DIVERSIFICATION IN OIL-DEPENDENT ECONOMIES: The Experience Of The GCC Countries 1/ 

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1/ The Gulf Cooperation Council (GCC) member countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.  
2/ The opinions expressed in this presentation are those of the author and do not represent the views of the national authorities and/or the IMF.

What Do We Mean by Diversification?

Economic diversification =
- developing non-oil sectors and lowering oil financial dependency (i.e., diversification of exports, government revenue, and economic base); and  
- creating a viable non-oil modern economy that can sustain a relatively high level of income.

Why is Economic Diversification Important?

Because
- Oil wealth per se creates few jobs directly, if any at all.  
- Oil prices/revenue fluctuate widely → oil distribution cannot support rising living standards.  
- Instability of oil revenue has an impact on the overall growth rates (mainly through changes in government spending), fiscal and external position, and employment.

Diversification is Also Important

- To reduce or spread risk  
- To promote economic development  
- To limit the impact of fluctuations in the oil price and quantity produced  
- To create job opportunities for a rapidly growing local labor force
Various Stages of Diversification Efforts

**Starting point**

The non-oil sector was constrained by very limited agricultural land and domestic labor, lack of qualified manpower, high illiteracy rate, and a relatively small market size.

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Given the Limitations of Resource Endowment

Diversification in the 1970s and 1980s has been based on the development of:

- capital- and energy-intensive industries;
- supporting industries;
- physical and social infrastructure (roads, housing, hospitals, schools, water, electricity); and
- government and private services (education, health, trade, transportation, and banking).

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Development of Productive Sectors and Heavy Industry

It concentrated on petrochemicals, chemical fertilizers, steel, aluminum (given the low cost of Hydrocarbon), capital abundance, and scarce domestic labor (perfect fit with their resource endowments):

- Saudi Arabia’s SABIC created in 1976;
- Dubai Aluminum started operations in 1980;
- Saudi Arabia became self-sufficient in wheat production in 1984; and
- Bahrain’s steel company started operations in 1985.

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Diversification Through Development of the Service Sector

- Bahrain established an offshore banking sector in 1975.
- Creation of free zones in Dubai since the mid-1980s (beginning with Jebel Ali Free Zone).
Lessons From Earlier Diversification Efforts

- Heavy cost in terms of subsidies (power, water, credit), tax exemptions (or lack of taxation), and other benefits;
- Heavy reliance on imported capital equipment, management, and labor (expatriate workers account for about three-fourths of the total labor force); and
- Transferring part of the oil wealth from governments to private citizens through diversification was questionable.

Lessons From Earlier Diversification Efforts (concluded)

- Negative implications of rapid diversification: inflation (15 percent, land prices skyrocketed), misallocation of resources (real estate market developed in a disorderly fashion);
- A majority of the domestic labor force turning (indirectly) into a "rentier" class status;
- Government (including public enterprises) accounted for most investment in the economy and for most paid employment to the indigenous population; and
- Cheap energy and abundant financial funds not enough to sustain industrialization;

Diversification Efforts in the 1990s

GCC countries were confronted with:
- rapidly growing local labor force;
- downward trend in global oil prices;
- deteriorating/weakening fiscal and external positions;
- lukewarm non-oil economic growth; and
- government expenditure structure that was not pro-growth (the wage bill and defense accounting for a large portion of spending).

Key Policies Were Reassessed (particularly since the oil shock of 1998)

- The role of foreign direct investment (FDI);
- Financial deepening;
- State enterprise reform and privatization;
- Creation of a business-friendly environment;
- Domestic competition (revision of agency laws);
- Administrative reforms;
- The role of the government;
- The education and training system; and
- Labor market reform.
Diversification in the 1990s was Mainly Based on:

- Continued development of downstream gas- and energy-intensive industries;
- Development of new services: tourism and entrepôt activities, IT;
- Development of liquefied natural gas;
- Creation of new free zones;

Diversification in the 1990s was Mainly Based on: (continued)

- Opening-up of real estate ownership to non-residents;
- Opening-up the economy to private sector initiative and FDI;
- Encouraging self-employment and development of small- and medium-sized enterprises; and

Diversification in the 1990s was Mainly Based on: (concluded)

- GCC countries are currently at various stages of implementing structural and institutional reforms that aim at consolidating the foundations for private sector-led and outward-oriented growth (see Appendix I for a summary or recent structural reforms in GCC countries).

Administrative Reforms

- Public expenditure management;
- Downsizing of civil service;
- Corporatization of public enterprises; and
- Revision of commercial laws.
Financial Sector Reforms

- Liberalization of deposit and lending interest rates;
- Strengthening central bank supervision;
- Adoption of new banking laws, including anti-money laundering legislation; and
- Adoption of new securities and capital market laws.

Foreign Direct Investment

- New FDI laws allowing foreigners to own 100 percent of local companies in the non-oil sector;
- Reduction in corporate income tax rate bias between local- and foreign-owned companies; and
- Streamlining investment approval procedures.

State Enterprise Reform and Privatization

- Power sector at the forefront of privatization efforts (but only new projects);
- Selling of existing assets in some GCC countries (telecommunication and small companies); and
- Privatization of management of service companies (i.e., airports and ports).

Labor Market Reforms

The challenge is:

- to eliminate the segmentation of the labor force along skills, wages, and sector of employment lines, without impairing the economy’s competitiveness, in particular of the private sector, which is expected to create most of the new jobs in the coming years; and
- Create jobs for nationals and increase the share of local workers in the private sector.
Labor Market Reforms (concluded)

Mixture of administrative (quotas), market-based (fees and taxes for the use of expatriate labor) and supply-side (modernization of educational system) policies:

- Improvement in vocational and training systems
- Modernization of educational system
- Creation of a national labor database to facilitate job search
- Enforcement of quotas for nationals working in the private sector
- Taxation of foreign workers (training tax)

What Have Been the Results of Diversification Efforts Over the Past Three Decades?

Figure 1. GCC Countries: Oil Dependency, 1980-2002

Figure 2. Non-Oil GDP share in Total Nominal GDP (In percent)
Figure 3. Distribution of Total Real GDP, 2001
(In percent)

Figure 4. Distribution of Non-Oil Real GDP, 2001
(In percent of Non-oil GDP)

1/ Other sectors includes construction; trade, restaurant and hotels; electricity and water; and other nongovernment services.

Figure 5. Non-Oil Government Revenue, 1992 and 2002
(In percent of Non-Oil GDP)

Figure 6. Current Expenditure, 1992 and 2002
(In percent of GDP)
Summary and Challenges Ahead

- Over the past three decades, GCC countries have witnessed an unprecedented economic and social transformation, but growth of the non-oil sector has remained weak relative to the growth of the domestic labor force.
- Progress toward diversification has been achieved with an open exchange and trade system and liberal capital flows.
- An open-door policy to attract expatriate labor has played an important role in the diversification of the production base and development of the service sector.

Summary and Challenges Ahead (continued)

- Access to foreign labor has contributed to maintaining external competitiveness.
- The main challenge facing GCC countries is to implement a comprehensive structural and institutional reform strategy over the medium term to help reallocate resources consistent with market signals, underpinned by a structural strengthening of the fiscal position, and investment in human capital.
- GCC countries are implementing policy reforms to accelerate non-oil growth and create employment opportunities for a rapidly growing labor force in a sustained fashion, though countries' experiences vary.
Summary and Challenges Ahead (continued)

This reform strategy, already under way in GCC countries, includes:

- Fiscal consolidation and structural strengthening of the budget to ensure long-term fiscal sustainability in line with intergenerational economic objectives;
- Expansion of the private sector through legal and institutional reforms along with privatization of state enterprises;
- Labor market reforms to prevent unemployment pressures from derailing the reform effort; and
- Closer integration of the GCC economies to help coordinate and strengthen macroeconomic policy and structural reforms underway.

Summary and Challenges Ahead (concluded)

- Liberalization of restrictions on foreign capital flows to support privatization and private sector developments;
- Labor market reforms to prevent unemployment pressures from derailing the reform effort; and
- Closer integration of the GCC economies to help coordinate and strengthen macroeconomic policy and structural reforms underway.

APPENDIX I

GCC Countries: Summary of Recent Key Structural Reforms in Selected Areas

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APPENDIX I

APPENDIX II

Source: Fasano and Schaechter

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The Privatization of Public Slaughter House and the Privatized Public Utilities in the GCC countries: Summary of Recent Key Structural Reforms in Selected Areas.

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