% of GDP in 2006. Although the current-account deficit is expected

to narrow in 2008-12, a large income deficit, low domestic savings and continued reliance on imports will prevent a more substantial improvement.

Economic policy outlook

Privatisation momentum is expected to pick up over the next few years, but Australian business is still hampered by red tape. The labour market has been one of the least attractive features of Australia’s business environment, reflecting restrictive labour laws and a high degree of wage regulation, but labour market reform is high on the economic policy agenda. Foreign investment rules are still moderately restrictive, but these will be relaxed as Australia signs more free-trade agreements (FTAs) in the region. Australia’s geographical isolation makes for high transport costs and restricts market opportunities.

Investment trends

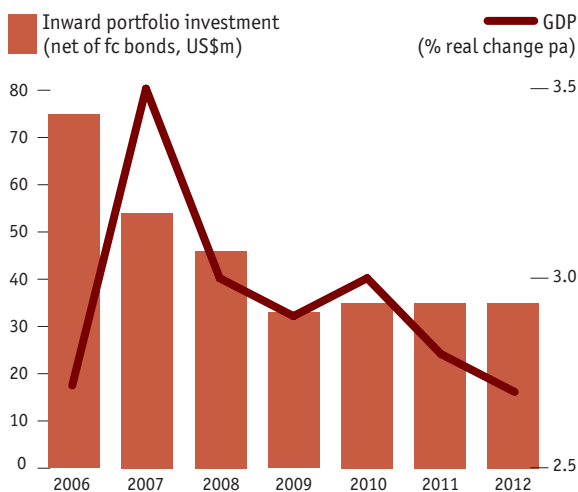
Australia attracted FDI totalling US\$24.7bn in 2006, according to the IMF, with the mining and financial services sectors attracting the largest inflows. Inflows will reach almost US\$40bn this year, before tailing off to an average of around US\$28bn in 2008-12.

The gradual opening up to competition of areas previously dominated by the public sector will create business opportunities for foreign players, although competition in sectors such as financial services and consumer goods is already tough.

There is limited scope for value-added investment in traditional Australian industries—such as agriculture, raw materials and mining—but the government is encouraging investment in newer industries such as technology, telecommunications, biotechnology, pharmaceuticals and resource-processing. However, bureaucratic red tape, competition from other countries in the region for investment, and limited financial and other incentives (such as streamlined approvals processes) may affect future flows of investment.

Despite its huge distance from the GCC, economic relations between Australia and the Gulf are reasonably well-established. Australia, for instance, supplies the bulk of livestock exports to the GCC. Kuwait Finance House (KFH) recently bought a string of mid-cap companies in Australia, such as shirt manufacturer, Canterbury. Banks such as Arcapita and KFH confirm a growing interest in Australian real estate and infrastructure, and are exploring opportunities in South Australia and Queensland.

Investment outlook



Source: Economist Intelligence Unit.



JAPAN

Macro/political outlook

As a major consumer of Gulf exports, Japan is a market of key importance to GCC investors. It benefits from a stable political environment, recent turbulence surrounding the resignation of the prime minister, Shinzo Abe, notwithstanding. Broad political stability—the ruling Liberal Democratic Party (LDP) has been in power for more than five decades—has, however, come at a cost of slow progress on structural reform. Relations with neighbouring China remain a significant source of political risk, although both sides are keen to improve these.

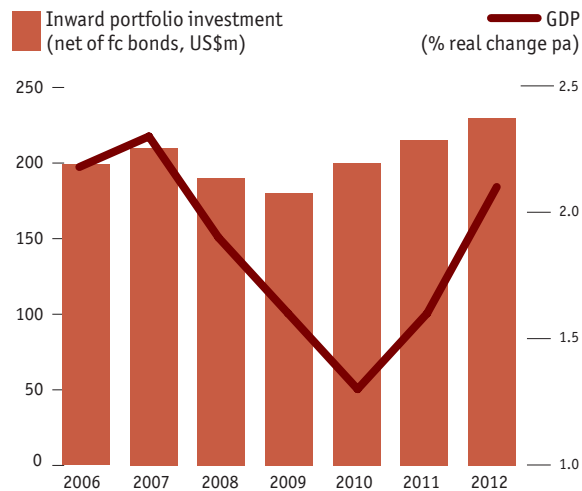
Japan's economy has largely recovered from the woes of the late 1990s and the early years of this decade. The medium-term outlook remains favourable, with real GDP growth forecast to stay around 2% per year in 2008-12, driven largely by private consumption and investment. The current account will remain in surplus, at over 4% of GDP, up to 2011, which along with the ending of the tight US monetary cycle and further interest rate increases by the Bank of Japan will support a steady strengthening of the yen against the US dollar in the same period.

Economic policy outlook

Notwithstanding the strength of the recent economic recovery, and its strong performance in price stability, the external balance and exchange-rate volatility, Japan's poor fiscal position casts a long shadow over overall economic stability. Although the risk of a full-blown fiscal crisis is low, the fiscal position is projected to deteriorate over the coming five years, largely because of the implementation during the 1990s of successive fiscal-stimulus packages with a combined headline value of more than US\$925bn. At 180% of GDP, Japan's government debt is by far the highest of any OECD economy.

The pace of deregulation and liberalisation has been slow. The rapid ageing of the population will impact on the future labour force, savings and the budget. The economic recovery has helped to buoy the largest banks, but concerns remain about the health of the smaller regional banks.

Investment outlook



Source: Economist Intelligence Unit.

Investment trends

Annual FDI inflows have been disappointing, and are expected to remain around only 0.2% of GDP per year over the near term. This weak performance is largely driven by persistent informal barriers to inward FDI such as the trade associations, which control whole sectors in order to ensure that prices remain high and to guard against interlopers; the unique character of Japanese business practices; and the high cost of doing business in the country, mainly as a result of high land and property prices.

Real estate developments, retail and financial sectors offer the best opportunities for GCC investors, with several large Gulf investors having completed their first real estate deals in Japan recently. Agriculture is essentially off limits for foreign investors, given its political sensitivity.

The Japan Bank for International Co-operation (JBIC) is actively seeking to boost its co-operation with Gulf investors. JBIC confirms that it is keen to tap GCC liquidity to fund projects in various emerging Asian countries, with Japanese financial institutions providing structuring and placement expertise. The Bank is in the process of launching its first Islamic bond issuance.



Near East meets Far East

The rise of Gulf investment in Asia

SINGAPORE

Macro/political outlook

The island-state of Singapore is one of the most politically stable in Asia, and the ruling People's Action Party (PAP), which has been in power since 1959, will continue to dominate politics over the medium term. While Singapore is seen by some observers as a one-party authoritarian state—the government has little tolerance for dissent and is active in promoting social mores—the stability this brings has proven a boon for investors.

Real GDP growth is projected to fall from 7.9% in 2006 to an annual average of 4.6% in 2007–11 as the economy slows down to a more sustainable pace. This deceleration will be largely underpinned by a slowdown in manufacturing activity and a sharp deterioration in the external balance as demand for consumer and investment goods imports rises.

Going forward, private consumption and investment will be the main drivers of growth. Consumer price inflation will remain low over the medium term, which together with ongoing external surpluses will alleviate any downward pressure on the Singapore dollar against the US dollar.

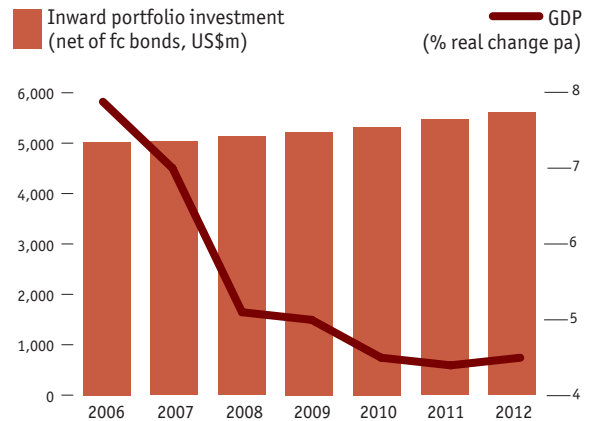
Economic policy outlook

Singapore's economic policy has been highly interventionist. Individual industries have been encouraged, and the government is deeply involved in economic development, not only through its macro- and micro-economic policies, but also through its ownership of firms in many sectors. Foreign firms operating in Singapore accept this; in return, they are provided with an exceptionally stable operating environment and an effective infrastructure.

Globalisation has forced the government to undertake a shift in economic structure away from manufacturing to a knowledge-based economy. The biggest challenge is currently ensuring an adequate supply into the workforce of people who are IT-literate, especially given the limitations of the country's population and low birth-rate.

Singapore has a good reputation in protection of private property and intellectual property rights. The business environment also benefits from a highly-trained workforce and a world-class infrastructure. Moreover, the island state is developing a network of bilateral and multilateral FTAs to improve market access.

Investment outlook



Source: Economist Intelligence Unit.

Investment trends

Singapore's foreign investment and international trade regime, its well-developed capital markets, and a liberal tax regime (its tax burden is one of the lowest in the region) have made it a top business location in the Asia-Pacific region. To facilitate the development of a knowledge-based economy, the government is encouraging worker retraining, a revamp of the education system in order to put greater emphasis on IT, and technical entrepreneurship. In addition it is offering incentives to encourage inward investment in high-technology industries and services, as the government is particularly keen to attract investment that involves the transfer of technology or expertise.

Nonetheless, Singapore is constrained by its size and its small population, and as such, market opportunities are limited. Real estate, retail and financial services offer the best investment prospects. Given the high level of GDP per head, which is projected to reach US\$40,445 by 2011, Singapore will continue to be an important market for luxury goods. In addition, Singapore is promoting itself as a tourism and regional headquarters hub—the expatriate community in Singapore has boomed in the past two years—and as a base for research and development.

Despite its high cost of living, high wages, and high property and rental prices, many GCC companies use Singapore as a regional hub in preference to Malaysia and Hong Kong. Tricon of Abu Dhabi and National Commercial Bank of Saudi Arabia have both had a long-established presence in Singapore, and Arcapita of Bahrain opened an office at the start of 2007.



THE “TIER TWO” MARKETS— INDONESIA, HONG KONG, THAILAND, KOREA

In addition to the leading markets, there is also a group of “second tier” countries of interest to GCC investors. These markets are of lesser interest in some cases because of size and lack of market opportunity/dealflow, but also because of greater concerns about transparency and information flow, language barriers, protectionist investment and trade laws, high levels of corruption and potential political instability.

Macro/political outlook

Indonesia, after decades of military rule, is now an emerging parliamentary democracy. As a huge and highly fragmented country, the process of evolution to more liberalised rule brings with it substantial risks to investors, both in terms of the pace of reform and basic political and social stability. Secessionist movements such as the one in Aceh Province are a deterrent. Real GDP growth will remain at a robust 5.5-6% per year during 2008-12, but inflation will remain around 6% in the same period.

Hong Kong's size and its edgy relationship with Beijing constrain its relations with other markets. Despite its status as a global financial centre, there remains uncertainty about the island's long-term commitment to democratic reforms and market transparency, and the debate over the short term will be focused on political reform, including the introduction of universal suffrage. Slower world GDP growth and higher domestic interest rates will see Hong Kong's economic growth fall from over 6% in 2007 to around 5% during 2008-12 and inflation will be about 1-percentage-point higher in 2008-12 than the 2% recorded in 2007.

Thailand remains a political enigma for many Gulf investors. It is currently ruled by a military junta following the ousting of the prime minister, Thaksin Shinawatra, in September 2006. The military has promised fresh elections at the end of 2007, but there is little likelihood of a quick return to political stability. Domestic demand has been severely weakened by the high degree of political uncertainty that followed the coup, which along with weaker export growth will see real GDP growth slow to an annual average of around 4.3% per year during 2008-12, down from

5% in 2006.

South Korea benefits from broad political stability despite a recent period of fractious relations between the government and opposition. Its militant trade unions and the “Northern Question”—relations with communist North Korea—are major potential sources of instability. Real GDP will grow by an annual average of around 4.8% over the next five years, buoyed by robust private consumption growth as households rebuild their balance sheets.

Economic policy outlook

Indonesia faces general disillusionment among the business community in the country with the slow pace of economic reform and the government's failure to create jobs. A new investment law has been passed, but delays to a planned tax law and the abandonment of extensive reforms to labour legislation in the face of strong union opposition continue to damage the government's credibility.

In **Hong Kong**, the government will seek to address the challenge to Hong Kong's port and financial industry posed by the rise of rival centres on the mainland, by strengthening the territory's role as a trading hub. However, as Hong Kong's economy becomes more closely integrated with that of China, Hong Kong will find itself increasingly affected by policy developments on the mainland.

In **Thailand**, the military-appointed prime minister, Surayud Chulanont, a retired general, has adopted a “sufficiency” model of economic management, but his government is relying on expansionary measures to stimulate the economy, which remains weak.

South Korea still has to shake off its “Fortress Korea” image and open up its economy in terms of removal of tariffs and subsidies. A backlash against perceived foreign dominance in the financial sector may lead to non-local bidders being disadvantaged in future privatisations in this sector. Foreign capital will increasingly, if grudgingly, be accepted as a normal part of economic life.

Investment trends

Indonesia is already relatively investor-friendly: liberal foreign-exchange policies remain in force, and the trade regime will be deregulated further. Tax incentives are offered in many sectors, and procedures have been simplified. The opening up of utilities (including power) provides attractive opportunities for foreign investors that may not exist in other regional markets.



Near East meets Far East

The rise of Gulf investment in Asia

The **Hong Kong** government is keen to attract investment in financial services, logistics, tourism and professional services. Hong Kong has an established financial sector, and the government has stated an aim of making the country a global centre for Islamic finance, but several GCC institutions, including Arab Banking Corporation and Kuwait Asia Bank, have in recent years divested from the island.

In **Thailand**, opposition to the sale of assets to foreigners, particularly in the utilities sector, will narrow opportunities for Gulf investors. More importantly, until Thailand settles back to democratic rule, GCC investors will remain reluctant to enter. The previous Thai government was particularly keen on GCC investment in the Islamic financial sector following the establishment of the Islamic Bank of Thailand, which attracted significant interest from GCC institutions.

While trade has flourished between **South Korea** and the Gulf states, and South Korean companies have had their fair share of contracts, especially in the oil and gas and manufacturing sectors, GCC investment interest in the country has been limited, primarily because of barriers to entry and language differences.

Of the second-tier countries, Indonesia holds the most promise for GCC investors, both because it is the most populous Muslim-majority country in the world—with a rising middle class—and because of its proximity to Malaysia. Several GCC banks and corporates have publicly confirmed their interest in Indonesia, and selective investments have already been made by Gulf-based banks in the financial sector.

Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

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