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.

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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.

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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.

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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

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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).

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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.

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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;

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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).

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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.

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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;

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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

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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).

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Administrative Reforms

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

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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.

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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.

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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).

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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.

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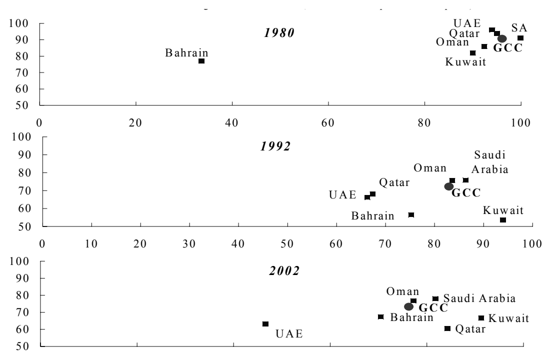
Labor Market Reforms (concluded)

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



Sources: National authorities; and author's estimates.

Figure 2. Non-Oil GDP share in Total Nominal GDP
(In percent)

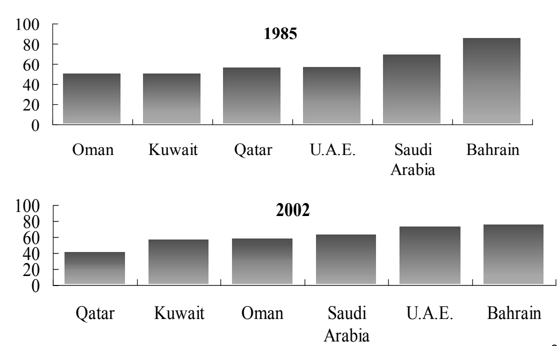


Figure 3. Distribution of Total Real GDP, 2001
(In percent)

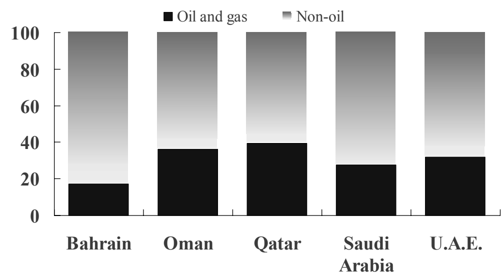


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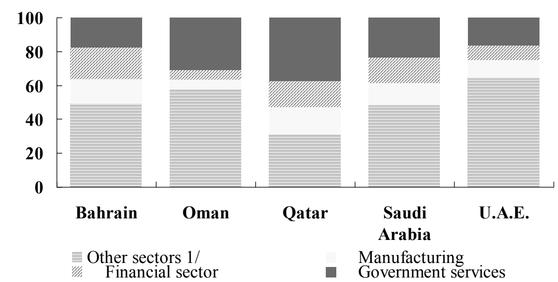
Figure 4. Distribution of Non-Oil Real GDP, 2001
(In percent of Non-oil GDP)



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

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

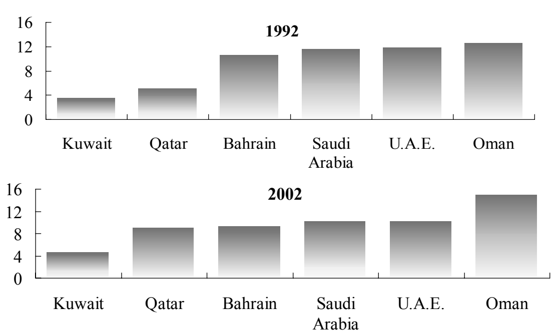

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Figure 6. Current Expenditure, 1992 and 2002
(In percent of GDP)

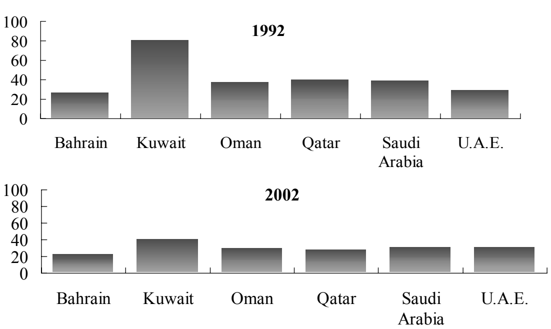

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Figure 7. Wage Bill, 1992 and 2002

(In percent of GDP)

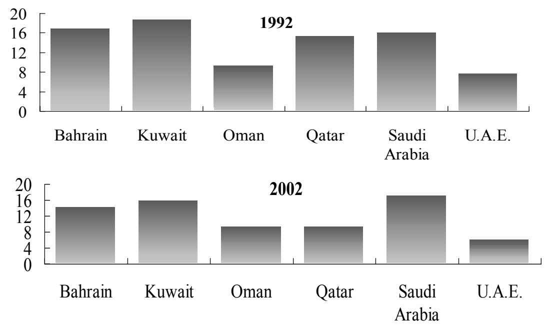

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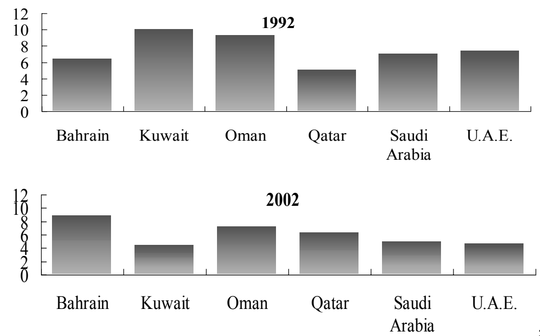
Figure 8. Capital Expenditure, 1992 and 2002

(In percent of GDP)



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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.

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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.

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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;

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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.

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APPENDIX I

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

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.
FINANCIAL SECTOR	Issued the first Islamic government bills to complement the working of the Islamic financial institutions, took steps toward improving prudential regulations for Islamic banking; ratified anti-money laundering legislation in January and October 2001; and enforced Bahrain Stock Exchange rules and regulations.	Adopted a portfolio foreign investment law allowing foreigners to own and trade shares of joint-stock companies listed on the Kuwait Stock Exchange, subject to specific limits.	Expanded repo facilities to the interbank market; implemented a capital market law to restructure the Muscat Securities Market into three separate bodies dealing with regulations, trading and exchange, and depository registration; and adopted a new banking law in 2000. The central bank has reactivated the issuance of certificate of deposits to manage liquidity, and implemented measures to reduce the risk of over lending to individuals and corporations. Oman has taken steps toward full compliance with the Financial Action Task Force (FATF) recommendations on money laundering and combating the financing of terrorism.	Removed interest ceilings on local currency deposits in February 2001; strengthened bank supervision, resulting in tightening of non-performing loan criteria; and introduced a new scheme to enhance liquidity management. Under this scheme, commercial banks can deposit their excess liquidity with or borrow from the central bank at rates determined by the central bank, which are fixed on a daily basis.	Allowed foreigners to trade on the stock market through open-ended mutual funds; and approved a new capital markets law to deepen the financial markets and strengthen the stock market. It enforced recommendations issued by the FATF relating to the prevention of money laundering, and adopted legislation to combat money laundering activities in the non-financial sector.	Established formal stock markets in 2000, and regulatory body for capital markets; enacted a new Securities Law to address volatility and malpractices that plagued security market in 1997 and 1998, and adopted a comprehensive anti-money laundering along with combating the financing of terrorism in January 2002. The central bank is implementing a comprehensive pilot risk-management module for banks.

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FOREIGN DIRECT INVESTMENT (FDI)	Eased rules on non-GCC firms to own buildings and lease land; established a one-stop shop to facilitate licensing procedures; permitted foreign ownership to increase from 49 to 100 percent of businesses in all but a few strategic sectors (e.g., oil and aluminum).	Passed a law allowing foreigners to own 100 percent of Kuwaiti companies and corporate taxes were reduced from 55 percent to 25 percent. A Foreign Investment Capital Office was established to process FDI applications.	Allowed 100 percent foreign ownership of companies in most sectors; reduced income tax disparity between Omani and foreign companies by raising the single rate for the former from 75 percent to 12 percent, and lowering the rates for the latter from 15–50 percent to 5–30 percent; redefined "foreign" company as one with more than 70 percent foreign ownership instead of currently 49 percent; and allowed foreign, non-GCC, firms to own buildings and lease land.	Allowed 100 percent foreign ownership in agriculture, industry, health, education and tourism sectors, and streamlined investment approval procedures. The maximum corporate tax was reduced from 35 to 30 percent.	Enacted a new Investment Law and established the associated investment authority (SAGIA) to facilitate foreign direct investment processing, including the establishment of one-stop shop. It also allowed for 100 percent foreign ownership of business in most sectors, including gas, power generation, water desalination, and petrochemicals. The highest corporate income tax on foreign investment was cut from 45 to 30 percent. It has permitted non-Saudis to own real estate for their business or residence, except in the 2 holy cities, and opened up the gas sector for investment by international oil companies.	The Emirate of Dubai launched several new free zones intended to establish the emirate as a global center for trade in gold bullion, research and development of technology, and financial activities. Dubai also relaxed restrictions for foreign investment in specific real estate projects.

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STATE ENTERPRISE REFORM AND PRIVATIZATION	Privatized the Public Slaughter House and the capital's waste collection and incineration. Other privatizations are under way, including the public transport company (bus), and tourism facilities. The telecommunications and postal services sectors are being liberalized.	The privatization law, approved by the Finance Committee of the National Assembly, establishes a comprehensive framework for large-scale privatization, identifies areas and modes of privatization, and sets up a pricing mechanism and safeguards against job losses. The government plans to offer for sale to the private sector most of the 62 public sector entities still under its control.	The power sector is at the forefront of privatization efforts, with three power plants currently under construction by foreign investors under a build-own-operate basis. Existing government power plants are being restructured for their future privatization. Oman has also recently privatized the management of airport services. Other services to be privatized in the near future include water distribution, waste water network, postal services, and telecommunications. The government also plans to gradually sell its participation in the few remaining non-oil public companies listed in the local stock market.	Partially privatized the Telecommunications Company at end-1998. It has corporatized the electricity and water sector, and the government has sold most of its power generation plants to Qatar Electricity and Water Company, which is majority-owned by the local private sector. Construction is under way of the first independent power and water plant, which is majority-owned by a foreign developer. Qatar has also sold 60 percent of the government's stake in a recently created company—spun off from Qatar Petroleum—to take over the local distribution of gasoline.	Announced in June 2002 a new privatization strategy under which autonomization of management would be followed by deregulation (corporatization) and ultimately private ownership. Twenty sectors are presently identified for privatization, including telecommunications, electricity, industrial parks, postal services, water, railroad, education, and air transportation. Saudi Arabia has recently privatized 30 percent of the Saudi Telecommunications Company. Eight regional electricity companies have been merged into the Saudi Electricity Company, and a regulatory authority was established to set tariff rates and regulate market access to new entrants.	The Emirate of Abu Dhabi has embraced utility privatization, embarking on new power projects through joint ventures with foreign investors, and selling of some existing assets.

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LABOR MARKET REFORM	Recently developed a new National Employment Strategy that includes providing fiscal subsidies for training nationals in the private sector, and financial aid for the unemployed. It also introduced measures to improve general education standards, and vocational and technical training programs, and increased employment quota of Bahrainis in small and medium size companies while abolishing "free visa" system to expatriate labor force.	The Manpower and Government Restructuring Program (MGRP) was established in July 2001 to implement the labor law, provide unemployment benefits to unemployed Kuwaiti nationals, and provide training and facilitate employment of Kuwaiti nationals in the privates sector. In September 2002, the government approved quotas for the proportion of Kuwaitis that private companies must employ; companies that fail to meet this target would be subject to a fine and sanctions such as exclusion from bidding for government contracts.	Introduced measures to improve vocational and technical training programs, and set a uniform minimum wage for Omanis at RO 100 (plus RO 20 as transportation allowance) instead of the previous two-tiered (skilled/unskilled) minimum wage.	Formally ended the policy of automatic employment for Qatari graduates. It now assists jobseekers by maintaining information on job openings and by counseling and training. A department has been established in the ministry of civil service with responsibility for this function.	Created the Human Resources Development Fund (HRDF) – with financial participation of the private sector – to provide training of Saudi labor force in skills required by the private sector, and development of a database for matching and placement of Saudi workers in the private sector.	Established the National Human Resource Development and Employment Authority to help improve skills of the U.A.E nationals looking for a job; and a national labor market database was established to facilitate job search by nationals.

Source: Fasano and Schaechter (2003).

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