Economic diversification in the GCC: dynamic drive needs to be confirmed

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The member countries of the Gulf Cooperation Council (GCC) underwent major economic transformations over the past decade. The main goal of the economic policies set into place was to diversify their economies away from the oil sector. This long-standing problem is linked to the non-renewable nature of oil resources. The volatility of oil revenues combined with strong demographic growth have brought the issue back into the headlines.

Measuring and tracking diversification in a rentier economy

Economic diversification in the GCC countries cannot be measured directly. To do so, we would have to have a breakdown of value added per sector, which is not possible with the national accounts of the GCC countries. The diversification issue can also be approached indirectly by measuring the dependence of economic activity, the budget and external accounts on production and revenues generated by the hydrocarbon sector (oil and natural gas).

Dependence of fiscal and export revenues

Budget revenues are highly dependent on hydrocarbon revenues in all the GCC countries. The level of dependency has changed slowly since 1990 (see chart 1). Moreover, tax revenues are still small compared to total government income. Corporate and household tax rates remain low due to the rentier economy of the Arab states, because hydrocarbon revenues are the preferred source of budget revenue.

For all of the GCC countries, oil revenues as a share of total budget revenues are higher than 80%. Public finance’s dependency on oil income introduces a high cyclicality of expenditure to oil prices, which comes on top of that of GDP, given the importance of the public sector and its oil extraction industries. With public spending structurally on the rise (strong demographic growth), public accounts are vulnerable and have accumulated massive deficits when oil prices are depressed.

The majority of export revenues are also linked to oil income, with no major changes over the past twenty years in Bahrain, Saudi Arabia, Qatar and Kuwait (see chart 2). Trends in Oman are notable because since 1990, hydrocarbon exports as a share of total exports have dropped from 90% to about 65%. Lastly, merchandise exports from the United Arab Emirates (UAE) have the lowest dependence on hydrocarbons due to re-exportation activities developed in Dubai.

![Hydrocarbon revenue, in % of total fiscal revenue](chart_1.png)

Sources: IIF, IMF, BNP Paribas
Non-oil GDP growth

Given the importance of the Persian Gulf countries to world oil supply, the hydrocarbon sector makes up a big share of the GCC economies (see chart 3): in 2010 it accounted for 28% at constant prices (based on 2000 GDP).

Non-hydrocarbon GDP, in % of total GDP

In comparison, the manufacturing sector accounts for less than 9% of GDP on average for all of the GCC countries. Moreover, this figure has declined slightly since 1990 (10%). Qatar’s GDP is more dependent on hydrocarbons (44%) while Bahrain, due to its low level of hydrocarbon resources, generates more than 92% of value added in the non-oil sectors. In Saudi Arabia, about 21% of GDP depends on the oil sector. Over the past two decades, in the Gulf countries as a whole, the share of the non-oil sector has grown (72% of GDP in 2010, vs. 54% in 1990), except in Qatar, where the trend has slowed with the development of natural gas production as of the late 1990s. The most spectacular increase is in Oman, where the contribution of the non-oil sector rose from 43% of GDP in 1990 to 71% in 2010.

Along with the non-oil sector’s share of GDP, it is also necessary to look at the importance of the private sector (see chart 4). Indeed, given the budget’s high dependence on revenues arising from oil income, it is the level and change in non-oil GDP generated by the private sector that gives a better approximation of the level of dependence. Kuwait and Qatar are the most dependent on oil income based on the public or private composition of non-oil GDP growth. For both countries, the private sector’s share of non-oil GDP does not exceed 50%. Since 1990, this figure has increased for Kuwait but declined for Qatar, where the economic diversification process still depends highly on the government. On the opposite side, the private sector plays a major role in non-oil GDP growth in Bahrain and the UAE (mainly Dubai): lacking major hydrocarbon resources, these countries have encouraged investment in the private sector.

Oman and Saudi Arabia are in an intermediate position with the private sector contributing about 70% of non-oil GDP. In Saudi Arabia, this share has increased by 10 points of GDP over the past decade.

In any case, the GCC countries are highly dependent on the oil sector, regardless of which selection criteria is used (budget, exports or GDP). If we combine the three indicators, then Kuwait is the most dependent, but on the whole, the economic dependence on the oil sector is basically the same in Saudi Arabia, Oman, Qatar and Kuwait. The UAE and Bahrain are less dependent, even though a large part of their business is indirectly linked to the regional oil cycle.
Why the need for diversification?

The GCC countries are key players in the world market for hydrocarbons. They claim 30% of world oil reserves and 20% of natural gas reserves. Their share of world production of oil and natural gas is 23% and 11%, respectively.

Uncertainty over future prospects for oil income

In the long term, it is hard to predict oil production prospects due to uncertainty over the level of reserves. According to Aissaoui estimates (2013) 1, GCC production could level off by 2025 before beginning to contract as of 2055, with a sharp decline by 2100. In terms of disposable oil income per capita, the survey shows that the GCC countries are relatively stable on average, although Saudi Arabia reports a notable decline, from an historical average of $6,275 to $4,785, mainly due to the doubling of its population by 2050. Although it is hard to estimate whether the amount of disposable oil income per capita will be sufficient to cover the population’s needs, we can already see that the current rise in dependency on oil income is not very sustainable.

Medium-term trends in the energy market only strengthen the prospects of a long-term decline. According to the 2012 world outlook by the International Energy Agency (IEA), prospects could be less favourable for certain GCC countries, notably Saudi Arabia. The rapid increase in US and Iraqi oil production and the development of natural gas alternatives at the world level could strain oil pricing trends. Second, domestic oil consumption by the GCC countries has been rising constantly, by about 5% a year. This is due to both demographic momentum and the country’s industrial development mode, which encouraged investment in energy-intensive activities. In Saudi Arabia, oil consumption has doubled since 2000.

All in all, from a medium to long-term perspective, oil income is under pressure from a number of factors, including both domestic trends in the Gulf countries (reduction in available exportable resources) and trends in the world energy market (greater competition). For the most heavily populated countries, the decline in income per capita could become politically unsustainable.

Need to create jobs

Economic diversification policies set up in the Gulf countries are largely motivated by the need to create jobs for national populations. In certain countries with a population of less than a million nationals (UAE, Bahrain and Qatar), unemployment is a relatively negligible problem. The official unemployment rate is less than 3% of the active population. Other countries – mainly Saudi Arabia and Oman – are confronted with unemployment problems that are virtually structural due to massive demographic pressure and an economic development model based on the development of hydrocarbon sector and industrial sectors that do not create many jobs2. To meet the enormous labour needs arising from rapid economic development, historically governments have called massively on foreign labour, which is employed primarily in the private sector (see chart 5). National populations mainly hold public sector jobs (see chart 6) in a kind of income redistribution system: there are either no incentives or they lack the skills necessary to hold private sector jobs. In general, 90% of nationals have public sector jobs while 90% of private sector jobs are held by expatriates.

Until recently, demographic growth has been strong, notably due to a high fertility rate. Although the demographic transition is now complete, job market pressures are still fierce due to the large share of youth: in Oman and Saudi Arabia, for example, more than 60% of the population is under 25. The participation rate is also increasing steadily as more and more women gain access to the job market.

Private sector employment by nationality

![Chart 5](sources: Central banks, NCB, BNP Paribas)
At 15% in 2011, Oman has the highest official unemployment rate. The annual growth rate of the active population is also one of the highest in the region at 5%, the equivalent of 184,000 new arrivals per year on the job market. In Saudi Arabia, the active population is growing by more than 3% a year, i.e. the equivalent of 400,000 new arrivals on the job market. Public sector recruitment of nationals has become more restrictive, notably following the oil counter-shock of the late 1990s. The ongoing increase in the total public sector wage bill is no longer sustainable. Until very recently, too few nationals have been recruited by the private sector, regardless of their skills level (see table). In the services and construction sectors, hardship factors and low wages proved to be disincentives, while the lack of education limited access to more qualified positions in private sector companies. The combination of strong demographic pressure and major job market constraints has led directly to a high unemployment rate.

According to official statistics, jobless rates are holding at moderate levels, estimated at less than 10% of the active population in Saudi Arabia. This figure must be kept in perspective, however, since the real number of unemployed could be significantly higher given the size of the working age population who are not actively seeking work. In Saudi Arabia, for example, the introduction of jobless benefits revealed an unemployment rate of more than 20% of the active population. Moreover it was particularly high for young workers aged 15-29, which is estimated at more than 30%.

From a long-term perspective, all of the GCC countries face the question of diversification to take into account the downward trend in disposable oil income. In the shorter term, however, they need to develop non-oil sectors to face up to rising unemployment among national populations.

Results and outlook for diversification policies

Diversification policies have had mixed results. Certain non-oil sectors have been developed, but they have yet to have a sufficient impact on the job market.

Persistently strong dependence on oil income

Oil and natural gas revenues still make up the lion’s share of budget and export revenues.
**Public finances**

In general, there has been little change in the structure of budget and export revenues since 1990. There is still a high level of dependency on oil income. The dependency of public finances has even tended to increase. This dependency is confirmed by the change in oil prices per barrel necessary to balance the budget (see chart 7). In addition to dependency, it is an indicator of the budget’s vulnerability to oil price trends. The budget breakeven price rose sharply in recent years, from $50 per barrel in 2008 to about $70 per barrel in 2012. The situation varies widely between countries. Kuwait, Qatar and UAE are in an acceptable position while the vulnerability of Saudi Arabia and especially Oman is much stronger, with an equilibrium price that is approaching current market prices, at $78 and $97 in 2012, respectively. With a breakeven price of $130 in 2012, the situation in Bahrain is the least sustainable and should continue to deteriorate, at least in the short term. Increasing budget dependency on oil income and growing vulnerability to oil prices are in part due to cyclical factors: with the Arab Spring and the political changes that have swept the Arab world since 2011, governments have worked hard to curtail social pressures by increasing budget spending, notably in terms of public sector wage increases and job creations.

**Breakeven oil prices**

For the past ten years, the negative effects of the dependency of public revenues on oil income have been offset in part by the creation of sovereign funds, which limit their dependency on oil cycles, and by the governments’ determination to increase public capital expenditure to accelerate the expansion of the non-oil private sector. The development of sovereign funds over the past 15 years has reduced budget volatility by favouring a kind of counter-cyclical budget spending. Current account surpluses have been placed in relatively diversified assets that generate additional revenues, which can surpass 10% of total budget revenues (in Qatar, Kuwait and UAE, for example), and which can be used to cover any eventual deficits. The macroeconomic stability arising from a more cautious approach to the management of public finances coupled with development plans geared specifically towards the non-oil private sector have had a notable impact on the growth of non-oil GDP.

**Export revenues**

At first sight, export revenues are still highly dependent on oil income, since about 80% are generated by oil exports. However, a look at export trends in the non-oil sector shows a positive increase as of the year 2000s in all of the GCC countries (see chart 8).

**Non-hydrocarbon exports, index base 1989=100, in value**

Growth is strongest in Oman, Qatar and Saudi Arabia. In Kuwait, the lack of economic diversification limits the increase in non-oil exports. Moreover, in the UAE and Bahrain, which traditionally have the most diversified economies in the region and thus benefit from a carryover effect, non-oil exports are growing, but at a slower pace. Export revenues in both countries are comprised notably of services (tourism, transport and finance). After integrating services into the equation, Bahrain’s dependency on oil exports drops to 65% (2010 data), compared to 80% when only goods are taken into account. In the UAE, the integration of services brings the level of dependency to 57% from 60% (2011 data).

From a sector point of view, non-oil exports of goods are concentrated primarily in sectors for which the availability of cheap energy is a key advantage (the
authorities provide energy at below world-market prices). This mainly concerns refining and petrochemical industries as well as a few heavy industries such as aluminium production. On the whole, the dependency of exports on the hydrocarbon sector has been strong and relatively stable over time. This observation should not be allowed to mask the rapid growth of merchandise exports in the non-oil sectors. These sectors really began to boom as of the 2000s, in keeping with the industrial development observed throughout the region. Growth of non-hydrocarbon exports is strongest in Oman, Qatar and Saudi Arabia.

Contrasting evolution of economic structures

An analysis of changes in non-oil GDP as a share of total GDP shows that diversification is generally on the rise, albeit at a slow pace.

**Rapid growth of non-oil GDP since 2000**

Unsurprisingly, Bahrain’s GDP is the least dependent. More noteworthy is the situation in Saudi Arabia, which reported the strongest diversification of the oil producing countries: practically 80% of GDP in 2012 vs. 61% in 1990, comes from non-oil sectors. In contrast, Qatar has the least diversified economy and the trend has been negative for the past two decades: 56% in 2012 compared to 60% in 1990.

Non-hydrocarbon GDP, average annual growth in volume

![Chart: Non-hydrocarbon GDP, average annual growth in volume](chart9)

If we look at the growth in value of non-oil GDP, we can see a very strong increase in Qatar, while Saudi Arabia reported weaker growth (see chart 9). This apparent contradiction between the two measures reflects structural differences in the two economies and their modification over time. In Saudi Arabia, industrial sectors (petrochemicals) and services are a rather old development: consequently they have evolved more slowly over the past two decades. In Qatar, the boom in the natural gas sector has dramatically changed the structure of GDP since the end of the 1990s. Although the non-oil sector has grown rapidly, the development of natural gas has reduced its importance for the economy.

**Dynamic momentum in the services sector**

Non-oil sectors have been the motors of economic growth in all of the GCC economies. Services were by far the most dynamic sector, with average growth of about 2.8% between 1991 and 2009 for the region as a whole, compared to less than 1% for the extraction sectors and 0.5% for manufacturing industries (see chart 10). The growth of services primarily accelerated as of 2001, notably in Qatar (+6.2% on average) and Bahrain (+5.3%). Preliminary assessments of the change in productive structures seem to be positive: traditionally the most diversified countries continued to progress (Bahrain, UAE) while those with larger energy resources reported spectacular increases in non-oil GDP.

Average sectoral contribution to non-hydrocarbon sector growth, in volume

![Chart: Average sectoral contribution to non-hydrocarbon sector growth, in volume](chart10)

**Mild gearing effects**

However, diversification is largely incomplete and continues to reflect a rentier economy, both in manufacturing and services (see chart 11). As we pointed out above, although the region’s industrial development can be considered a success from a sector point of view -- the Middle East (mainly the GCC) has become the world’s biggest exporter of petrochemicals and owns 8.5% of world refining capacity -- the industry remains highly dependent on the energy sector. By industrial sector, the strongest growth is in activities using hydrocarbons as a raw material (refining,
Despite strong growth in the non-oil sector (8% on average in real terms over the period 2007-2012), its job creation potential falls far short of the needs of the job market for nationals. A major share of non-oil sector activities is not very rich in employment (downstream oil industries) or its development potential is relatively limited (low value-added services). In 2011, 844,000 Saudis were employed in the private sector out of a total employable labour pool of about 4 million. Assuming private sector employment grows at an annual rate of 10% (vs. 11.3% in 2011) and has the same structural profile (11% of private jobs are held by nationals), the private sector has an absorption capacity of only 84,400 nationals, compared to 400,000 new entrants on the job market each year. Seeing that it must go beyond the natural growth rate of the job market, the government has set up a system of incentives with quotas for nationals in private sector companies. Until 2011, however, this policy has had only very limited results.

The political upheavals in the Arab world since 2011 have led the authorities to accelerate the “Saudization” of private sector employment. Jobs policies set up since 2011 are much more proactive and use methods that are more interventionist than before. Quotas for Saudi employees were set by sector of activity, along with potentially severe penalties in case of non-compliance (refusal to issue new visas for hiring foreign workers, exclusion from public contracts, and impossibility to receive business licenses or permits). Moreover, the introduction of a public sector minimum wage will serve indirectly as the wage base for Saudis working in the private sector. It is still too early to draw any conclusions on the accelerated Saudization programme to boost employment among nationals. The government announced the creation of 300,000 jobs for nationals over the past 18 months. Only a third of companies managed to reach their quota target, and the programme has had to be scaled back for small businesses with few employees. Looking beyond the positive short-term impact, it seems these measures will have a relatively slow uptake rate – or risk disrupting corporate functioning – with only a limited impact on unemployment, given the number of jobs that need to be created and the structural rigidities of the Saudi labour market. Nationals will continue to have a strong preference for public sector jobs in the medium term, especially since the massive increase in public expenditure since 2011 has notably been accompanied by the creation of public sector jobs. Given the downside rigidity of wages for nationals, developing employment
also means increasing productivity and thus an improvement in the level of human capital. For years, the government has launched major efforts to improve education\textsuperscript{5}, but they will not produce any immediate effects (education expenses have increased 14\% a year on average since 2008). For the moment, only a limited number of labour-intensive manufacturing industries or high value-added services have been set up that are capable of creating jobs and diffusing their technological content to the rest of the economy.

All in all, notable progress has been made towards economic diversification, mainly since 2000. Yet this first impulse is still highly dependent on government actions (infrastructure, industrial development, services more or less associated with oil income, and job market initiatives). Moreover, the most developed non-oil sectors still have only a limited gearing effect on the rest of the economy: energy intensive industries are still highly productive and closely tied to the oil sector. In general, services are not very productive, generate little value added and have a feeble gearing effect on the rest of the economy. With the exception of the UAE, much still needs to be done to develop economic sectors that are not dependent on oil income. The accent on education in recent years and the more recent launch of higher education and research programmes in association with international universities could trigger positive momentum to improve local human capital and to encourage the development of high value-added activities outside of the sphere of a rentier model based on oil income.

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Average annual price of oil on the world market (in this case, Brent spot in US$) needed to balance public finances in a given year.

When Saudis are paid less than the public sector minimum wage, an increase in the Saudi quota is imposed on the company.

Education expenditures rose from 10% of total spending in 1970 to about 25% at present. Over the same period, the level of alphabetisation leaped from 15% to 97%.

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