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Financial Cooperation between Korea and the Middle East in a New Industrial and Financial Environment

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Introduction

Over the past four decades, Korea and the Middle East countries have promoted economic cooperation, focusing on two sectors. While the Middle East countries have provided oil and gas to Korea, Korean construction companies have been venturing actively into the Middle East region since the 1970s. In particular, the bilateral economic relations were strengthened, relying heavily on high oil prices at that time. Although the Middle Eastern construction boom diminished significantly as international oil prices started dropping in the mid-1980s, it played a significant role in Korea's economic development in the 1970s.

However, this pattern of bilateral cooperation cannot produce a long-term and stable partnership because of oil price volatility. Recent sharp decline in oil prices witnessed since the end of last year proves the necessity of diversified cooperation. Thus it is necessary to find a new way to expand business opportunities for sustainable cooperation, based on changing industrial and financial environment in the Middle East region.

Changes in the Industrial and Financial Environment in the Middle East

The industrial and financial environment in the Middle East has undergone rapid changes in the wake of the 2008 global financial crisis and the Arab Spring, which shook the region from 2010 to 2012. For instance, the GCC (Gulf Cooperation Council) has recently rolled out economic and industrial diversification policies to foster the non-oil manufacturing sector as well as promote the ICT, financial, tourism and MICE industries, to prepare for the time when Middle Eastern oil producers will find themselves without oil resources. In line with this, there has been an increasing emphasis on the role of SMEs in each industry, and the private sector has also been expanding participation. In addition, in answer to the growing public call for better quality of life, the Middle Eastern governments have promoted national projects for social infrastructure such as medical facilities, schools and housing.

Such shifts in industrial demand and policies have been affecting the fiscal and financial environment of governments among Middle Eastern oil producers. A good case in point would be that while oil producing countries in the Middle East are registering considerable fiscal surplus thanks to high oil prices, the fiscal surplus to GDP ratio has continued to shrink. This shows that public revenue drawn from oil exports cannot suffice in handling the rising demand for projects. Consequently, governments of oil-producing states have been asking construction companies for financial arrangements, and in the case of power and desalination projects, prefer direct investment from private, independent businesses. There are also strong requests for Korean SMEs and established mid-size enterprises to engage in direct investment to broaden the manufacturing base in the Middle East region.

Amid the shifts in the Middle Eastern industrial and financial environment, there are two obstacles to overcome for Korean companies in order to succeed in a more sustainable way in their ventures into the Middle East. The first would be that EPC (Engineering, Procurement and Construction) contract-based projects, which proved effective in the 1970s to 1980s, display many flaws when it comes to boosting value-added creation, as they instead give rise to an environment marked by excessive competition and low price bidding. Instead of limiting the focus to construction, a more long-term perspective should be employed, expanding the scope of business to project development or operations and maintenance.

Another obstacle is that insufficient financial procurement capabilities are causing difficulties in securing large-scale contracts. As projects have recently been becoming much larger, and direct investment from the private sector more extensive, financing capabilities take on greater significance. Mere loans from financial institutions will no longer do the trick; it is now necessary to secure profitability through equity investment and project finance (PF).

The Role of International Development Finance Institutions

IFC (International Finance Corporation), a member of the World Bank Group, is an institution that focuses on private sector investment; in the Middle East, likewise, it concentrates on fostering the private sector and improving corporate competitiveness. Jordan's Queen Alia International Airport project, in which the IFC played a leading role, is the first-ever public-private partnership airport project in the Middle East. Participation by the IFC made it possible to reduce country risk and served as a catalyst for financing. In addition, UAE-based ADIC (Abu Dhabi Investment Council) and Kuwait-based Noor Financial Investment Company made share investments in the project, setting an example of joint investment in a non-GCC nation.

Meanwhile the IDB (Islamic Development Bank) is a financial institution that aims to promote the economic development and social progress of member countries and practices Islamic banking. Its focus is on infrastructure construction investment to support the sustainable economic development of Muslim countries, more than half of IDB investment directed toward Middle Eastern and North African countries. The bank also reinforces financial cooperation with development funds in Middle Eastern oil producing-nations and multilateral development finance institutions. The Doraleh Container Terminal project in Djibouti, one of the major investment deals undertaken by the IDB, is a joint venture by Dubai-based, state-run DP World and the Djibouti government, and several other banks participated in financing through Islamic banking, including the IDB, Standard Chartered Bank and Dubai Islamic Bank.

The Japan Bank for International Cooperation, or JBIC, is an export credit agency that supports trade finance or overseas ventures of Japanese businesses. There has been an upturn in financial support toward projects involving resource and energy development and infrastructure construction, and stronger support for SMEs entering overseas markets. Partnerships with private financial institutions have been established as JBIC's key strategy, and various supporting methods such as investment shares and local currency financing are being developed and utilized. Qatar's Barzan Gas Project is being undertaken on a massive scale amounting to over USD 10.2 billion; over a third of the loans were covered by export credit agencies. In Korea and Japan in particular, EPC companies and export credit agencies form a structure of mutual cooperation.

Policy Proposals for Korea-Middle East Financial Cooperation

Korean financial institutions should begin by enhancing global financial capability. The financial institutions that display the most prominent global financial capability in Korea are policy finance institutions represented by the Korea Development Bank, Korea Eximbank and Korea Trade Insurance Corporation. These institutions, therefore, should lead the way in raising the nation's global financial capability by drawing upon their experience and professional manpower. Since private sector financial institutions lag behind in terms of professional manpower, experience and networks required to enter the overseas project market, it will be necessary to enact measures that would help them find a better footing. Also, to balance the supply and demand for professional manpower overall, efforts should be made to train experts specializing in development finance or regional studies, as well as to employ an integrated approach in educating financial and regional specialists.

The second step would be to build the Korea-Middle East financial network in a more systematic manner. To this end, Korean financial institutions should work to raise brand awareness by venturing as actively as possible into local markets. If this presents a difficult challenge for financial institutions lacking the capability, they should then make various strategic detours including joint-venture banks, joint acquisitions and strategic partnerships. It will also be necessary to encourage information sharing and professional manpower exchanges related to locally placed public-private partnerships and SME investment projects, and build an investment platform for matching local industry and technology demand to the supply of capabilities of Korean enterprises. This is expected to contribute greatly to the formation of investment models by sector and the subsequent development of new projects.

Third, it is advisable to identify investment projects that allow for broader private participation in countries aside from the GCC such as emerging economies in the Middle East, Africa and Central Asia, so as to find opportunities for joint investment. In other words, this would involve joint development projects in emerging economies, harnessing the abundant liquidity in GCC countries and the technology and experience of Korean companies. The biggest problem in this case would be country risk, including disinvestment risk. As a precautionary measure, a legal and institutional basis should be prepared to build a sound investment environment. The engagement of multilateral development finance institutions should also be encouraged as a means to curtail country risk. This would also help attract project participation from export credit agencies, policy finance institutions and private sector commercial banks. KIEP