

Soaring of the Gulf Falcons: Diversification in GCC Oil Exporters in Seven Propositions

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International Monetary Fund

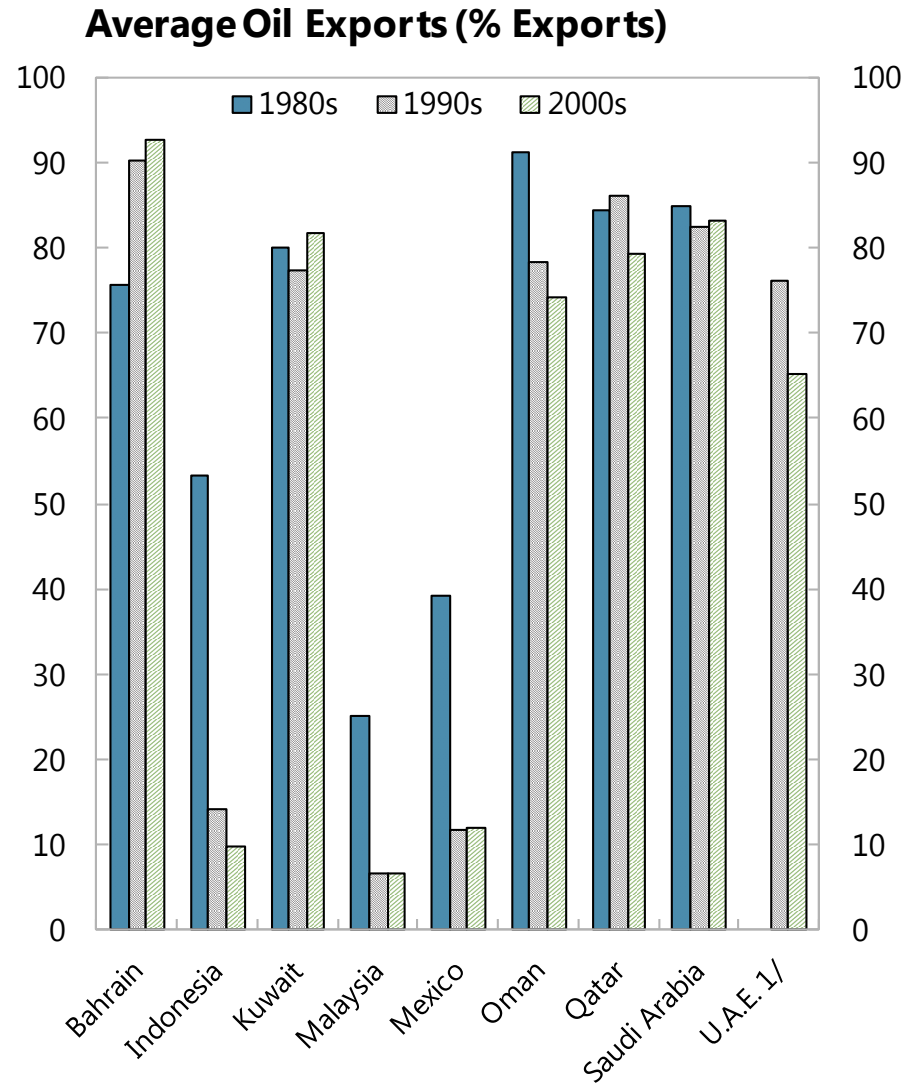
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Proposition 1

The prevailing growth model achieved a large improvement in human development indicators but also resulted in a decline in relative economic performance.

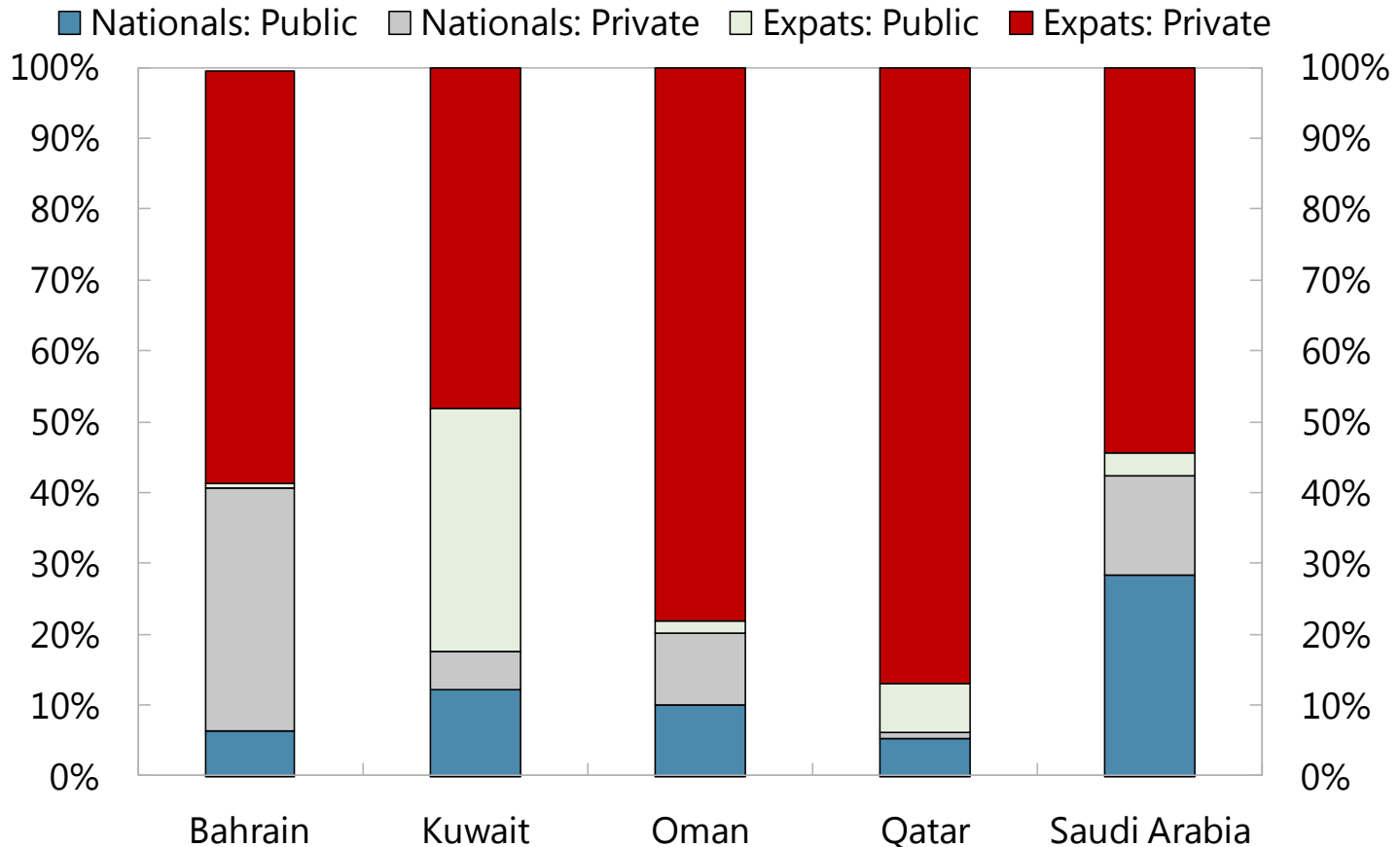
The current model relies heavily on oil



1/ U.A.E. Goods and Services exports excludes re-exports.

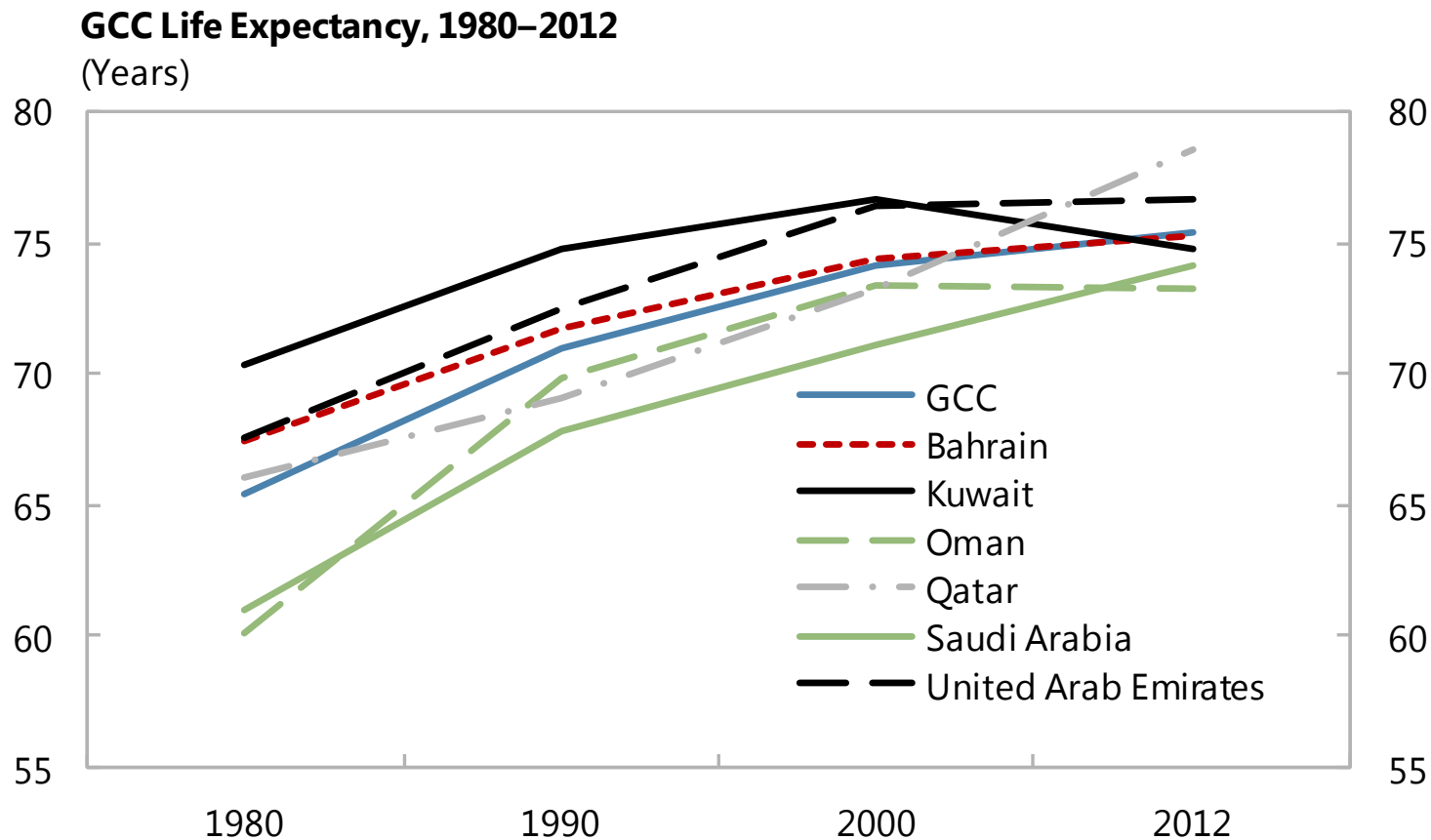
Majority of nationals work in the government in most GCC

Composition of GCC Labor Market, 2012¹



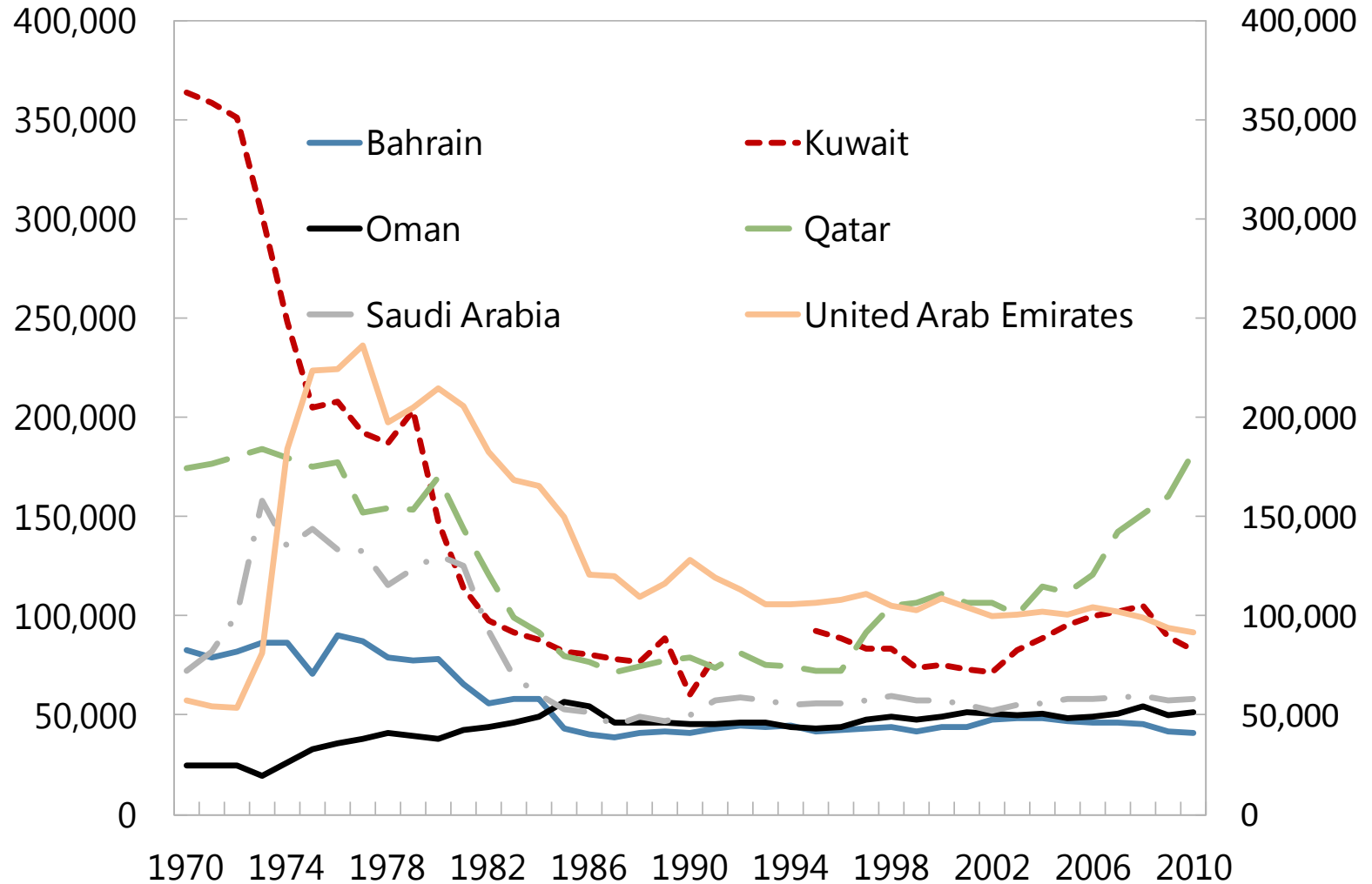
¹Kuwait data is 2011; U.A.E data unavailable for publication.

The GCC achieved huge improvements in HDI and living standards



But relative income declined

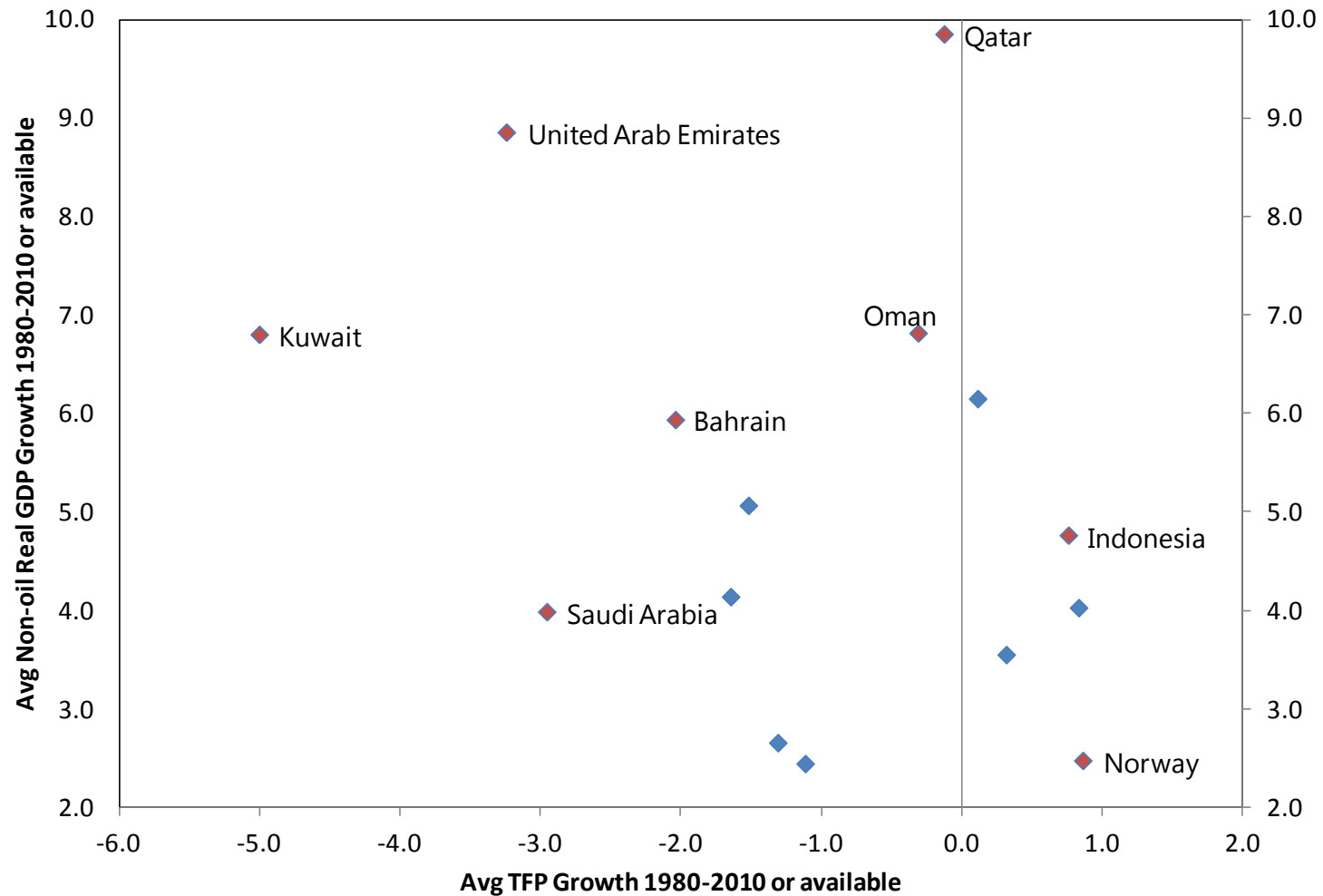
GDP Per Worker (PPP \$), 1970–2010



Proposition 2

A sustainable growth model requires a diversified tradable sector.

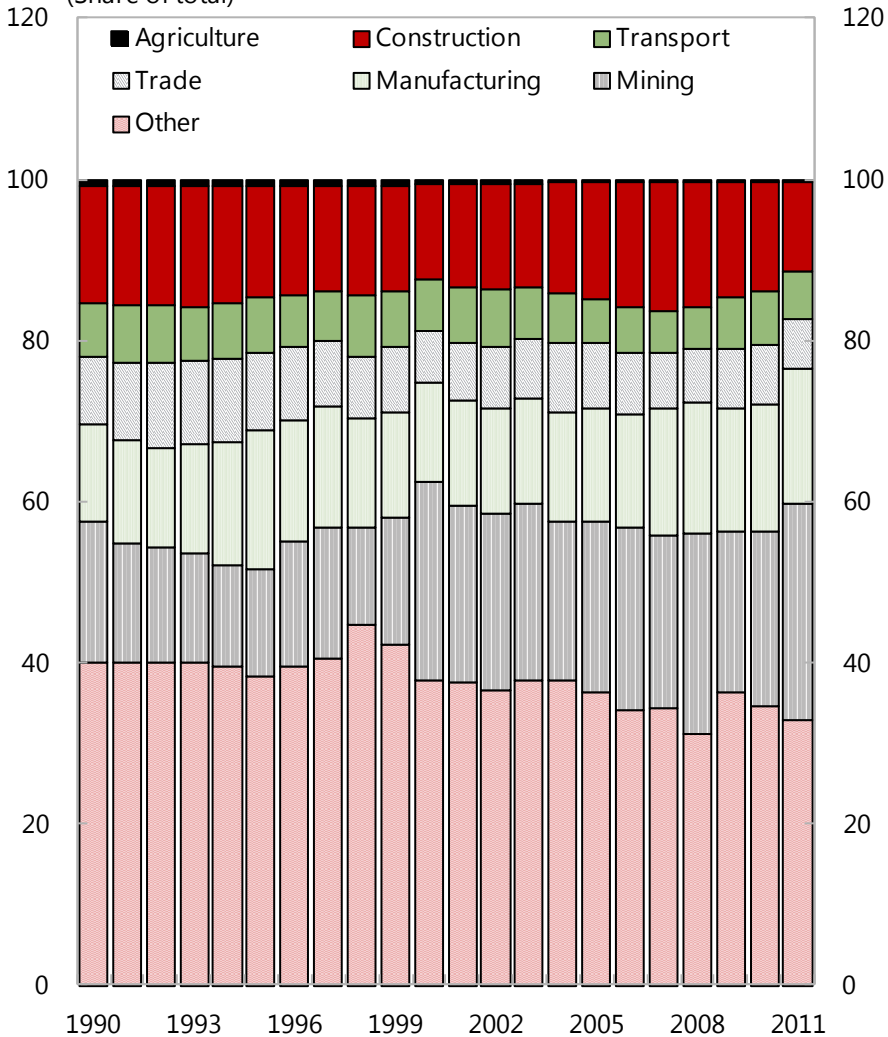
Non-oil GDP increased but productivity declined



Non-Oil GDP is misleading indicator

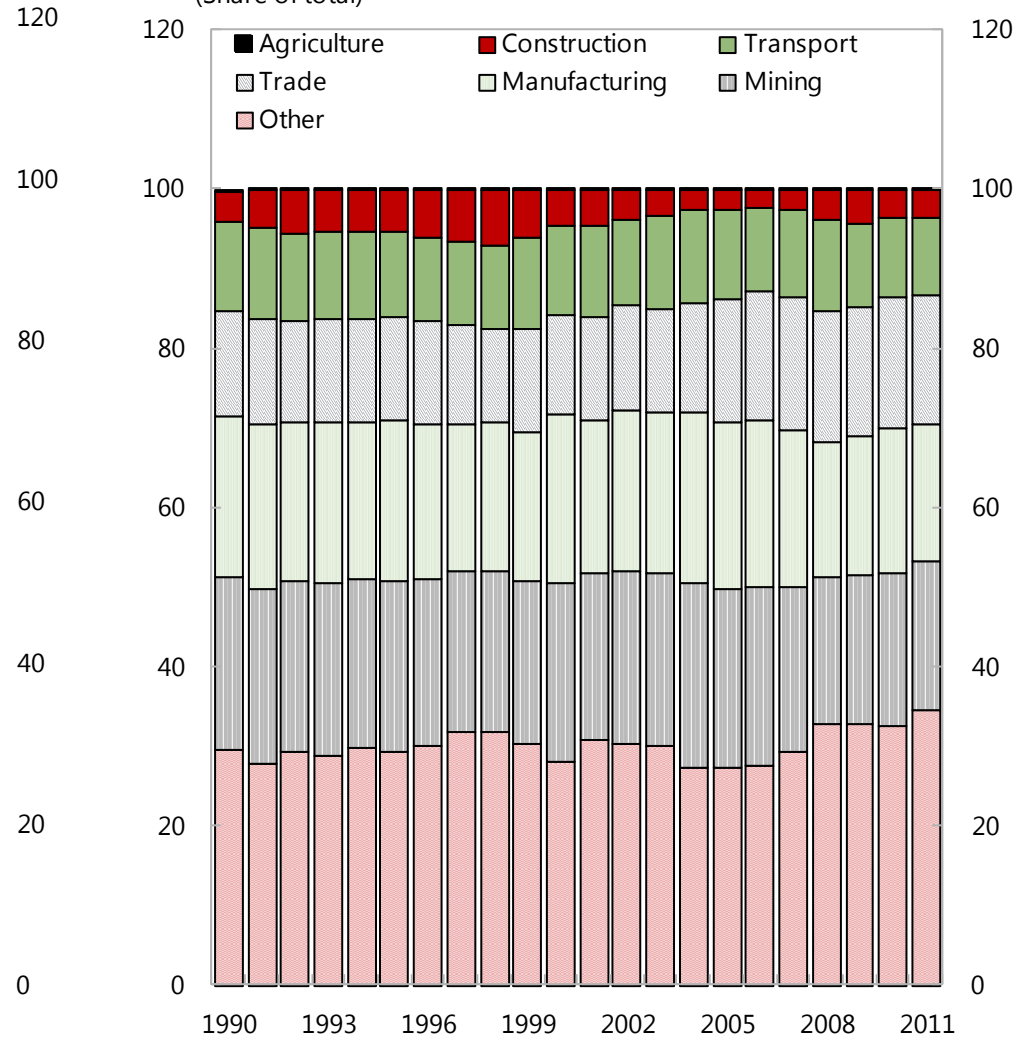
Bahrain - GDP by Sector, 1990–2011

(Share of total)



Singapore - GDP by Sector, 1990–2011

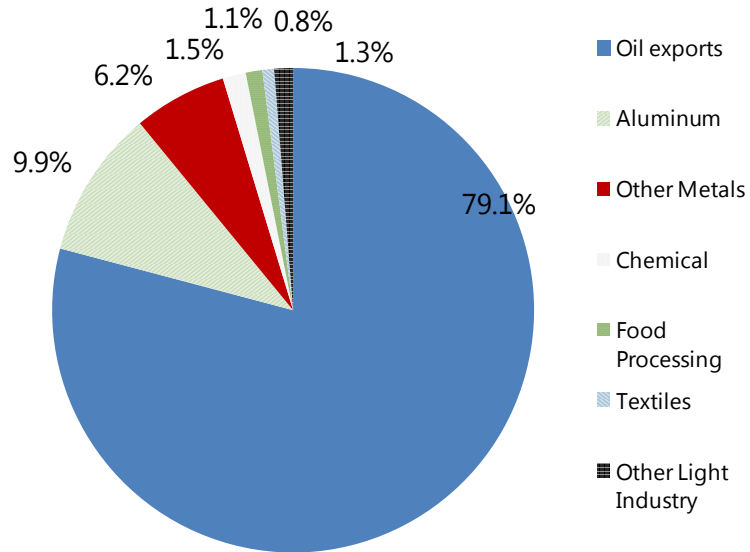
(Share of total)



It is all about export composition

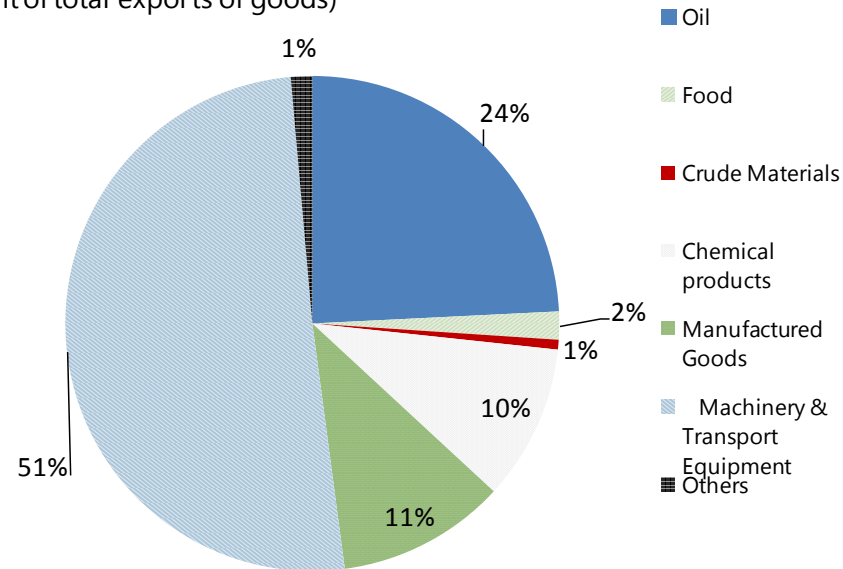
Bahrain, Top 50 Exports of Goods, 2008

(Percent of total exports of goods)



Singapore Exports by Sector, 2008

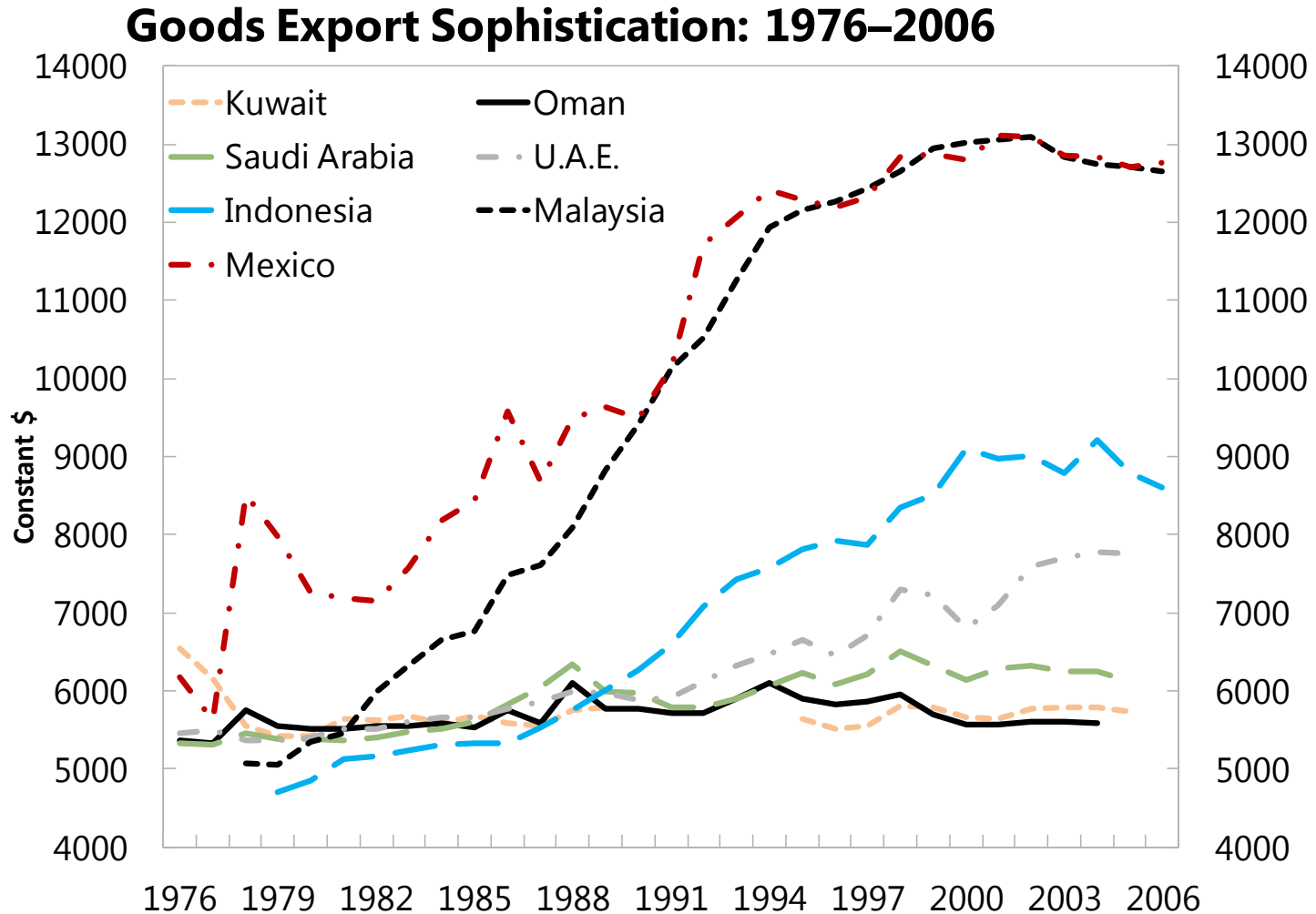
(Percent of total exports of goods)



Yet GCC countries have attempted to diversify their economies

- Development of petrochemical and metal industries bear little linkages to the rest of the economy
- Promotion of services helped diversify economies but services may not be sufficient for sustainable growth
 - Focus on tourism, logistics, finance, etc.
- Recent attempts at creating clusters, technology parks, and manufacturing industries in free zones have yet to yield substantial results

Export sophistication has not improved in the GCC



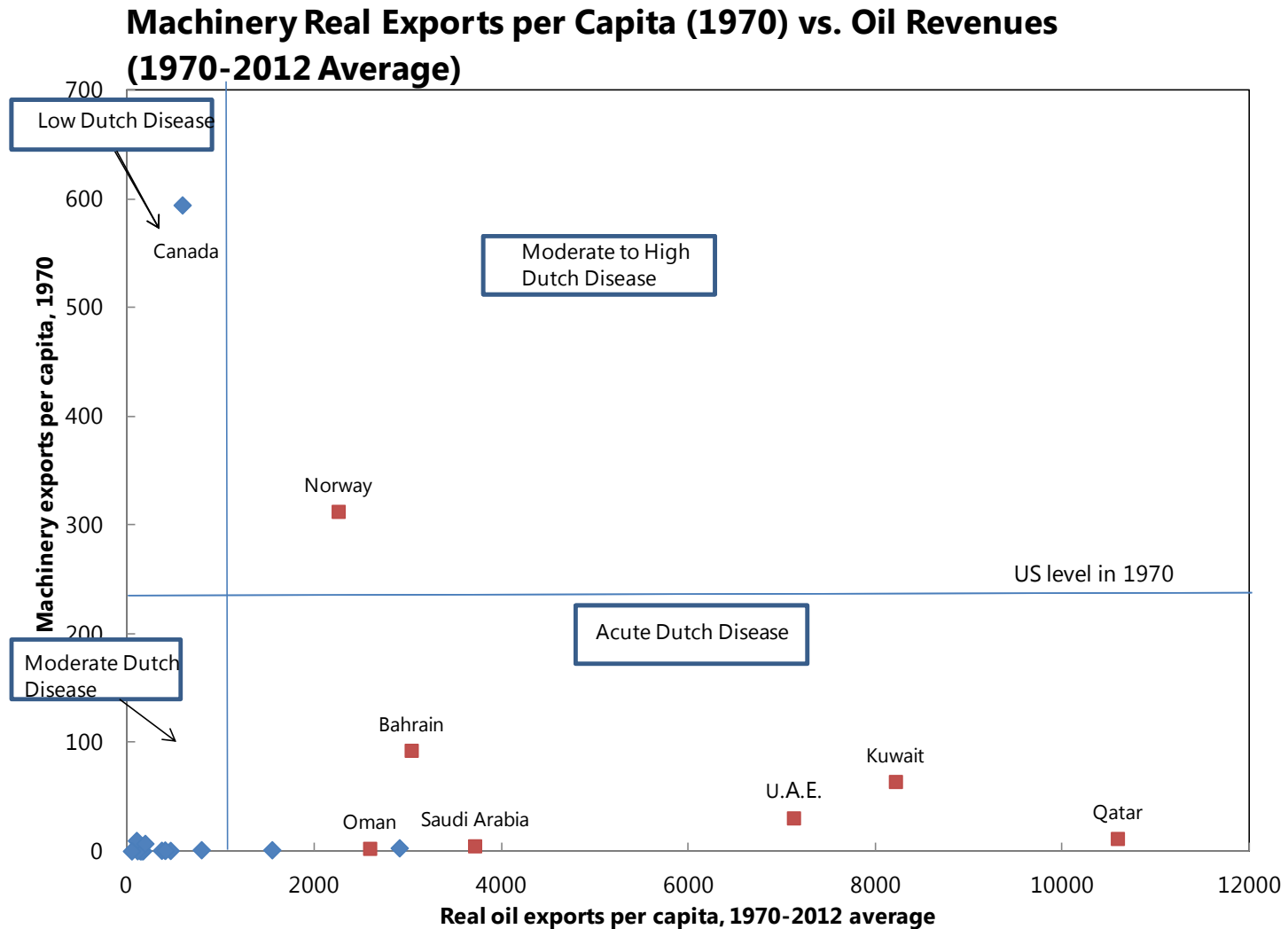
Sustainable growth requires diversified exports

- Empirically, export sophistication is an important determinant of long-run growth – Hausmann, Hwang, and Rodrik (2007), Spatafora and Papageorgiou (2013), and Cherif and Hasanov (2014)
- Theoretically, continuous introduction of new goods and tasks and moving up the “quality ladder” lead to sustained productivity gains – Lucas (1993) and Aghion and Howitt (1992)

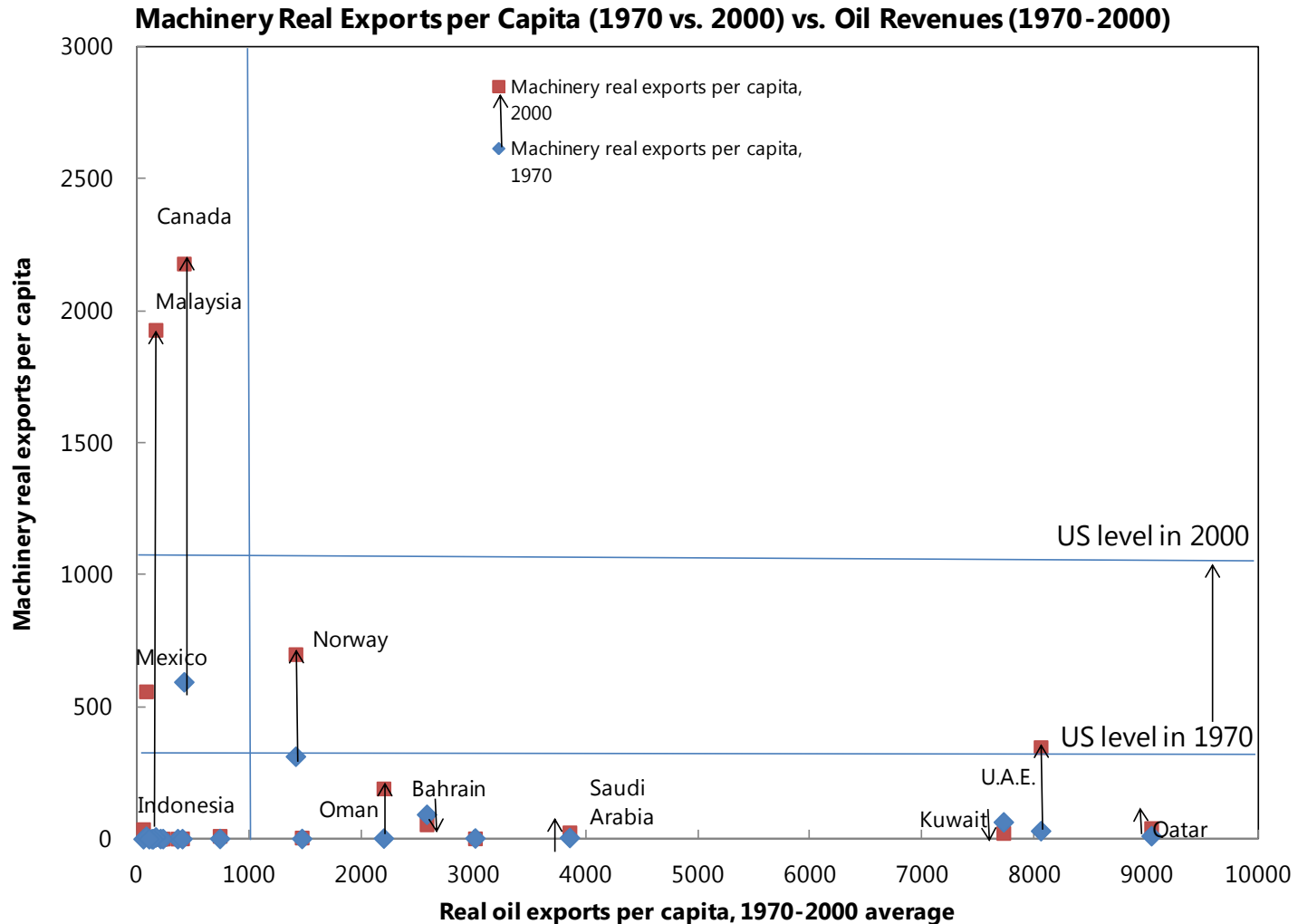
Proposition 3

Both the initial technological gap and the size of oil revenues determine the chances of success or failure at diversification in oil-exporting countries, while policies adopted magnify or mitigate this effect.

The GCC faced high oil revenues at low levels of technology



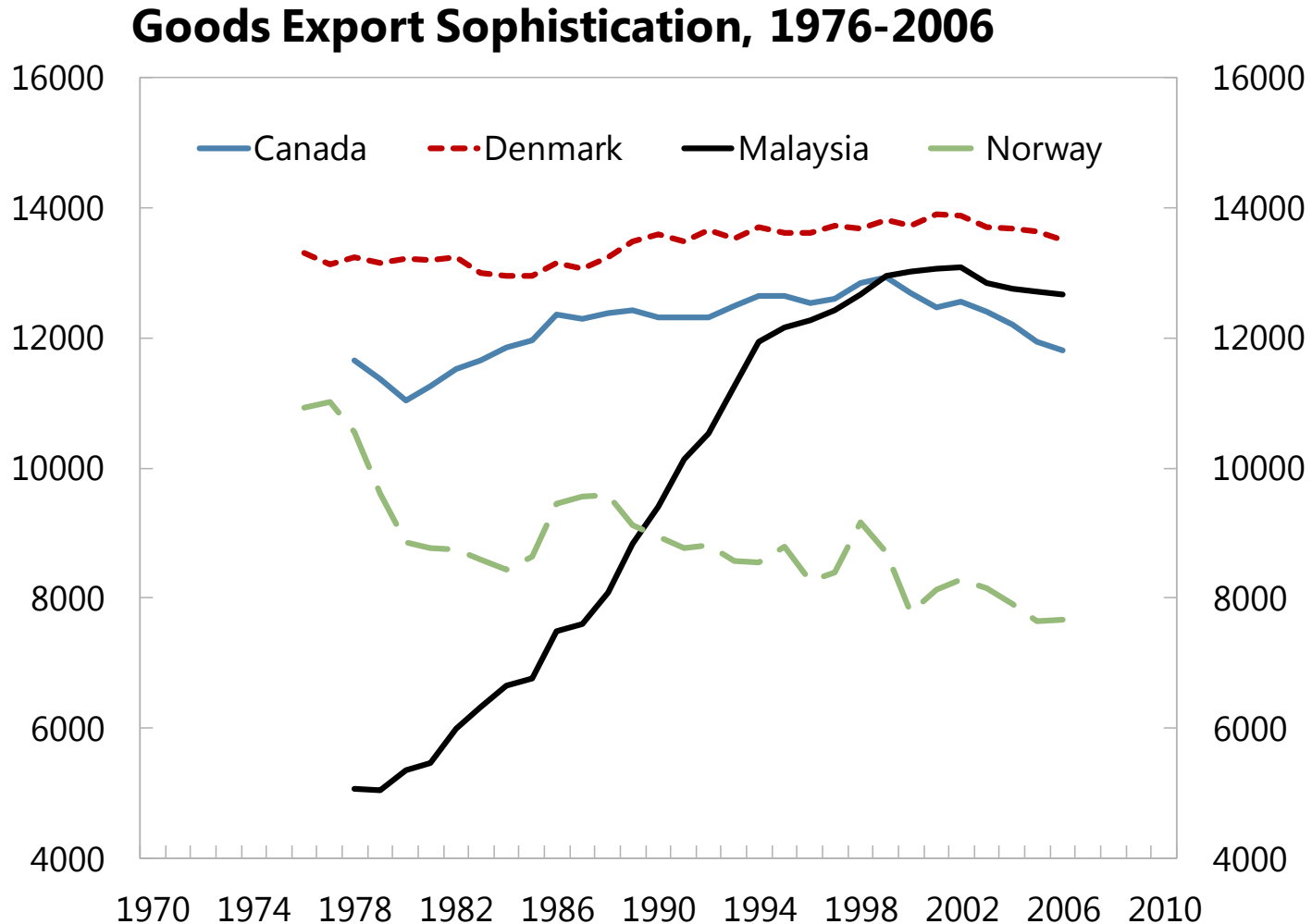
The technological upgrading that followed was minimal



Norway: Falling prey to the Dutch Disease

- In 2012, manufacturing hourly wages were the highest in the world and about double that of the US or Japan
- Unit labor costs increased by 50 percent in the 2000s, whereas they declined in Germany and Sweden
- Annual average hours per worker declined by 600 hours since 1960 to about 1400 hours in 2012, third lowest in OECD

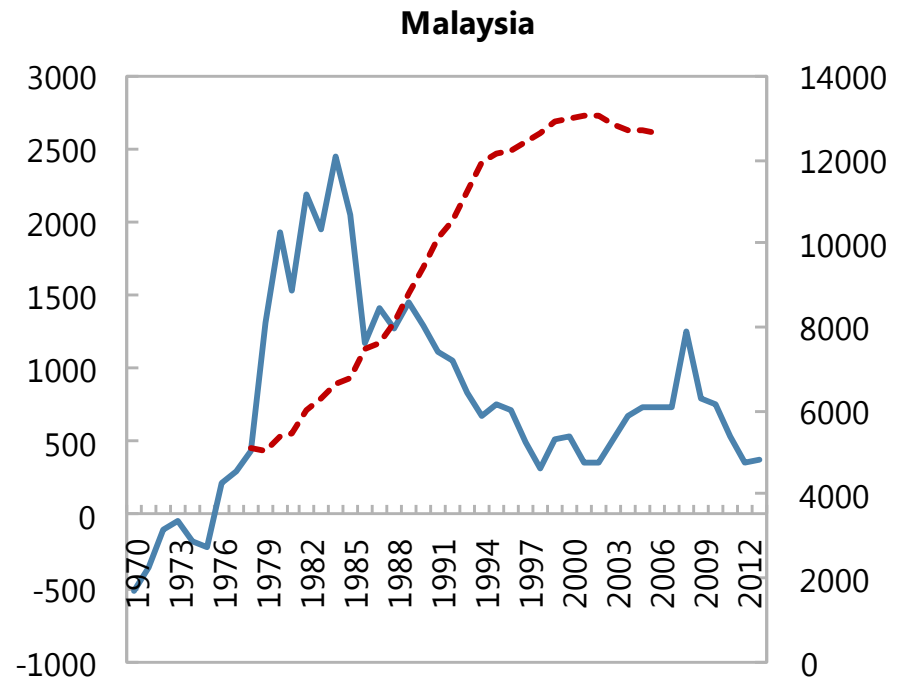
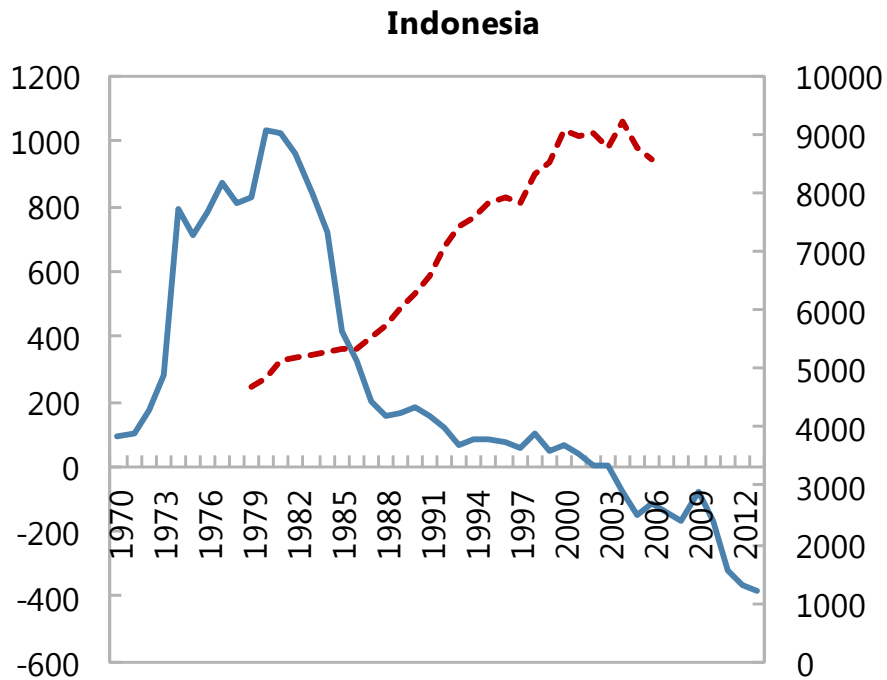
The Norwegian Disease: Norway experienced decline in export sophistication



A few relative successes: Importance of policies

- Indonesia, Malaysia, and Mexico did better than other oil exporters and prepared the ground before the oil revenues started falling
- Import substitution strategy created mostly inefficient firms because they were not encouraged to compete on international markets
- The policy mix of Malaysia involved investment in higher value added comparative advantage industries (e.g. natural resource-related manufacturing) and going beyond comparative advantage (e.g. electronics)
- Indonesia and Mexico show that relying mostly on low wages and labor intensive manufacturing would eventually lead to limited productivity gains
- These countries' experience suggests that a focus on competing on international markets and an emphasis on technological upgrade and climbing the value added ladder is crucial

Export sophistication improved amid dwindling oil revenues



— Net oil exports deflated by US CPI per capita

- - - Exports Sophistication (RHS)

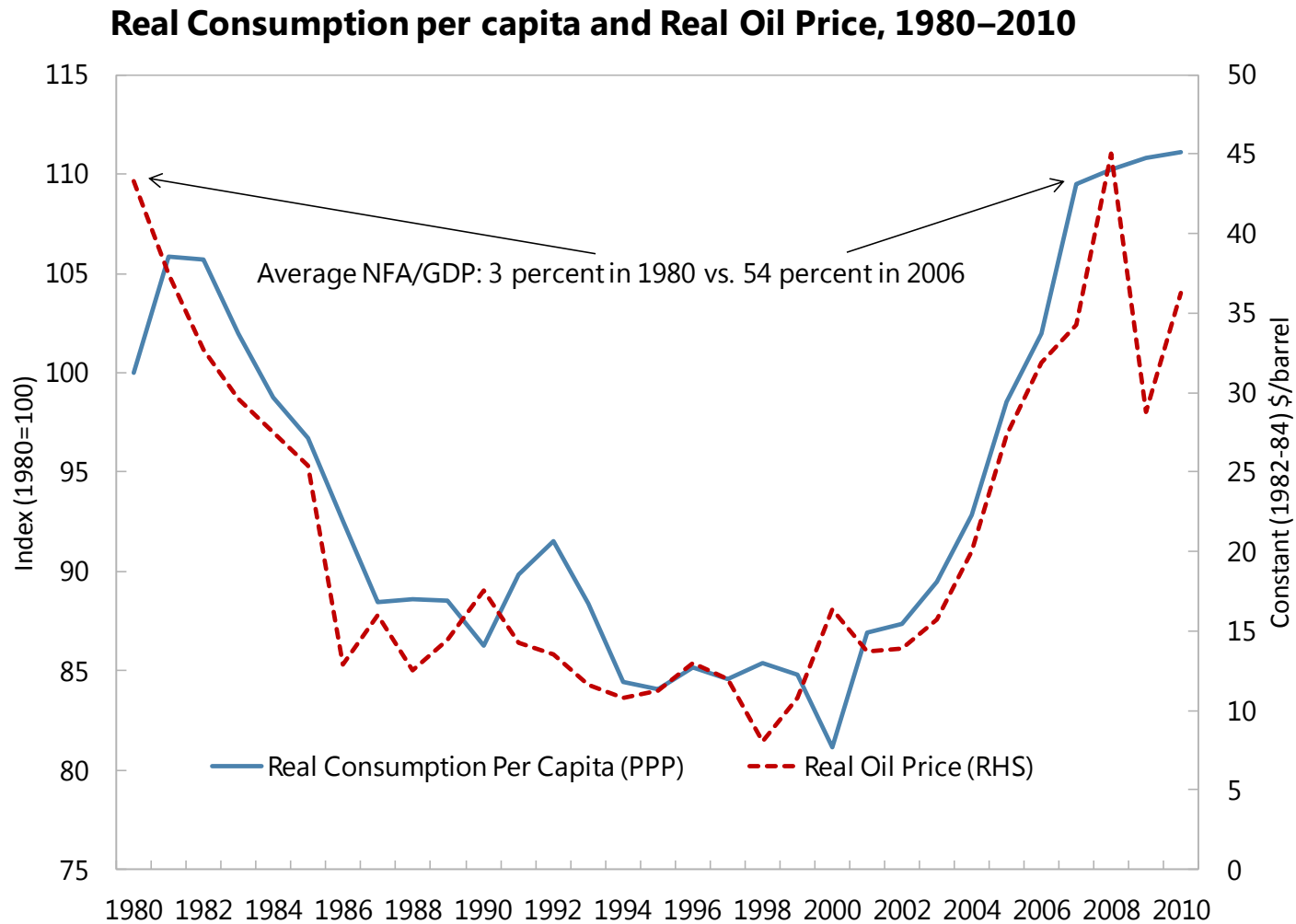
Proposition 4

Exports diversification must start now.

It takes decades

- The experience of oil exporters and other countries suggests that it take a long time to develop industries
- It took Malaysia 20-30 years to increase export sophistication
- What if oil prices fell again as in the 1980s-90s?

Avoiding another large and lasting decline in welfare



Proposition 5

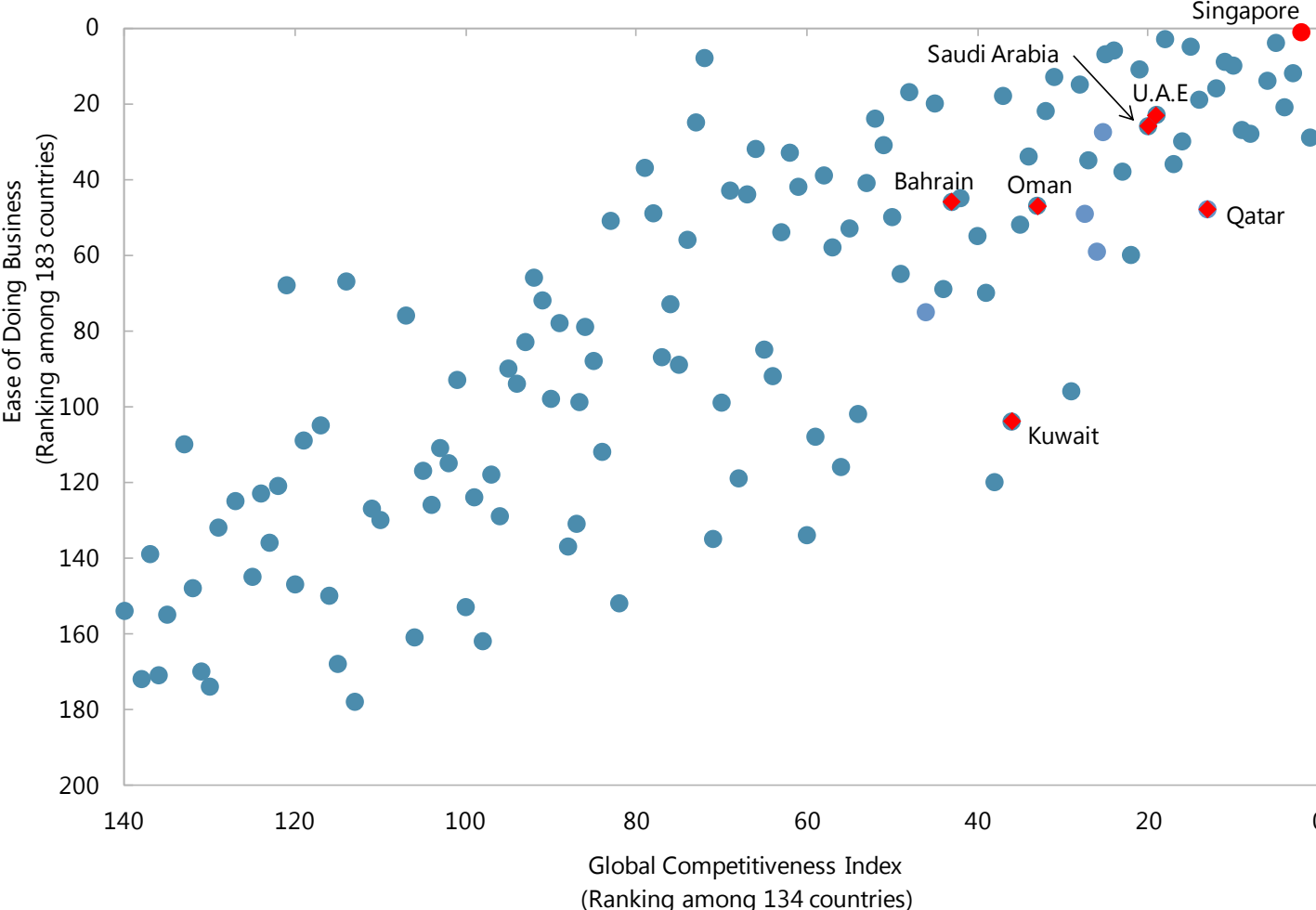
The standard policy advice—implementing structural reforms, improving institutions and business environment, investing in infrastructure, and reducing regulations—may not be sufficient to spur tradable production because of market failures.

Standard policy advice for growth may not be sufficient

- Standard policy prescription includes macroeconomic stability, minimum state intervention and an enabling environment conducive to investment in both physical and human capital
- It consists in tackling “government failures” (Rodrik 2005)
- The GCC has improved in most of these dimensions but relative economic improvement did not follow

Tackling “Government Failures” I

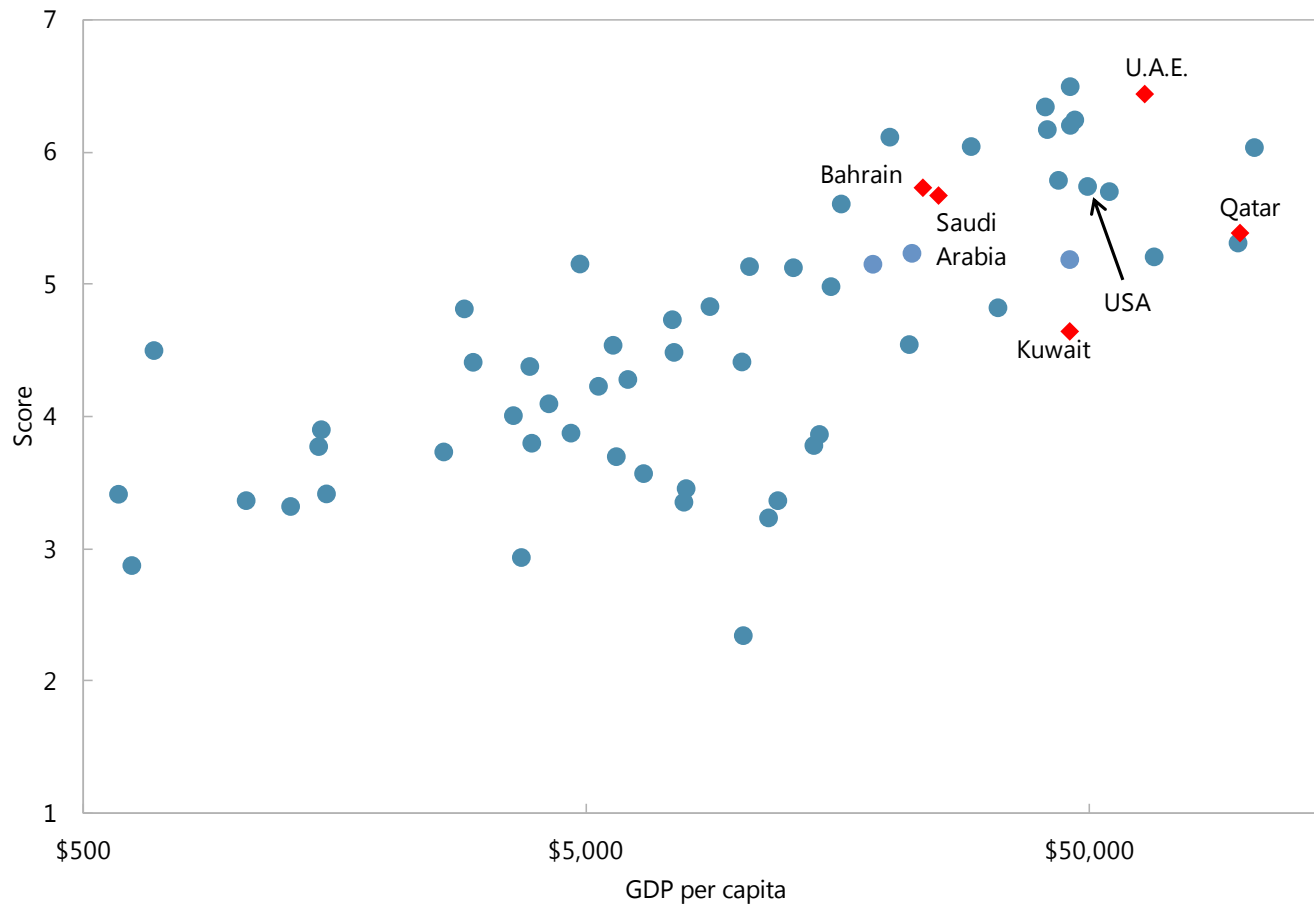
Doing Business vs. Global Competitiveness Index, 2013



Tackling “Government Failures” II

Quality of Infrastructure, 2013

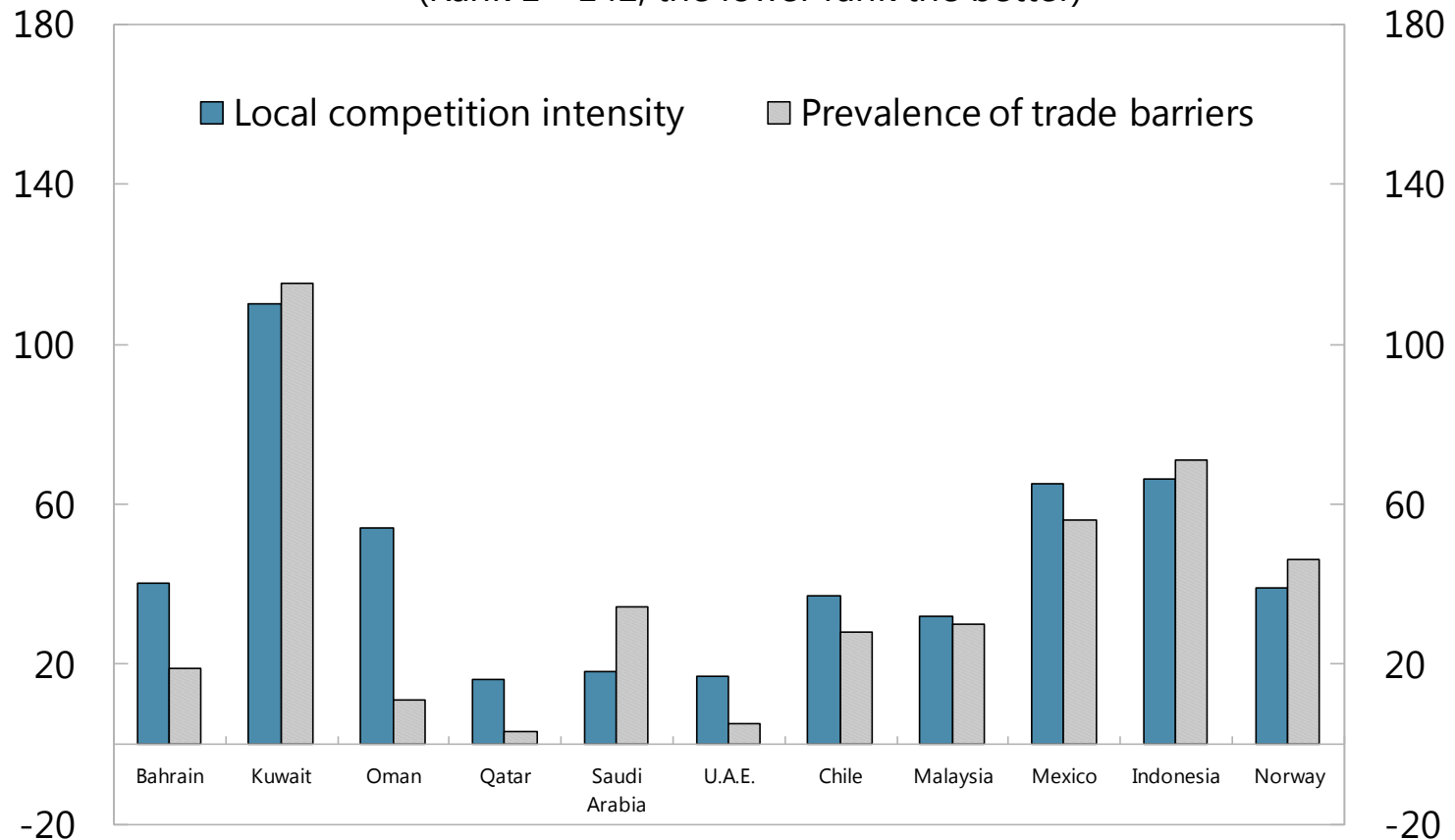
(Score of 7 "meets the highest standards in the world")



Tackling “Government Failures” III

Monopoly Related Indicators

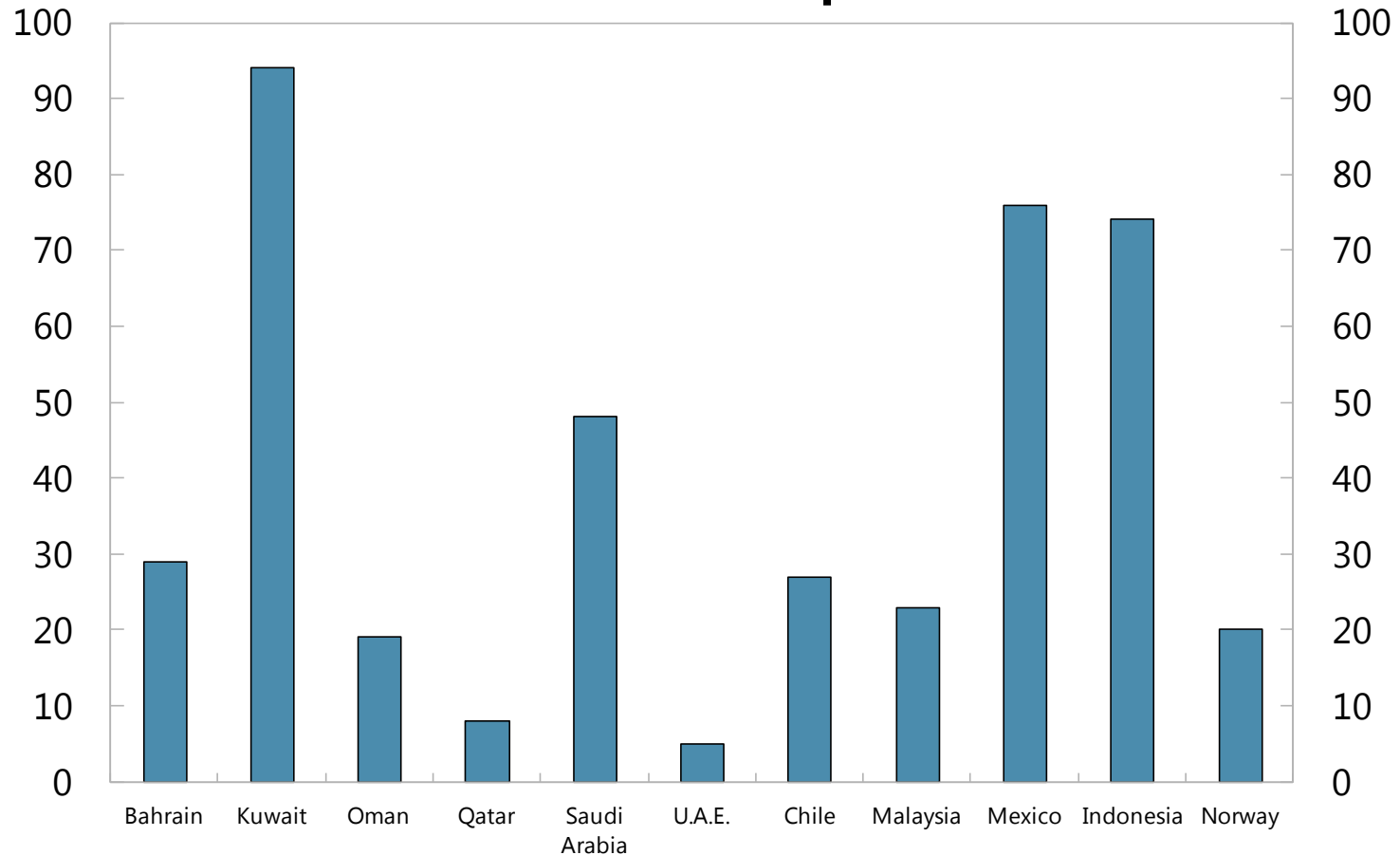
(Rank 1 - 142, the lower rank the better)



Sources: The World Economic Forum's Global Competitiveness Indicators (2013-14).

Tackling “Government Failures” IV

Burden of customs procedures



Source: The World Economic Forum's Global Competitiveness Indicators (2013-14).

“Market failures” are the binding constraint

- High scores in infrastructure quality and other business quality indicators in the GCC and much better than in successful oil exporters
- Norway could not escape the Dutch disease although government failures are basically nonexistent there, in particular in comparison with other oil exporters
- The diversification in successful oil exporters began when oil revenues were dwindling or about to start declining. Were it due to solving the government failures, this would have been a very unlikely coincidence
- Firms choose to produce non-tradables over tradables because of risk-return trade-off largely favoring non-tradables
- The “market failures” necessitate government intervention

Proposition 6

The government needs to change the prevailing incentive structure in the society.

Current incentive structure is not conducive for sustainable growth

- Public sector is the “employer of first resort”
- Generous pensions, early retirement age (below 60), high consumer subsidies (10-20 percent of GDP) and transfers
- The current system is not conducive to investment in human capital, employment in the private sector, and entrepreneurship

Changing incentives

- Setting firm limits on public employment and wages, substituted with social safety nets and minimal income and training vouchers
- Improving education quality through
 - Early childhood education programs (Heckman 2008)
 - Teacher quality enhancement programs
- Changing social attitudes through “Saemaul Undong”-type social development program
 - Encouraging communities to undertake small scale projects to improve their surrounding environment, followed by the investment in income-generating projects
 - The Saemaul Undong “...was in a sense, a movement for spiritual reform of Korean people, and has achieved a lot in this respect. It changed people’s attitude from laziness to diligence, from dependence to self-reliance, and from individual selfishness to cooperation with others.” (Choe 2005)

Proposition 7

The state could act as a venture capitalist and foster public-private collaboration to design and implement strategies that go beyond the comparative advantage sectors and target high value-added sectors with large potential spillovers and productivity gains.

The state as a venture capitalist

Experiences in other countries suggest:

- Policy mix in vertical and horizontal diversification
- Vertical approach:
 - Creating clusters around comparative advantage sectors in oil and gas, e.g. Norway in the 1970s
 - Building domestic capabilities and climbing the “quality ladder” with the emphasis on technological transfer and upgrade
- Horizontal approach:
 - Endeavoring beyond comparative advantage sectors
 - Pursuing high value added manufacturing and services such as IT
 - Venturing into innovation sectors

Policies for diversification in other countries

- Taxing non-tradable sectors and using subsidies to support exporters
- Using development banks, venture capital funds, and export promotion agencies
- Creating clusters with links to universities and investing in specific-purpose skills and infrastructure
- Coordinating regionally on strategies

3 key elements of success

- Clarity: The main policy objective should be the development of domestic exporters in high value added products stated in clear terms and measurable objectives
- Discipline: There must be a high level of government commitment to the objectives in social and industrial development with a comprehensive and credible accountability framework
- Trust: A high level of cooperation and trust is required for policies to succeed. Without tackling simultaneously social incentives, the strategies proposed would fail

Concluding remarks

- International experience of successful oil exporters suggest that the GCC countries have been trying some of the policies cited (e.g. horizontal and vertical diversification, clusters, investment funds)
- However, the main challenge is to fix the incentives for both firms and workers
- An emphasis on competing in international markets, technological upgrading, climbing the value added ladder, and enforcing market discipline and accountability is needed