Economic Diversification in the GCC

Dialogue Snapshot Report
February 2020

the Hollings Center
for international dialogue

Dialogue Summary

In all six Gulf Cooperation Council (GCC) countries[1], the bulk of government revenues comes from hydrocarbons. Despite the recent rise in the price of oil, some countries in the GCC face a harsh economic outlook due to unemployment, high debt levels, and strained financial markets. In addition to the socioeconomic challenges, GCC countries are likely to feel the increased impact of climate change over the next decades, as well as mounting geopolitical and security concerns. Shifts in U.S. policy in the Middle East; increased engagement from China; ongoing conflicts in Syria, Yemen, and Iraq; as well as tensions between regional powers provide increased impetus for inter-GCC dialogue, and coordination with international partners like the United States and the European Union.

Against this backdrop, the Hollings Center for International Dialogue and the Brookings Doha Center convened experts, scholars, and international organization representatives to discuss the incentives and disincentives for economic diversification in the GCC. Held in Muscat, Oman, in February 2019, the dialogue reflected diverse viewpoints that loosely converged around the following points:

- **GCC nations are at different points in the economic diversification spectrum with varying levels of success.** This new normal is disincentivizing leaders from implementing reforms that will have a hard impact on the incentive structures in the economy.

- **Incentives for the private sector are missing.** Measures to address these incentive issues could include limiting and reorienting government spending, strengthening private sector competition, providing guarantees and financial support for those firms engaged in export activity, and implementing labor market reforms to make nationals more competitive for private sector employment.

- **Work culture needs to change in GCC countries, while labor market reforms are sorely needed.** Young people's sense of entitlement, regarding education as almost an unemployment benefit, and lax work ethics are impediments to maintaining high-quality human resources for a globally competitive private sector.

- **Leaders need to find ways to share wealth other than employing people in the public sector.** Universal basic income or transitioning to a more conventional welfare state can be two models.

- **Economic challenges are anchored in politics.** Policymakers speak to each other and to consultants, and this creates a gap between them and the public. **A new social contract—a redefinition of the parameters of state-society relations, especially as they pertain to the economy—is needed.**

[1] The GCC is comprised of Bahrain, Kuwait, Oman, Qatar, the Kingdom of Saudi Arabia and the United Arab Emirates.

Economic Diversification in the GCC

Why Diversify?

Global economic prospects are weakening due to U.S.-China trade tensions, tightening U.S. financial policy, Europe's economic woes due to Brexit and other factors, and high debt in GCC countries. Oil prices are unlikely to rise due to growing output most significantly from the United States. Uncertainties in some oil-producing nations like Iran and Venezuela are also not enough to increase prices significantly. Countries of the GCC are now grappling with where growth will come from if not the oil sector. How will it be possible to create alternative pathways for economic growth when the public still enjoys oil revenue distribution? How can governments move resources from low- to high-productivity sectors and increase economic complexity in their countries, defined as the diversity of exports a country produces and their ubiquity?[2]

A participant pointed out that the energy market is always in transition, meaning oil prices have historical upward and downward trends. In other words, the current outlook is not unprecedented. The question is, how will GCC countries navigate the lower oil price era, and what reforms will they be able to implement to decrease their dependency on this volatile commodity? Participants discussed policies such as devaluation and reduction of public expenditure as possible ways to endure this climate. Energy demands will dramatically increase with global population growth, which means that oil will remain a commodity in demand regardless of the rising share of other energy sources such as liquefied natural gas (LNG) or renewables within the market.[3] The key is to understand the shift in demand, with China and India as the foremost consumers of energy, and Africa as a speedily emerging market. Participants emphasized the need for GCC countries to gear their trade policies to accommodate these non-Western partners.

"How do you convince policymakers and governments who have seen so many of these economic cycles with oil prices falling, and who have been warned by economists so many times before regarding the need for diversification, that this time it is for real?"

The Organization of Petroleum Exporting Countries (OPEC) used to be the umbrella structure under which these issues could be addressed strategically and regionally. However, that organization has remained largely irrelevant in the recent years. A participant suggested that OPEC should broaden its scope to include shale and other energy sources to be able to better prepare both the supply and demand sides to the volatility of the energy market in the future.

GCC countries have the necessary assets for diversification: high-quality infrastructure, stable political environment and service provision, and low-cost and abundant capital. A

[2] Atlas of Economic Complexity, Glossary, http://atlas.cid.harvard.edu/glossary.

[3] Based on current and announced policy frameworks, oil will make up about 28 percent of the global energy mix in the year 2040, reflecting an increase of 400 million tons of oil equivalent (MTOE) from 2018. International Energy Agency, World Energy Outlook 2019, https://www.iea.org/reports/world-energy-outlook-2019.

participant underlined that the good practices in diversification also need to be visible. For instance, spending oil revenue within the economy significantly declined in Saudi Arabia, but the country is still being pushed for more diversification. The participant questioned whether diversification efforts were the best channel for sovereign funds, which have been instrumental in stabilizing government spending.

All six countries in the region have been developing long-term plans that they call "Visions" (such as "Saudi Vision 2030," "Oman 2020," "Abu Dhabi Economic Vision 2030," among others), in which they are striving to create a more foreign direct investment (FDI) friendly environment by improving governance and accountability. These efforts were welcomed by some participants, while others were more skeptical toward implementing these plans.

The Challenges of Economic Diversification

Participants agreed that pockets of diversification exist within different countries and sectors, but there are three reasons why these limited experiences have not been able to grow. First, the political equilibrium among GCC countries has made it hard for any single country to maneuver in terms of its trade and oil policies. Second, the cost of reducing public spending to channel resources into growth and job creation is politically high, and it is the bitter pill no leader wants to swallow. Third, demographic growth is putting a strain on service provision, infrastructure, and jobs. Finally, there is lack of know-how on diversification, and a lack of experience on implementation.

> **"Should a country be pushing and pressuring its own economic institutions when it is trying to compete within these regional tensions? I am concerned that diversification becomes too subordinate to political objectives and foreign policy."**

Participants accepted that the current intra-GCC tensions will not easily be solved. However, leaders stand to lose a lot more economically, compared to what they might gain politically from any grandstanding with neighboring countries. For innovation and new technologies to catch on, there needs to be an overhaul of trade and industrial policies, requiring wider and deeper regional integration, as none of the GCC economies are large enough by themselves. Moreover, there needs to be better integration with Asia and Africa, but more specifically China.

In terms of improving governance, laws allowing for 100 percent foreign ownership of direct investments, as well as public-private partnership (PPP) laws are encouraging, but application is yet to be seen. Some participants pointed toward weak economic leadership and institutions, and poor management of the business cycle—meaning relying too much on hydrocarbon revenues instead of more durable solutions to problems such as recession. Participants believed the role of the state in pushing private sector development and incubating certain industries is understandable, but once they take off, subsidies should not be provided as they come at the expense of taxpayers and consumers, without any value added. Subsidies, if any, need to be geared toward encouraging youth employment, and for innovating industrial policies through fintech.

View from Nizwa Fort, Oman. Oman has taken significant steps to begin diversifying its economy, particularly focusing on education. Image source: Sanem Guner.

One major challenge that participants repeatedly underlined was that of human resources. GCC countries are falling short of accumulating human capital even with high levels of spending on education. Participants underlined the need to focus on science, technology, engineering, math (STEM) as well as “digital education for digital employment,” all coupled with gender policy, in order to increase employability skills of graduates. One participant contended, “It is not necessarily the skills that are missing, but it is the new generation of workers that see themselves as entitled.” Others said that human capital could indeed be an asset if it receives investment.

Changing Labor Mentalities and Practices

Participants converged around three main questions in the discussion on reforming the supply and demand sides of labor: (1) how to move away from government employment as the key welfare provider; (2) how to reach out to women and youth as the underused potential that could dynamize the labor force as economies branch out into different sectors; and (3) how to encourage vocational and technical training for the economy’s need for intermediate personnel.

On the first issue, there were not many specific policy proposals, but rather a general agreement that a new social contract is needed. A participant cited the results of a recent survey he conducted in the Gulf. According to his research, citizens agree strongly with principles of entrepreneurialism, and believe that the government should not intervene. However, when asked about labor expectations, people demand guarantees by their governments. So, what can leaders do? Leaders may choose to continue the status quo, or take action. If they choose the former, this might cause public dissent and ultimate upheaval, as seen in the Arab Spring. If leaders opt to be proactive, they start by fixing macroeconomic imbalances, reducing inequality by improving equal opportunity, and creating growth—not through capital accumulation as in the past, but by increasing productivity.

"Energy used to be the glue that held the GCC together. I came to this dialogue to answer the question, "what is the new glue?"

Another key discussion was on how to overcome the cultural, religious, and structural barriers that are keeping women out. A McKinsey report found that if the gender gap in economic participation of women were fully closed, it could add $2.2 trillion USD to the combined gross domestic products of GCC. Some participants asserted that the problem of unemployment had to be seen comprehensively, and singling out incentives for increased women's employment could prove counterproductive. Others suggested a tradeoff between foreign labor and women, which was contended by some participants. A participant raised the question of what to do with the highly educated female population in the Gulf—more females enroll in tertiary education in the GCC than males, but more university graduate females are unemployed.[4] The one glimmer of hope is that, as one participant reminded, the issue of women's participation in the economy is not a problem endemic to the GCC, and we have seen progress elsewhere. So, with the right approach that can demonstrate a win-win scenario to employers, and the will from many countries in the region to change the status of women in public life, some changes might be in store.

As GCC governments are substantiating their medium-term "Visions," an important objective is to promote knowledge-based economies. However, the generous wealth distribution in the GCC (thanks to oil revenue-based economies) has created distortions in the labor market, with 70 percent of workers in the service sector. A solution has been to push people into receiving education, but this is not sustainable in the long term because the economy will not need as many white-collar workers. A solution that participants agreed on was for the private sector to think more creatively in terms of what they can offer to this transitioning workforce. Opportunities may fall short of full-fledged employment, but would still benefit especially the younger cohort in the labor force in terms of skills and experience acquisition. Internships, apprenticeships, and career development programs were among some examples cited.

The GCC Factor

It would be impossible to address some of the structural challenges within GCC countries without understanding the challenges within the GCC as a regional body. The Council came about with the primary aim of economic development cooperation, and a secondary aim of providing regional security. After the members moved to a common market, intra-GCC trade accelerated; there were many joint projects such as the electricity grid, Gulf rail and Gulf

[4] https://agsiw.org/small-victories-for-gcc-women-more-educated-more-unemployed/

pipeline, and cross-investment at the regional level. These were promising in terms of connecting the people across different countries. But when it came to political and security issues, GCC members remained incohesive, in the sense that they never moved beyond statements of coordination. Most recently, the Arab Spring brought to fore the disagreements within the body and proved that there is no consensus on security. These tensions undermine the GCC and its strategic relationship with regional and international partners.

Participants discussed if the GCC has become a failed or moot regional body such as the Arab League. Some participants said that the members are simply re-aligning, which doesn't exclude the possibility of regional cooperation. They added that the GCC secretariat has been alive and active for the past 40 years, and this is not the first time that the body's functionality has come into question. Those seeing the future of the GCC as bleak predicted a post-GCC bloc on one side, and Qatar reaching beyond the region to find partners on the opposite side. A participant said, "A reconstruction of the sub-regional, multilateral arrangements is in order, but at the expense of the GCC." Others said that the GCC was never able to build strong institutions that were able to assume the sovereign powers of its member states, and that is why it is breaking down. Nevertheless Oman, the then-president of GCC, has been trying to reinvigorate the regulations built around societal integration at a multinational level, and it was commended for its efforts.

Other significant points in this debate included the disproportionate role and influence of Saudi Arabia, the role of non-Arab countries, and the need for GCC to define its own security parameters independently from imposed agendas. Some participants pointed to the shifting security priorities within the GCC, from the Israeli-Palestinian conflict to tensions with Iran. This is not so much a sign of the changing times, but rather a sign of changing U.S. priorities and favorites in the region. Some participants questioned the U.S. motives in the policies it has pursued in the recent past, such as President Trump paying his first international visit to Riyadh, and alienating Qatar; whereas others said that this is more a reflection of the inter-institutional dynamics within U.S. foreign policy making.

There was some discussion around U.S.-GCC relations in the face of China's increasing presence. The economic stakes are too high to not strategize the relationship with China, or make it hostage to the U.S.-China rivalry, according to participants from the Gulf. Nonetheless no Arab country has a China policy, and as a result, the Belt and Road Initiative is now slated to bypass Gulf countries.

"China understands the region extremely well. Most Chinese diplomats speak Arabic and understand the culture and people very well, which is different than the US and the EU."

The Forest through the Trees: What Will Diversification Solve?

Moving economic activity away from oil-related industries, creating different employment incentive structures, and transforming national wealth-sharing structures are hard tasks that will require technical expertise, political will, and public buy-in. Participants identified several larger considerations for GCC leaders to take into account as diversification efforts gain speed:

1. **The youth surge.** In all GCC countries, a demographic transformation exists where an increasing number of young people are demanding education, jobs, and services.

2. **Income Inequality.** GCC is one of the most unequal regions in the world if one looks at asset distribution in addition to income distribution.

3. **Reform capacity.** Many GCC countries host foreign consultants at high fees to advise on economic reform packages, but much of their recipes do not trickle down to administrative levels, or are not implemented for fear of losing popularity in the public eye.

4. **The role of the military in the economy.** The level of asset accumulation and spending by the military is unprecedented. How can this spending be channeled into development?

5. **A new social contract.** Commonalities run through reconstruction experiences of different countries at different periods. A participant gave examples from Turkey, Japan, and Malaysia, and said, "elite consensus around reform, traditional forces being sidelined, strong and effective state, openness to globally mainstreamed economic practices" were elements these countries shared. The participant then asked, "Are these realistic things to expect from the GCC?" "There are no comparable models, and the region will have to chart its own course," another participant added. What the new state-society relationship will look like and how the social side of any economic transformation will be managed are yet to be explored.

Cover Painting: Osman Mohammad: After the Shower (Seria Town's Mosque), 2017

The Hollings Center for International Dialogue is a non-profit, non-governmental organization dedicated to fostering dialogue between the United States and countries with predominantly Muslim populations in the Middle East, North Africa, South Asia, Eurasia, and Europe. In pursuit of its mission, the Hollings Center convenes dialogue conferences that generate new thinking on important international issues and deepen channels of communication across opinion leaders and experts. The Hollings Center is headquartered in Washington, D.C. and maintains a representative office in Istanbul, Turkey.

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http://www.hollingscenter.org/about/mission-and-approach
info@hollingscenter.org