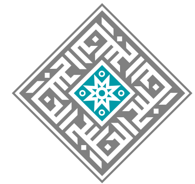
The Gulf Research Center's Thinking About the Economies of the Gulf Since 2000



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The study of Gulf economies has not been an easy task over the last decades. The Gulf Research Center was established right before the latest oil boom the Gulf witnessed in the 2000s. The GRC tried to cover with objectivity the different aspects of the region's attempts to diversify away from oil, from the Dubai-city model to the infrastructure boom witnessed throughout the rest of the Gulf economies in the first decade of the 2000s. The GRC made a noticeable contribution when it came to economic conferences and workshops, which no other center was managing at a time. Objectivity and impartiality was what defined the GRC in all its workings, sometimes to the objection of stakeholders, as a think tank's constructive criticism is part of its defining DNA.

> **"The GRC made a noticeable contribution when it came to economic conferences and workshops"**

From the outset, the GRC approached the study of the region's economies from the principle of having evolved significantly over the past decades, but further diversification was and is essential. The GCC countries have been implementing many policies to support economic diversification, including reforms to strengthen the business environment, develop infrastructure, increase financing for companies (particularly small and medium-sized enterprises (SMEs), and improve educational outcomes. While the share of non-hydrocarbons output in GDP has increased steadily, export diversification has been more limited. Further diversification would make Gulf economies less reliant on volatile hydrocarbon revenues (as the latest 2020 crisis indicates), would create high-value-added private sector jobs for nationals, and would establish the non-oil economy that will be needed when oil reserves are eventually exhausted.

The multiple economic workshops held by the GRC concluded that international experience in diversifying away from oil is very difficult. A number of key obstacles often hinder diversification, including the economic volatility that is induced by reliance on oil revenues, the corroding effect that oil revenues have on governance and institutions, and the risks that oil revenues lead to overvalued real exchange rates (traditional Dutch-disease issues). Success or failure appears to depend on implementing appropriate policies well ahead of the decline in oil revenues. There are few relatively successful diversification cases (Indonesia, Malaysia, Mexico), but many examples of failure.

The GRC has been of the view that the GCC does not appear to suffer from traditional Dutch-disease problems that afflict many commodity-producing countries via an overvalued real exchange rate, the distribution of oil revenues within the economy may crowd out non-oil tradables production in other ways. The ready availability of low-wage expatriate labor in the region has meant that high oil revenues and oil wealth have not pushed up wages in the private sector; consequently, conventional Dutch-disease effects have not been evident. However, the distribution of oil revenues does have important effects on the incentive structure in the economy that crowds out non-oil tradables production.

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The relatively higher wages and benefits available for nationals in the public sector often make it a more attractive employment choice, particularly for lower-skilled workers, compared with the private sector. At the same time, for firms, producing goods and services to meet the consumption and investment needs of the domestic market while relying on low-wage foreign labor is a more reliable income source than attempting to enter riskier export markets. The risk-return trade-off favors the nontradables sector. Improving the business environment, investing in infrastructure, and reducing regulations are very important to spur tradables production, but will not be sufficient unless the incentive structure within the economy, for both workers and firms, is changed. Reforms are therefore needed to change the existing incentive structure. Nationals need to be encouraged to seek private sector employment and firms to develop business models that have an increased focus on the tradables sector. In this context, this paper sets out the case for export diversification in the GCC, assesses progress to date, and considers the policies that are needed to spur further diversification. It particularly highlights a "missing link" in current policies—the need to fundamentally change the incentive structure of firms and workers.

"A number of policies and initiatives have been implemented in recent years to improve the business climate across the GCC"

The GCC economic model relies on oil as the main source of export and fiscal revenues and that became apparent in all GRC studies. The government is the dominant force in the economy, receiving oil export revenues and in turn distributing them to citizens. A portion of these revenues is spent directly by the government and provided to citizens through transfers and public sector jobs; another portion is invested in infrastructure and real estate, education, and health; while the rest is saved, including in sovereign wealth funds (SWFs). Most GCC countries have long oil and/or gas production horizons and, consequently, have significant wealth underground as well as saved in SWFs or at the central bank. This growth model has helped achieve rapid economic development and a significant improvement in social indicators.

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Over the past two decades, the GCC has been one of the fastest-growing regions in the world because it has benefited from rising oil prices; sound macroeconomic policies; investments in health, education, and infrastructure; and reforms to the business environment. Human development index scores have improved substantially, infant mortality has decreased, expected years of schooling have increased; and life expectancy has risen. Yet, the growth model has been facing weaknesses. Over the past two decades, strong GDP growth was supported by rising government spending, financed by rapidly increasing oil revenues. However, with oil prices unlikely to show significant increases going forward, this growth strategy may no longer be viable. Moreover, even with strong growth, average labor productivity growth has been weak or negative and total factor productivity growth for the overall economy and for the non-oil economy has been negative, with only Saudi Arabia experiencing slightly positive Total factor productivity (TFP) growth in the non-oil sector. Indeed, a sectoral decomposition of employment and average labor productivity in Saudi Arabia over the past decade has found that employment is increasingly shifting toward sectors with relatively low productivity (for example, construction and nongovernment services). Private sector activity has remained concentrated in low-skilled nontradables sectors. These trends contrast with the international growth experience.Empirical studies have documented a strong association between economic diversification and sustained growth for low- and middle-income economies. Higher GDP per capita and lower volatility are strongly positively associated with diversification of output and exports in low- and middle-income countries. Diversification in output and exports are closely linked to one another and are considered to be the outcome of structural transformation—the dynamic reallocation of resources from less productive to more productive sectors and activities.

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This transformation involves a reallocation away from agriculture and natural resources and toward manufacturing, as the latter has greater potential for improvements in productivity and upgrading quality. However, as countries become wealthier and reach advanced-economy status, their diversification declines. The decline in diversification at high income levels involves specialization in high-value-added products.

Higher income levels are also strongly associated with export quality upgrading and greater exports sophistication. Exports can provide an important channel for utilizing economies of scale and a path to new technologies and knowledge spillovers. Lucas argues that constantly introducing new goods rather than learning only with a fixed set of goods is needed to generate productivity gains and move up the quality ladder. Aghion and Howitt emphasize the importance of innovation and moving up the quality ladder. To accumulate human capital, boost productivity, and move up the quality ladder on a large scale, the country must be a large exporter. Evidence shows that export quality upgrading is strongly associated with higher per capita income. Some studies have also found that export sophistication is a major predictor of subsequent growth, even after controlling for initial conditions, institutions, financial development, and other growth factors.

“GCC countries have sought to diversify their industrial base and service sectors”

of policies and initiatives have been implemented in recent years to improve the business climate across the GCC. Wide-ranging reforms have streamlined the legal and regulatory environment in a number of areas, including start-up and licensing procedures for businesses, competition policies, investor and consumer rights, and bankruptcy and company laws. Financial market infrastructure has been enhanced to improve credit information and transparency in financial markets. A number of policies geared toward the support, development, and promotion of SMEs have been enacted (for example, through extending affordable bank sector loans, loan guarantees, feasibility studies, and establishment of a national fund for SME development in Kuwait).

“Financial market infrastructure has been enhanced to improve credit information and transparency”

GCC countries have sought to diversify their industrial base and service sectors. The GCC countries have developed oil-related industries, tourism, logistics, transportation, business, and financial services. For example, Bahrain has invested in an offshore financial sector, while the United Arab Emirates and Qatar have developed airlines and logistics with the former developing into a major trade and services hub in the Middle East.Saudi Arabia is developing industrial and economic cities to promote technology and industrial and service clusters around oil and mining. Kuwait is developing downstream oil industries and Qatar has established industrial cities to house a mix of energy-related industries to help integrate upstream and downstream hydrocarbon activity, however, suggests that while the investments in chemicals and energy-intensive sectors like aluminum have helped diversify production and exports, industries have few links to the rest of the economy. Local sourcing of tradables has not been developed, and most of the complex technology is still imported because investment in research and development is low. As a result, the productivity gains and spillovers have been limited and the employment impact of these capital-intensive industries is small.

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Multiple studies of the GRC concluded that the GCC economic model rewards firms that produce in the nontradables sector. Producing in the tradables sector is typically more challenging and riskier because firms have to continually invest in new technologies to be internationally competitive; albeit, it can enable them to grow faster if the domestic market size is small. In the GCC, producing nontradables is less risky and more profitable for the following reasons, iterated in multiple GRC workshops:

- Rapid growth in government spending on infrastructure and wages has contributed to strong growth in low-value-added sectors such as construction, trade and retail, transport, and restaurants. Producing goods and services to meet the consumption and investment needs of the domestic market has so far been a reliable income source, made possible by recycled oil revenues. This has provided incentives for economic activity to shift into mostly low-skilled sectors, contributing to declining labor and total factor productivity. In fact, large infrastructure projects may exacerbate the crowding out of the tradables sector as they increase risk-adjusted returns in the nontradables sector.
- The availability of low-wage, low-skilled foreign workers has helped firms to extract large rents. Reservation wages of low-skilled foreign workers are often set in their home countries because they have limited bargaining power and mobility in the GCC labor market. The coexistence of large increases in their employment with declining average labor productivity over time suggests that wages for this group of workers may lie below their marginal product, leading to large rents for firms. In equilibrium, this is also consistent with the existence of entry barriers in product and labor markets.
- The GCC immigration system does little to attract high-skilled, high-productivity workers. In today's global economy, high-skilled workers are internationally mobile and countries compete to attract them. The GCC framework of employer sponsorship does little to distinguish between high- and low-skilled workers and provides employers with limited flexibility to attract top talent.

The presence of oil revenues may crowd out the production of non-oil tradables goods and services. This crowding out is important because the non-oil tradables sector will not develop to eventually replace oil when oil resources deplete in the future. The GCC countries do not appear to suffer from traditional Dutch-disease problems that hold back the development of the non-oil tradables sector because the ready availability of low-wage expatriate labor in the region has meant that high oil revenues and oil wealth have not pushed up wages in the private sector and, consequently, conventional Dutch-disease effects have not been evident.5 However, the distribution of oil revenues does have important effects on the incentive structure in the economy, which crowds out non-oil tradables production. First, for domestic firms, the availability of government contracts in the non-traded sector provides a means of realizing healthy profits at relatively low risk compared with gearing business plans toward export-oriented activities. Second, for national workers, the relatively higher wages available in the public sector are a more attractive employment choice, particularly for the lower skilled, than private sector options. Indeed, these two effects on the incentive structure have historically been self-reinforcing. The lack of high-paying jobs in the private sector means that young people have an incentive to get an education that is suited to employment in the public sector, while the lack of nationals with the skills needed for the private sector combined with an immigration system that may discourage high-skilled expatriate labor has left firms unable to produce the higher-value-added tradables goods that can compete internationally.

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A number of measures have been highlighted by the GRC that could help to strengthen the incentives for, and abilities of, nationals to work in the private sector. These include the following:

- Limiting government employment—Firm limits need to be placed on public sector jobs and wages, and it should be clearly communicated to people that they should not expect to obtain a public sector job. Transitioning to a model with smaller public sector employment could be accomplished in the context of a civil service review to ensure that nonessential positions are eliminated as they become vacant.
- Strengthening social safety nets—Rather than using public sector employment as a safety net, unemployment insurance and job search support needs to be in place to ensure that those without a job have a minimum income level and the incentives to search for employment. As in Belgium and Germany, vouchers could be used for various training programs, apprenticeships, and vocational education to support retraining and skills acquisition where needed.
- Ensuring that the education and training systems provide workers with the skills needed for private sector employment—Oil revenues can be used to increase investment in education and skills development. Further, improving the quality of schools and universities and creating apprenticeship and vocational programs could provide the relevant skill sets. Improvements to teacher quality and early childhood education can help boost student achievement and change societal attitudes.

It would be improper to merely list the countless workshops and publications the GRC has published over the course of two decades on the economy. Certainly, the research community has benefited greatly from the GRC's contribution. Its legacy remains unmatched in the Gulf and its imprint is visible.

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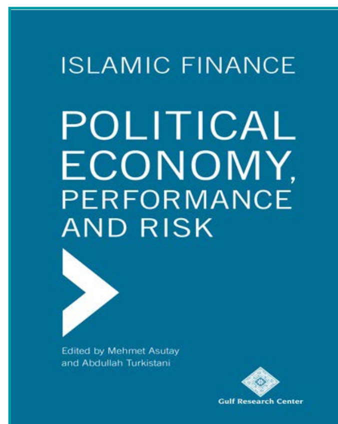

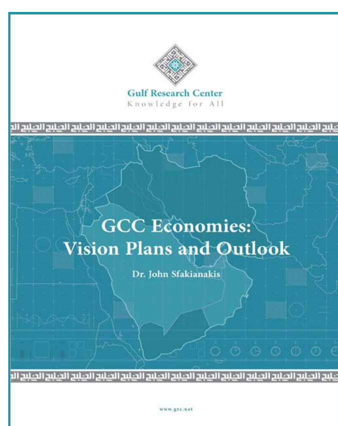

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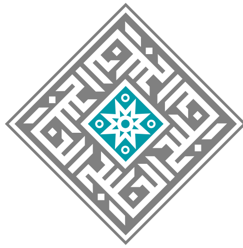

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