

# The GCC: Increasingly Diversified Economies

## Highlights

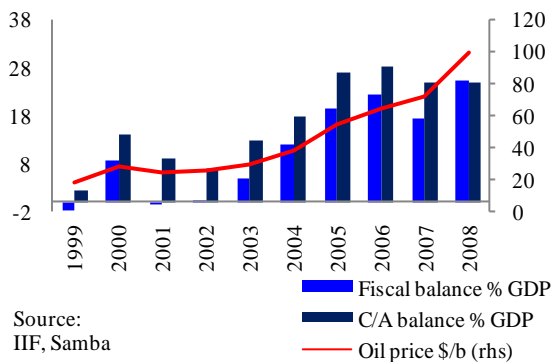
- Over the past two decades the economies of the Gulf Cooperation Council (GCC) have undergone an impressive economic transformation which is still underway. Concerted government policies have led to increasingly diversified economies and large external savings, which have helped the region weather the recent global economic and financial crisis.
- GCC governments have used the oil windfall of 2003-08 to good effect, initially by paying down government debt and building up foreign assets, and later by using the fiscal space afforded by increasing revenues to implement ambitious investment programs aimed at diversifying their economies and providing employment.
- Real growth in the region's non-oil sectors averaged between 4-10 percent a year during 1999-09 and was the main driver behind annual average GCC real GDP growth of 5 percent. Country circumstances vary, but the structure of GCC economies and the composition of their exports are changing, particularly in the UAE and Bahrain where the non-hydrocarbons sector now account for between 60-70 percent of GDP.
- GCC governments have implemented a variety of measures to boost private sector activity and encourage foreign investment, and their success in this has been recognised by a number of surveys that rank global business environments and competitiveness. More significantly, foreign direct investment into the region has surged over the past five years.
- Although diversification is gathering pace, hydrocarbons still play a dominant role. They provide the majority of government revenues, and are likely to do so for some time given the region's still vast oil and gas reserves. This dependence remains a source of vulnerability given the volatility of world prices and the finite nature of these reserves. However, GCC governments are proving themselves increasingly adept at managing large and volatile revenues, and in avoiding the so called 'resource curse'.

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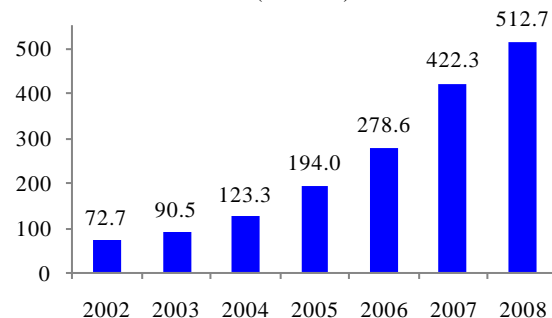
*While still heavily dependent on hydrocarbon revenues, GCC economies are undergoing an impressive economic transformation which has resulted in growing non-oil sectors.*

**GCC saved much of the 2003-08 oil windfall**



Source: IIF, Samba

**GCC: Central Bank External Reserve Assets (\$ billion)**



Source: Central Banks

## The GCC: Increasingly Diversified Economies

The resilience of GCC economies (comprising Saudi Arabia, the UAE, Kuwait, Qatar, Oman and Bahrain) during the steep global recession and slump in oil prices is testament in part to the successful economic diversification and development programs which have been pursued over the past couple of decades. While still heavily dependent on hydrocarbon revenues, GCC economies are undergoing an impressive economic transformation which has resulted in growing non-oil sectors. In addition, governments have taken advantage of the boom in oil revenues during 2003-08 to build up large external savings. These external assets have been drawn upon to smooth the downturn in revenues following the steep decline in oil prices from their mid-2008 highs, helping to sustain growth in the region's non-oil sectors despite the difficulties presented by the slump in global trade and growth. In most GCC countries expanding non-oil sectors during 2009 were sufficient to keep overall real GDP growth positive, despite large contractions in oil sectors as both production (due to cuts in OPEC quotas) and prices fell.

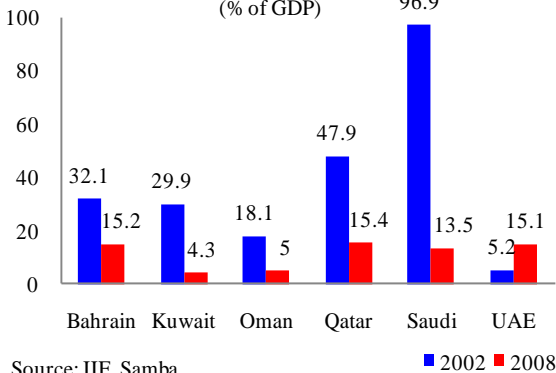
The ability of the GCC to use counter cyclical fiscal policy to support their economies stems from its dual approach to utilizing its oil wealth. Consistent with the oft cited 'permanent income hypothesis'<sup>1</sup>, GCC governments have saved a large proportion of oil revenues which have been invested into foreign assets (often through Sovereign Wealth Funds), the returns from which support spending on the non-oil budget. At the same time, GCC governments have used oil and gas revenues to fuel industrial development, and large scale public infrastructure and investment programs, including in education, aimed at improving the environment and returns for private investment, and boosting employment outside the government sector. Where completed, these investment programs have already helped expand productive capacity outside the immediate oil sector (for example in petrochemicals, aluminium, tourism and trade), and during implementation have fuelled strong growth in GCC construction sectors.

### Using the oil windfall 2003-08

A windfall in oil revenues such as experienced by the GCC during 2003-08 presents governments with a number of choices of how to manage public finances. Is it best to pay down debt; accumulate foreign assets; invest in public infrastructure to stimulate economic activity; or pass on dividends to the population directly through subsidies and/or the provision of more education, healthcare and other public goods to improve living standards? There is considerable debate about the optimal policy mix, with much depending on the existing level of economic development, the state of public finances, access to capital markets, the political systems in place, and the maturity of the country's oil sector.

<sup>1</sup> This seeks constant government consumption (in real terms) of oil resources over time that is equivalent to interest income on the net present value of a country's oil wealth, and entails the use of a permanent fund for future generations to secure intergenerational equity and guarantee a permanent flow of resources that will foster economic development even after oil resources have been exhausted.

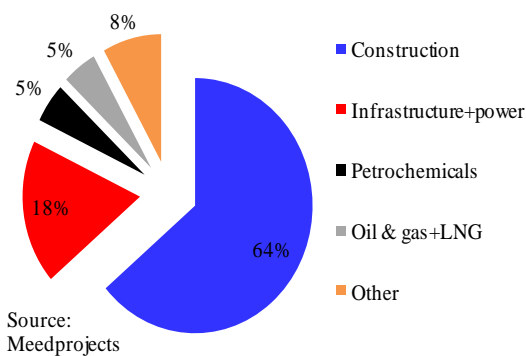
GCC: Government Debt (% of GDP)



With oil receipts accruing to governments, the conduct of fiscal policy is central to the policy response of the GCC, and this has evolved somewhat over time. In the early years of the boom GCC governments prudently used increased oil revenues to build up foreign assets and pay down government debt. However, the sheer size and duration of the oil boom has effectively allowed them to extend their policy options to encompass large and ambitious infrastructure programs and increased provision of social benefits, while still maintaining fiscal and current account surpluses.

- Running fiscal and current account surpluses:** Much of the oil revenue windfall of the last five years has been saved rather than spent. This prudent fiscal management has been reflected in the sharp improvement in the region's fiscal balances from 2003 onwards. Having run fiscal deficits for most of 1990s and into early 2000 the combined GCC fiscal accounts moved strongly into surplus, averaging around 20 percent of GDP during 2004-08. Despite significant increases in import demand the region's current account balances also soared, with surpluses averaging close to 25 percent of GDP during the same period.

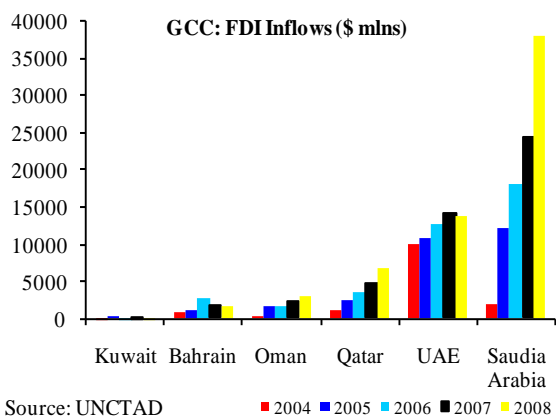
GCC: \$2.8 Trillion Project Pipeline



- Building up foreign assets:** GCC oil export earnings tend to be generated by a single state-owned firm making it relatively simple to sterilise excess earnings i.e. once the needs of the budget have been deducted, residual export earnings can be channelled into foreign assets, thereby helping to limit the build-up of excess liquidity in the domestic financial system, and also allowing diversification into income-earning assets outside the domestic economy. During 2002-08, GCC central bank external reserve assets increased seven fold to over \$500 billion, while savings in SWFs also soared. Little data are available on the size of the region's SWFs, but overall the GCC is estimated to have built up official external assets of over \$1 trillion by 2008.

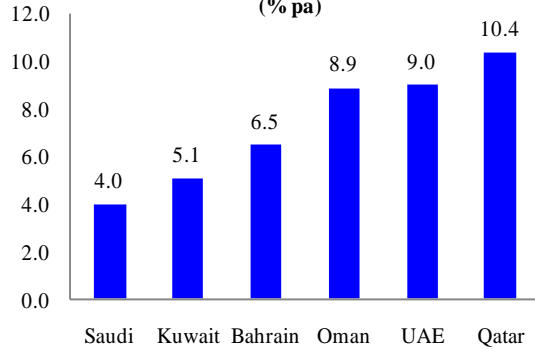
- Reducing government debt:** In addition to building up foreign assets, part of the fiscal surplus was used to retire domestic and external government debt. In particular, Saudi Arabia reduced its government debt levels from 97 percent of GDP in 2002 to 13.5 percent in 2008. Similar large reductions were made by other GCC governments, except in the UAE where government debt grew to a modest 15 percent of GDP.

GCC: FDI Inflows (\$ mlns)



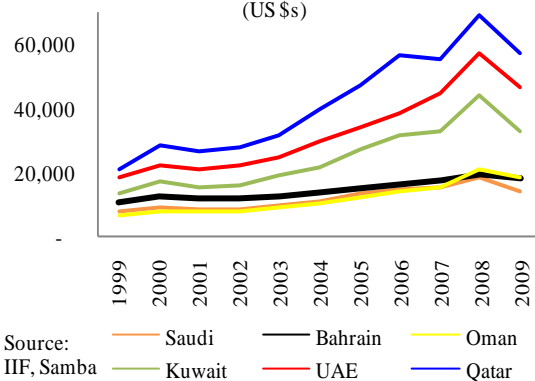
- Investing in infrastructure:** As oil prices continued to strengthen GCC governments started to make use of the fiscal space increasing revenues afforded to initiate ambitious investment programs aimed at diversifying their economies and reducing unemployment. Budgetary spending on capital projects has risen strongly and government related entities started to tap international capital markets to fund large scale infrastructure projects. In this they were aided by positive market perceptions on the strength of GCC public finances and economic growth prospects, which also encouraged growing FDI inflows. By early 2010, the value of projects planned or underway had reached \$2.5 trillion, with more than half accounted for by the UAE, and mostly focused on construction, infrastructure and power projects.

Average real non-oil growth 1999-09 (% pa)



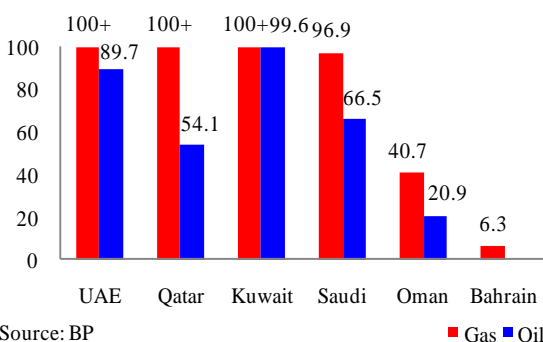
Source: IIF, Samba

GCC: Per Capita Income (US \$s)



Source: IIF, Samba

GCC: 2008 Reserves/Production Ratio (Years)



Source: BP

## Reaping the Rewards

The combination of growing oil revenues, large scale investment in infrastructure and development projects and expanding non-oil sectors has led to an impressive economic and social transformation. Already high, life expectancy in the GCC area increased by another couple of years during 2000-07 to 76 years, and literacy rates have risen to over 80 percent. Average per capita income in the GCC is estimated at \$22,000 in 2009 (having dropped back from \$28,000 in 2008 in the wake of the global crisis). Real GDP growth has been impressive at an average of 5 percent a year during 1999-09 for the GCC as a whole, with most of the impetus coming from the non-hydrocarbons sector where output grew by between 4-10 percent a year in individual countries. Until 2007-08 this was achieved in a low inflation environment. Foreign direct investment into the region has also surged from less than \$1 billion during 1990-2000 to \$6.3 billion in 2008 alone, the majority destined for Saudi Arabia (\$3.8 billion).

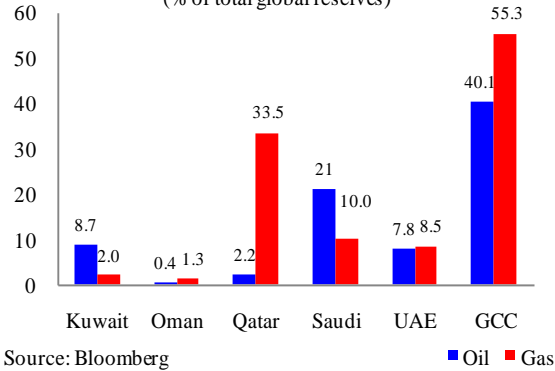
### Looking forward, oil and gas still provide a solid base for development

With about 40 percent of the world proven reserves, the GCC has abundant oil resources. These will eventually run dry, but in most countries there is still considerable time till then and production capacity continues to rise in the region in response to sustained investment. In addition, advances in technology are also likely to maintain proven reserve levels for longer than currently estimated. On the basis of these estimates, Oman and Bahrain face the most pressing need to develop their non-oil economies as their proven oil reserves will only last another 20 years, or less, according to 2008 data from BP. In Qatar and Saudi they will last between 54-66 years, respectively (although other sources put the figure closed between 80-90 years for Saudi), while the UAE and Kuwait have the largest cushion, with reserves calculated to last between 90-100 years.

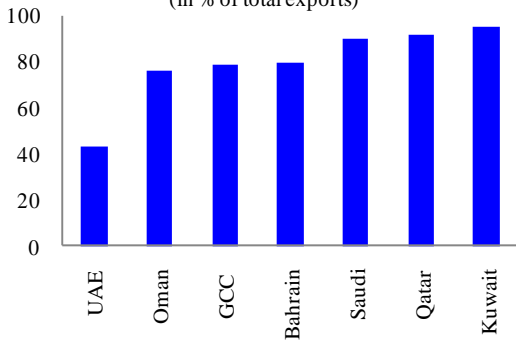
Conscious of the finite nature of their oil reserves GCC countries have looked to diversify into gas production as well. GCC proven gas reserves account for about 55 percent of the global total and are concentrated in Qatar (33 percent of global), Saudi Arabia and the UAE. In these three countries reserves are sufficient to last 100 years or more. Although absolute reserve levels are lower in Kuwait and Oman, they are expected to last over 100 years and 40 years, respectively. Development of gas reserves has been most pronounced in Qatar which has become the world largest exporter of LNG. Oman has also developed LNG export capacity and is embarked on a gas-based industrial growth strategy. However, with the exception of Qatar, regional gas production has lagged the rapid expansion in GCC economies, and this is beginning to lead to domestic shortages as gas is a key feedstock for industrial development, primarily for petrochemicals, steel, aluminium, fertilizers, cement and desalination.

The combined hydrocarbon (oil and gas) resources of the GCC are vast and their extraction is the largest single economic activity in the region accounting for between 13 percent and 50 percent of real GDP in the six economies, while their share of nominal GDP is much larger. However, the sector's

**GCC: Oil & Gas Reserves**  
(% of total global reserves)



**GCC: Oil Exports**  
(in % of total exports)



*Banking and financial services now play a major role in all GCC economies.*

importance extends well beyond its direct contribution: hydrocarbons account for between 43 percent and 95 percent of country export earnings, and thereby provide the main source of revenue for the public sector. Government spending in turn is the main driver of consumption in GCC economies, both of itself, and by dint of the fact that the vast majority of GCC nationals rely on government wages and salaries for their own consumption.

***GCC economies are increasingly diversified***

Despite the still prominent role of hydrocarbons, GCC economies have become increasingly diversified, particularly in the UAE and Bahrain where the non-hydrocarbons sectors account for between 60-70 percent of GDP. Country circumstances vary, but the structure of GCC economies and the composition of their exports are changing. The last couple of decades have seen the emergence of manufacturing, finance and insurance, trade and hospitality, transport and communication, and construction as major contributors to national GDP.

GCC: Non-hydrocarbon Sectors in Percent of Total Real GDP						
	Saudi	UAE*	Oman	Qatar	Bahrain	Kuwait
Manufacturing	12.1	12.2	9.2	4.8	16	4.3
Construction	6.9	5.5	6.7	7.7	na	Na
Government services	17.1	6.5	9.6	12.1	14.6	16.7
Finance & insurance	12.5	6	12.1	9.5	26.6	11.2
Trade & hospitality	8.3	12.2	12.3	7.5	7.8	5.2
Transport & com.	6.3	6.4	9.7	5.4	8.7	7.6

Source: national authorities, latest available data \*nominal GDP

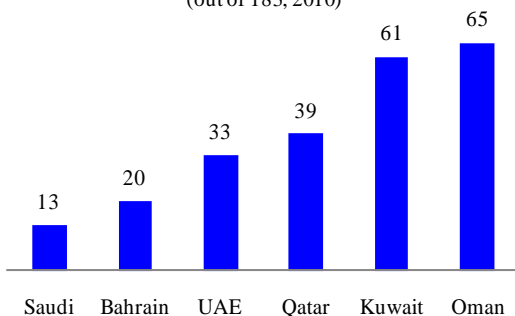
Saudi Arabia, Bahrain, Qatar and the UAE (Abu Dhabi) have made great strides in developing their industrial sectors, mainly through leveraging their natural advantages of cheap energy, plentiful capital, and a prime geographic location between Asia and Europe. Output of petrochemicals, fertilizers, cement, and aluminium have grown rapidly, and the manufacturing sectors' contribution to real GDP now ranges from 4-16 percent in the GCC. Growth has been facilitated by the development of industrial cities and free trade zones, particularly in Saudi and the UAE, as well as an increasing emphasis on improving the business and investment climate both for local and foreign investors, and the use of joint ventures.

In addition to industrial sector development, the GCC has seen a sharp acceleration in the development of its services sectors. Banking and financial services now play a major role in all GCC economies, and the sector dominates in Bahrain where it accounts for more than a quarter of real GDP. This development has been facilitated by increasing liberalization and improved regulatory regimes throughout the region. In addition, trade and transport services have grown steadily as the GCC has expanded its container port facilities (in the UAE, Oman and Bahrain), and its airline networks. Tourism has also grown rapidly, especially in the UAE and increasingly so in Oman.

*Throughout the GCC, large public investments in infrastructure and a real estate boom have provided a major boost to the construction sector.*

*The increasing economic diversification is also being reflected in employment patterns.*

**GCC: Ease of Doing Business Global Rank**  
(out of 183, 2010)



Source: World Bank

Perhaps most remarkable has been the development of Dubai's service based economy based on its role as a commercial, telecommunications, trade and financial hub, as well as the GCC's top tourism destination. However, with few oil resources, much of this development was debt financed and Dubai has recently suffered as a result of the global credit crunch and a crash in its overheated real estate sector. Despite the current problems, the emirate has built up a world class infrastructure, and once the dust settles the foundations remain in place for a vibrant services based economy.

Throughout the GCC, large public investments in infrastructure and a real estate boom aimed at providing residential, retail, office, and hotel accommodation, have provided a major boost to the construction sector. Available data indicate that the construction sector accounted for between 5.5-7.7 percent of real GDP in Saudi, the UAE, Qatar, and Oman in 2008. While the bursting of the real estate bubble has dampened prospects, ongoing and planned public infrastructure investments should keep construction's share of GDP healthy.

GCC Employment by sector: % of total					
	Oil & gas	Government	Manu.	Construction	Trade
Kuwait	0.3	47.5	5.4	8.1	13.6
Oman	1.8	16.0	10.6	37.5	15.5
Qatar	5.0	10.0	8.6	44.3	11.0
Saudi	1.0	13.0	9.0	35.0	20.0
UAE	1.2	10.4	12.7	22.3	23.2

Source: GCC authorities, latest available data

The increasing economic diversification is also being reflected in employment patterns. The recent construction boom has ensured that this sector is now one of the largest employers in the region. The government sector is still a major source of employment (primarily for nationals), but has now been surpassed by the trade sector (retail and wholesale) in most GCC countries. Manufacturing, meanwhile, accounts for between 5.4 percent of the total in Kuwait, and 12.7 percent in the UAE. Although large as a share of GDP, the hydrocarbons sector is capital intensive and provides few jobs, employing only between 0.3-5 percent of the workforce in GCC countries.

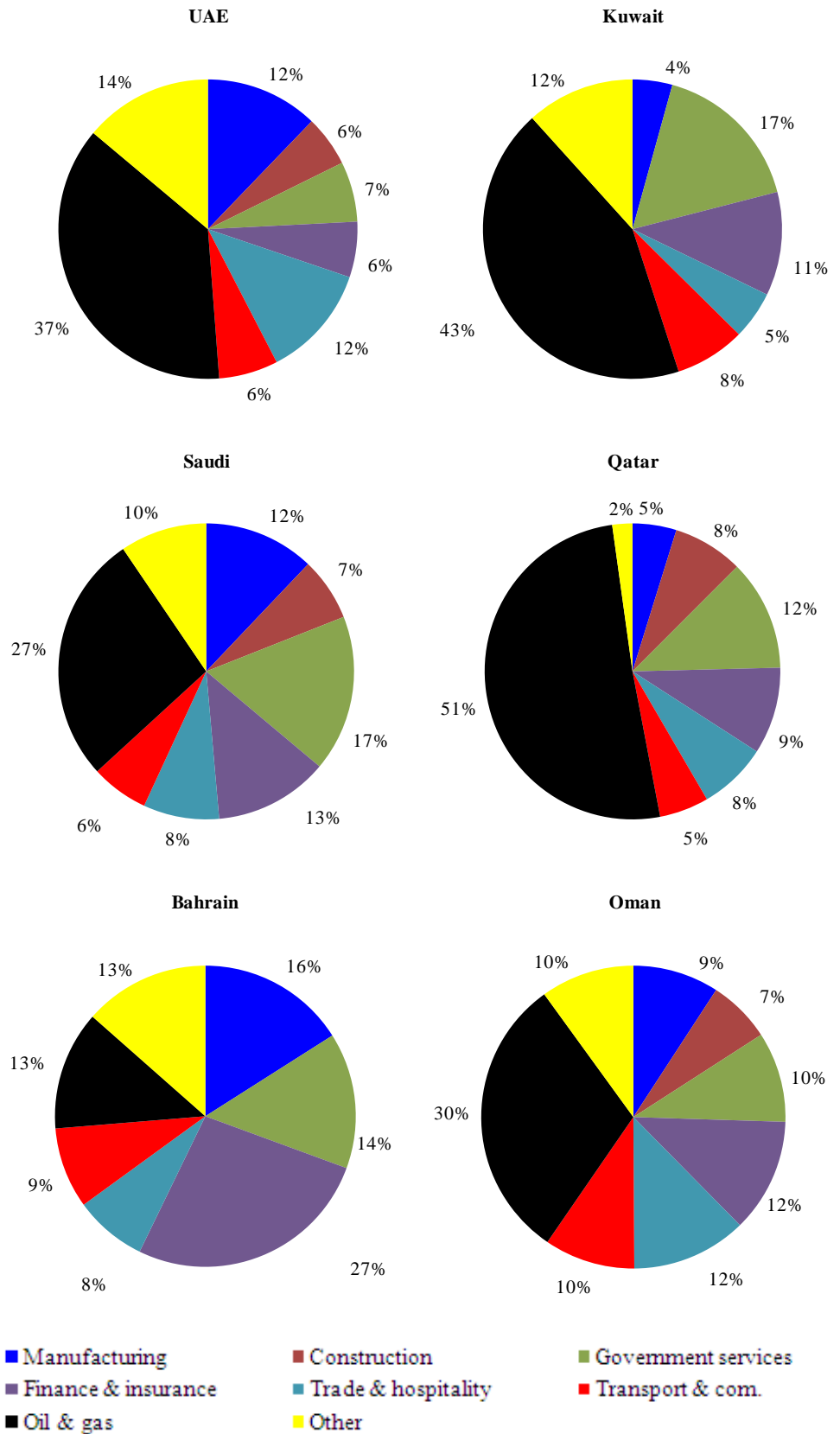
### **Improving investment climates**

The increasing diversification away from oil is testament to the policy and reform agenda being pursued by governments in the region. Strong public finances have been accompanied by an open exchange and trade system under the peg to the US dollar, liberal capital flows, sound and well regulated financial systems, and open borders for foreign labour. Country circumstances vary, but in general GCC governments have embraced foreign investment and have instigated policies to improve the climate for private sector activity, including privatisation of certain public enterprises, particularly in telecommunications, utilities and the banking sector. Full foreign ownership is allowed in most non-hydrocarbons sectors, and free trade zones have also

**GCC: Sectoral Shares in Real GDP**

*Despite the still prominent role of hydrocarbons, GCC economies have become increasingly diversified, particularly in the UAE and Bahrain where the non-hydrocarbons sectors account for between 60-70 percent of GDP.*

*Banking and financial services now play a major role in all GCC economies, and the sector dominates in Bahrain where it accounts for more than a quarter of real GDP.*



been established in some states (eg Dubai) that allow 100 percent foreign ownership of companies. Land and property ownership laws and regulations have also been improved.

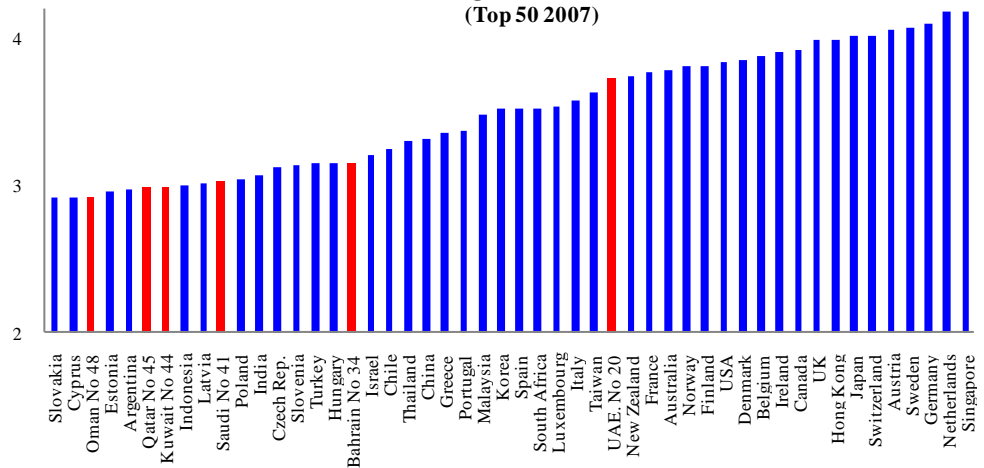
GCC efforts to streamline regulations and improve the business environment have been recognised by a number of surveys that rank global competitiveness and business environments. The World Bank Doing Business survey for 2010 shows that the GCC has two countries (Saudi Arabia No. 13 and Bahrain No.20) in the top 20 rankings for the ease of doing business. The UAE and Qatar rank in the top 50, while Kuwait and Oman rank at 61 and 65, respectively, out of 183 countries.

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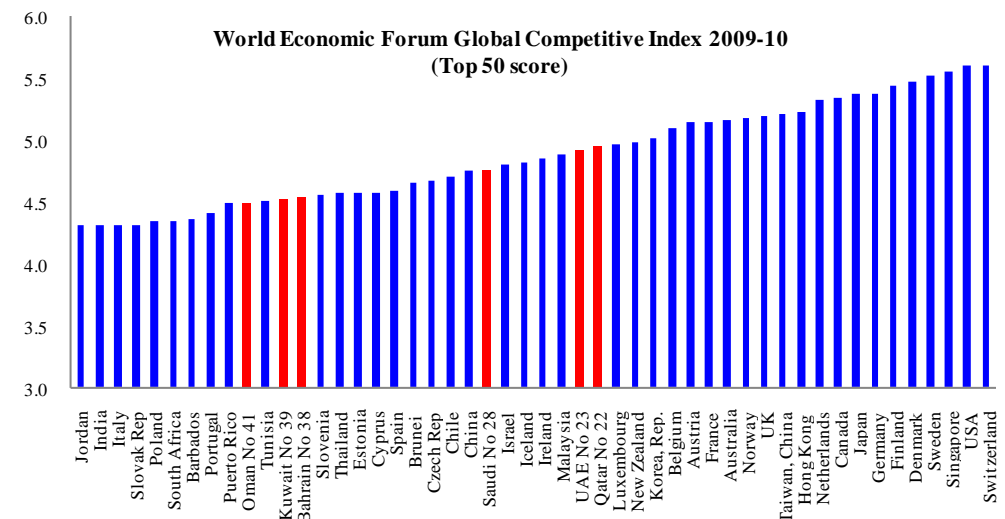
In addition, all six GCC countries score in the top 50 of the World Economic Forum's Global competitiveness index for 2009-10, with Qatar and the UAE ranking 22 and 23 respectively. The World Bank has also developed a logistical performance index which provides an assessment of trade logistics performance – an important determinant of global competitiveness - for 150 countries. Again, all the GCC countries rank in the top 50 countries, with the UAE scoring particularly well to rank at 20.

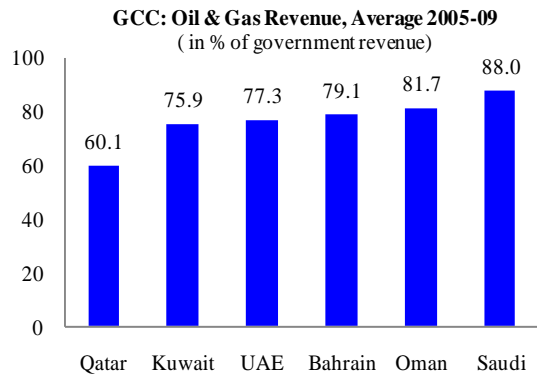
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**World Bank Logistical Performance Index (Top 50 2007)**

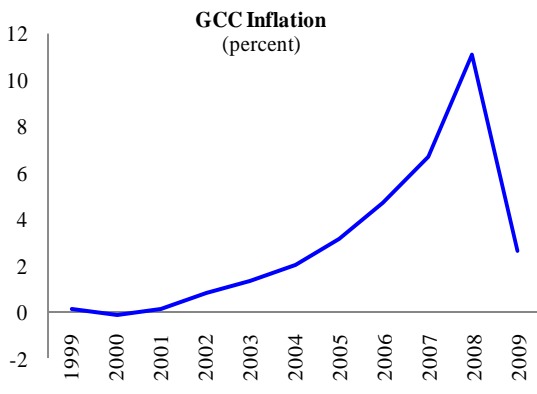


**World Economic Forum Global Competitive Index 2009-10 (Top 50 score)**





Source: IIF, Samba



Source: IIF, Samba

*Managing large and volatile hydrocarbon revenues is challenging and the GCC is becoming increasingly adept at avoiding the so called 'resource curse'.*

## Challenges

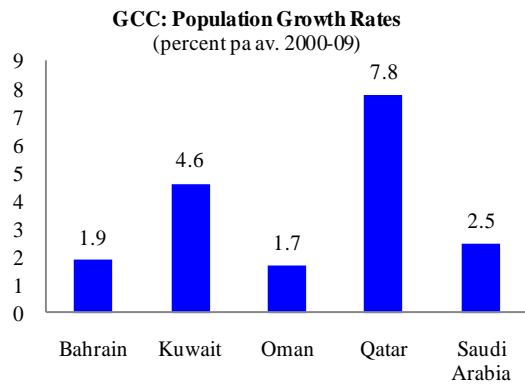
While considerable progress has been made in developing and diversifying GCC economies the process is still underway and challenges remain. Two issues stand out: the need to ensure macro stability is maintained and that fiscal policies are sustainable, and the need to provide productive employment for the rapidly growing labour force. As things stand GCC government revenues remain dominated by hydrocarbon earnings and are thus susceptible to historically volatile global oil prices in the short term, and the inevitable reduction in oil output in the long term. Government control of hydrocarbon earnings has also entrenched a system that has left most GCC nationals reliant on public sector employment. This costs governments a lot of money, and is particularly burdensome during extended periods of low oil prices. It also leaves the private sector heavily dependent on foreign nationals.

### **Maintaining macro stability and fostering fiscal sustainability**

Our regular reports on the GCC (available on Samba's web site) have analysed the sharp reversal of fortune in the GCC during 2008-09 when oil prices slumped, particularly developments in the financial sector and the role of monetary/exchange rate policy in accentuating the pre-crisis boom. This report does not intend to go over the same ground, but rather focus on some of the issues that touch more directly on the diversification and development agenda. In particular, the record inflation rates recorded during 2007-08 are a reminder that care needs to be taken when implementing public spending programs on the back of booming oil revenues. If costs and prices are forced up then government revenues are in part dissipated by the additional costs (i.e the government gets less bang for the buck), and this is especially true in construction which is prone to bottlenecks in land, roads, infrastructure, material inputs and skills.

While some inflationary pressures are an inevitable result of the desire to spend oil revenues on fostering the development of the non-oil sector, attention needs to be paid to the speed at which a country's construction sector can expand without severely driving up prices. In boom times there may be less scope to accelerate spending. However, the reverse is true during a downturn, and this is something Saudi Arabia is keen to take advantage of by starting a \$400 billion five-year investment program which should benefit from lower project costs. More generally, increases in domestic spending need to be phased in over time, taking into account each country's specific macroeconomic conditions, their absorptive capacities, and long-term sustainability.

Managing large and volatile hydrocarbon revenues is challenging and the GCC is becoming increasingly adept at avoiding the so called 'resource curse' - a complex phenomenon in which through several economic, institutional and political economy transmission mechanisms, an abundance of resource revenues can translate into stagnation, waste, corruption and conflict. This owes much to the region's understanding of the need to build infrastructure and diversify the non-oil economy while preserving long-term fiscal



Source: National Sources

*Non-oil revenues remain low and fiscal consolidation continues to be a key challenge.*

**Box: The Resource Curse**

Resource revenues present specific challenges, the most prominent being how to avoid what has come to be described as the ‘resource curse’. This has been best defined by the IMF<sup>2</sup> as a complex phenomenon in which, through several economic, institutional and political economy transmission mechanisms, resource abundance may translate into economic stagnation, waste and conflict. Major challenges and issues include:

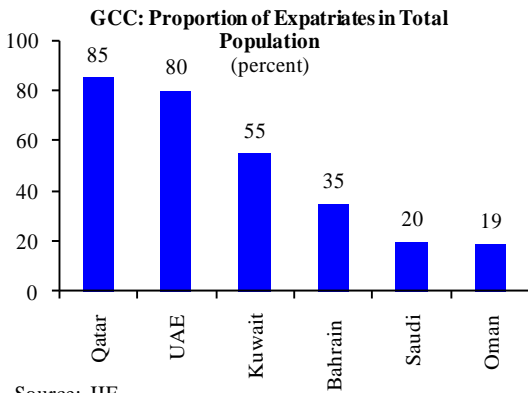
- Avoiding ‘**Dutch Disease**’; a set of negative macroeconomic effects caused by a large increase in oil or gas funded spending. If this spending is primarily directed at domestically produced goods, then domestic prices can be pushed up, and the exchange rate appreciate. This can result in a shift of capital and labour into the production of non-traded goods and an erosion of the competitiveness of the non-hydrocarbons economy.
- Dealing with extreme revenue volatility which can lead to **waste, boom and bust cycles, and excessive borrowing** (either in expectation of revenues, or to sustain spending levels when oil revenues fall).
- Using resource revenues **depletes a non-renewable nonfinancial asset**. Thus if part of the resource revenues are not saved or allocated to the production or acquisition of other productive capital, their use will reduce the government’s net worth for future generations.
- Excessive reliance on resource revenues could transform **resource-producing countries into rentier states** in which governments devote more attention to potentially inefficient redistributive functions (e.g subsidies, bloated bureaucracies) and interventionist functions, than to functions related to the regulation, supervision, taxation, and management of the economy.

sustainability. That said, non-oil revenues remain low and fiscal consolidation continues to be a key challenge - through reducing and better targeting subsidies, improving tax administration, reducing current outlays and redirecting spending towards capital formation, both human and physical. Already plans are underway to introduce Value Added Tax (VAT) in the GCC, possibly by 2012, and more structural reforms to generate additional revenues are likely to be forthcoming. In addition, GCC countries are moving towards casting fiscal policy in a medium-term framework using conservative oil price assumptions, and this will help reduce the reliance of expenditure on short-term oil revenues.

	Kuwait	Oman	Saudi	Qatar	UAE	Bahrain
0-14	26.4%	42.7%	38.0%	21.8%	20.4%	25.9%
15-64	70.7%	54.5%	59.5%	76.8%	78.7%	70.1%
65+	3.0%	2.8%	2.5%	1.4%	0.9%	4.0%

Source: National sources

<sup>2</sup> A Public Financial Management Framework for Resource-Producing Countries, IMF Working Paper 2010, Daban & Helis



Source: IIF

*GCC governments are aware of this and most have targeted improving education as a key pillar of their development strategies.*

**Labour markets are segmented**

GCC local populations are young (over a third are under the age of 15) and growing rapidly, and cannot all be productively employed in the public sector. This presents GCC authorities with a challenge as most have afforded socio-economic protection to their national populations through employment in the public sector (as well as entitlements to subsidies and cost free services), while the private sector has been dominated by foreign labour. This has led to a large influx of expatriate labour which now considerably exceeds the local population in Qatar, the UAE, and Kuwait, and represents a sizeable proportion of the total in the other GCC countries.

Most GCC governments have undertaken labour market nationalization policies of some kind with a view to decreasing foreign labour market dependency in the long term. However, local skills and educational backgrounds are often incompatible with the needs of the private sector, and these policies have created strains in the business community. In addition, the ambitious development strategies of the GCC imply that it will remain dependent on foreign labour for the foreseeable future.

GCC governments thus face a challenging balancing act of furthering the development of their economies with foreign labour, while at the same time ensuring that nationals are increasingly absorbed into the private sector. Addressing the wage gap (private sector wages tend to be comparatively low compared with the government) and the skills gap will not happen overnight and will need to be viewed as a long-term undertaking. GCC governments are aware of this and most have targeted improving education as a key pillar of their development strategies in order that their nationals can compete in the increasingly knowledge based economic order.

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