EY: growth drivers

Understanding the opportunities and challenges for businesses in the GCC
Bringing young nationals into the private sector is an urgent strategic imperative

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We spend a lot of time having conversations with business people who are interested in the opportunities for growth around the GCC. In a global economy, where so many developed and emerging markets are struggling to maintain solid growth, they see strong and growing demand, especially in Saudi Arabia, the UAE and Qatar. Where elsewhere in the world austerity policies dominate the news, they see governments using oil and gas revenues to develop new industries, while setting the foundations for a knowledge economy. And where economic power centers are shifting, they see new global cities emerging.

But the tone of the conversations is not all about opportunity. Companies operating in the Gulf states are also challenged by complicated regulations and the difficulties of hiring and retaining local talent. These barriers to realizing the potential they see mean that global companies also worry about their long-term future in the GCC. The danger is that, once other big markets pick up and if the world’s appetite for oil starts to fall, the Gulf states may no longer be as attractive within the global economy as they are today.

This report is designed to address these issues head on. We focus on the four big drivers of policy, common across all of the Gulf states, despite their many differences: nationalization of employment, diversification, global positioning and stability. Each of these drivers brings with it a policy agenda that impacts business both directly and indirectly.

In many respects, these agendas complement each other. Ensuring that nationals have the skills and motivation to work in the private sector, for example, is essential if diversification is to succeed. But they also at times contradict each other, creating tensions that negatively affect business – as collateral damage, not intention.

Businesses interested in the region need to understand these drivers, if they want to realize the potential that is undoubtedly here. It is crucial to align their strategies with these overall policy aims, while tactically working around any contradictions in their implementation. Policy-makers also need to be aware that pursuing these goals, without taking into account their impact on investors, can make business expansion a slower and harder process than it needs to be. That holds back the progress of the Gulf states toward becoming attractive locations for global business, regardless of oil revenues.

As the oldest and largest professional services organization in the Gulf, with over 90 years of experience in the Arab world, EY is uniquely placed to offer in-depth insight into these critical issues, but also has a responsibility for taking the debate forward. That is why we are launching this report as the first in a new research series, EY growth drivers, designed to provide concise, thought-provoking and highly relevant input, in what is a very dynamic region. We hope that our efforts to help businesses and governments understand each other’s concerns take us a further step in helping to build a better working world.

Gerard Gallagher
Managing Partner
EY Advisory Services
gerard.gallagher@ae.ee.com
Driver 1

Bringing nationals into the private sector is an urgent strategic imperative.

Providing sustainable employment for nationals has become a growing concern in all of the Gulf states. In the past, jobs have mostly been created through the public sector, meaning that most nationals now work in government, while the private sector is dominated by expatriates at both the management and worker levels. That model is no longer viable, and there is a strong drive across the GCC to create jobs for nationals in the private sector.

Managed well, these employment nationalization initiatives can be beneficial for companies, employees and the state. But policies that are inconsistent can also disrupt economic activity, reduce profitability, discourage investment and harm the long-term prospects of a flourishing private sector capable of generating sufficient and suitable jobs for nationals. For companies, in other words, the nationalization drive brings both risks and opportunities.

Nationalization: ensuring that the private sector hires nationals

Over the past 15 years, all the GCC countries have had quota systems in place, requiring private companies to employ a certain percentage of nationals, depending on their sector, or face penalties. These initiatives have tried to address a number of different challenges. One has been to reduce the dependence on buying in skills as economies become more complex and diverse. Currently, GCC citizens account for a low of 1% of the private sector workforce in Qatar and the UAE.
and a high of 18% in Saudi Arabia. Increasingly, the dominance of expatriates in the business world is creating a sense of alienation among nationals, which is exacerbated by the rise in youth unemployment.

Another objective has been to avoid overstaffing in the public sector. Rising costs, as the population grows and more women enter the workforce, make the traditional social contract where the government guarantees jobs for all nationals in the workforce impractical in Bahrain, Oman and Saudi Arabia, where oil revenue per national is below US$15,000. But it is undesirable even in the three wealthiest Gulf states – Qatar, Kuwait and the UAE – where the policy creates cumbersome bureaucracies and jobs that often provide few opportunities for skill development and unsatisfying career paths.

Quotas have worked relatively well in a few sectors, such as financial services, where jobs are generally well paid and the relationship networks and local knowledge nationals can provide are commercially valuable. But in other sectors, companies are often reluctant to hire nationals, since they cost more than expatriates with equal or better skills and productivity. As a result, they have tended to view quotas as a kind of indirect tax and employ nationals in empty roles, expecting more experienced expatriates to do most of the work. Governments, too, have sought ways around the quotas, as rapid economic growth and dramatic demographic changes brought new needs and realities.

In recent years, nationalization initiatives have been pursued with a new urgency and greater creativity. The sudden drop in oil prices in 2008-09 reminded Gulf governments about the fragility of oil revenues, after a decade of nearly constant rises, prompting a more determined focus on diversification. Then the Arab Spring in 2011 led to greater emphasis on providing economic and social security to nationals. While the initial response was to raise public sector pay and recruitment, governments are now making renewed efforts, some of them quite innovative, to boost the employment of nationals in the private sector.

Quota systems are being overhauled to create more achievable targets that are monitored and enforced. In addition, governments are providing incentives to hire nationals in quality jobs, as well as fines for failing to do so. Nationals are often reluctant to work in the private sector since pay and benefits are generally lower than in the public sector, where job security, social status and flexible working conditions are also guaranteed. As a result, new efforts are under way to make the private sector more attractive to employees.

Focus: Saudi Arabia

70% nationals in the population
32% nationals in the workforce
18% nationals in the private sector workforce

Youth unemployment is the major driver of Saudization, as 400,000 young Saudis attain working age annually

Focus: UAE

11% nationals in the population
7% nationals in the workforce
1% nationals in the private sector workforce

Current Emiratization initiatives are based on the need to streamline bureaucracy, boost diversification and innovation, and provide attractive employment for Emiratis.

Focus: Qatar

13% nationals in the population
6% nationals in the workforce
1% nationals in the private sector workforce

The share of Qataris in the population has halved since 2003; even the public sector is dominated by expatriates. Just 37% of public sector employees are nationals. Qatar needs to find a more productive role for young nationals.

A raft of new initiatives include raising minimum wages for nationals or paying a share of salaries for new trainees, for example, while improving regulations on working hours and holidays in the private sector. Surveys of students or the unemployed routinely reveal that a large proportion would not even consider a private sector role, preferring to wait, often for years, until a public sector opening is available.

Youth employment: ensuring job opportunities for young nationals

One of the new drivers behind nationalization initiatives is the growing issue of youth unemployment. This is of particular concern in Saudi Arabia, Bahrain and, to a slightly lesser extent, Oman. The jobless rate for Saudis under 25 is around 28% of the youth labor force, according to both ILO and national estimates. The rate for unemployed graduates is even higher, at more than 40%. Even in the UAE, which has a far smaller population, unemployment among young nationals is becoming an issue, with 11% of under 25s without a job.

The problem is particularly serious among women, who are driving the growth of the GCC workforce. They are increasingly well educated, even outnumbering male graduate numbers in some countries. Employers often report that they are more productive workers – perhaps because they have more need to prove themselves in society. However, the job market has not responded well enough, and they now form the majority of the unemployed in the region, also among the young. Unemployment rates vary widely across the region, ranging from 21% in the UAE to more than 34% in Saudi Arabia, but everywhere, female rates are five to seven times higher than those of men.

Outlook for 2030

- The growth rate of the national labor force will slow, with women marrying later and having smaller families, so governments will focus on job quality rather than quantity.
- Female participation rates are likely to continue to increase, with women increasingly taking a wider variety of positions. Women-only workplaces – such as a flagship 3,000-person business process outsourcing center in Riyadh being developed by Tata and GE – will play a role but are unlikely to be the solution.
- Nationalization ratios will improve naturally as major infrastructure and real-estate projects are completed, particularly in the UAE and Qatar, where temporary construction workers represent some 40% of the workforce.
- The business opportunities created by this new infrastructure should also create significant numbers of high-quality jobs for nationals.
- Rising incomes in countries such as India, and hence higher salary requirements by skilled expatriates, could reduce the gap to national pay requirements. This trend may, however, be counteracted, as some Gulf countries are already looking beyond traditional source countries to lower-cost countries such as Nepal and Uganda.
- There will be greater national employment in sectors such as tourism and trade, currently seen as unlikely employers for nationals, especially in countries such as Oman, where oil reserves are dwindling, but also in other diversifying GCC economies.

Key considerations

For government:
- Focus policy measures around becoming a long-term magnet for global talent as the best way of developing local skills
- Work with schools, media and companies to develop skills and positive attitudes to working in the private sector
- Celebrate entrepreneurship and provide joined-up support for small business

For business:
- Focus on developing genuine career paths for young locals
- Work closely with other companies to articulate skill needs now and in future
- Collaborate with educational institutions to provide on-the-job training and work experience opportunities
Education: developing the right skill sets for employment or entrepreneurship

Improving education and training is critical to develop both skills and motivation. Gulf countries’ spending on education has been increasing very rapidly in recent years, and per student expenditure is among the highest in the world. However, the results of this spending are often poor. School curricula are often not well geared to the job market and the teaching style does not develop the skills and attitudes needed to succeed in the private sector.

Tertiary education has improved with projects such as Saudi Arabia’s King Abdullah University of Science and Technology or the UAE’s Masdar Institute of Science and Technology. Changing the education system will take decades, although attempts are under way, including important initiatives to introduce vocational training, especially in priority growth sectors such as transport and tourism. Dozens of new colleges of excellence are being set up around Saudi Arabia, for example, under public private partnership agreements. These are proving attractive and are a positive step toward skills delivery that is better aligned to private sector needs.

Improvements are also being made to ensure better links between employers and jobseekers. Most GCC countries, led by Saudi Arabia and Bahrain, are establishing labor market observatories to improve data gathering on the labor force, employment trends and jobseekers; others are developing new policies in areas such as internships and career guidance.

Governments are increasingly viewing entrepreneurship as a solution to youth employment. A recent EY survey showed that, outside of Bahrain, the vast majority of young nationals do not see setting up their own business as a viable option for them. There is, however, renewed recognition across the GCC of the importance of small and medium-sized enterprises as a source of employment. Consequently, a number of initiatives are under way to develop skills and create a support network for young entrepreneurs.

In the UAE, for example, the Government plans to introduce legislation to enrol self-employed nationals in the state pension scheme. In Qatar, several incubators are being set up to provide training and financing to support local entrepreneurs.

Financial services
The banking industry has been a focus for national quotas throughout the GCC and is a popular career choice for young nationals. We expect the insurance industry to provide the next success story for nationalization in the financial services sector.

Information and communications technology (ICT)
Technology companies are the most popular private sector employers for young nationals, topping the list in Saudi Arabia, the UAE, Qatar and Kuwait, according to a 2014 EY survey.

Tourism and hospitality
As a significant growth sector across the GCC, tourism will increasingly be a focus for workforce nationalization initiatives. In the UAE and Oman, it is already a popular choice. In Saudi Arabia, tourism is forecast to create 1.8 million jobs by 2020 and has a current Saudization rate of 27%, despite being relatively unattractive to nationals. The Government is focusing strongly on labor market reform in the sector.

Transport infrastructure
Aviation, metro or rail and logistics are fast-growth sectors throughout the GCC and a focus for nationalization. In the UAE, Etihad Airways has an 11% participation of nationals and has training schemes for cadet pilots, engineers and graduate managers, in sales and at airports. This is a critical industry for GCC states, since a mature national infrastructure is critical to overall private sector growth.

Retail
The introduction of mandatory female staff in parts of the Saudi retail sector in 2011-12 has made this fast-growing sector a major focus of jobs for national women. Elsewhere in the GCC, retailers are increasingly focusing on hiring nationals.

Health care
The health care industry is seen as a good target for nationalization, but only in Bahrain is it seen as a popular career choice for young nationals. In Saudi Arabia, a plan was announced in 2013 to have 100% nationals in the medical field within five years but, as elsewhere in the GCC, there are insufficient medical staff in training.
Earnings from oil and gas still account for 80% of budget revenues across the region, despite several decades of diversification. Spreading the risk of managing that dependence on hydrocarbons is one of the biggest challenges the Gulf region faces.

Tackling the challenge means achieving three aims: stabilizing earnings from oil and gas, expanding the revenue base to other sectors, and creating growth, prosperity and jobs for nationals. Hitting the nail on the head of all three objectives is not easy.

Each of the Gulf states has developed long-term strategies, using different combinations of vertical and horizontal diversification. But the region has yet to take advantage of a key lever in implementing these visions: coordinating diversification to leverage each other’s strengths and maximize the power and attractiveness of the economic bloc.

Better coordination would lead to greater efficiencies and reduce the duplication of economic activities. The GCC could have, for example, one aviation or financial services hub that would benefit the entire region.

The absence of such coordination means that foreign investors think twice about large-scale investments, since they have to set up operations in several fragmented markets, each with different rules and regulations. The GCC customs union has increased intra-regional trade from less than 4% of total trade in 1980 to around 6% now. But that lags far behind the European Union (EU), where intra-regional trade accounts for 60%.

As an economic bloc, the GCC would represent one large market for strategic investors, one where it makes sense to transfer know-how and create jobs.

There are some important cross-border initiatives under way, such as the Etihad railway network, connecting Saudi Arabia and Oman via the UAE, or the integration of the electricity grid. But more needs to be done on the ground.

Infrastructure-based integration has clear benefits to all parties and could be accelerated, facilitating the drive for diversification and providing answers to some of the region’s most significant social and economic challenges.

Managing the many risks of oil dependence is the region’s biggest challenge.

Progress to reduce GCC dependence on oil has been mixed. Gulf governments are still overwhelmingly dependent on oil and gas income, but are now focusing strongly on diversification. Improvements in infrastructure and regulations, together with the dramatic growth in both government and private consumption, mean that the market opportunities are far greater than during previous diversification drives. Companies that are able to align themselves with specific diversification trends in each country will find significant opportunities open to them.

Rethinking oil and gas: creating a sustainable future for hydrocarbons

Once Gulf governments realized that oil exports would bring them significant revenues, they were very aware that the resource was finite and needed to be used creatively to provide for future generations. This resulted in a push to build refineries and set up heavy industry in the 1960s and 1970s. The sharp fall in oil prices from the mid-1980s until 2000 highlighted the dangers of oil dependency – including downstream expansion – but it also limited the state resources available to invest in diversification.

The massive increase in oil prices over the last decade has meant that the share of the oil sector in the Gulf has increased significantly, from 33% of regional growth domestic product (GDP) in 2002 to 48% in 2012. That obscures the progress in diversification, financed by the proceeds of the boom.

But it underlines the importance of oil and gas for both energy security and creating economic value, explaining the continuous investment in the hydrocarbon and energy sector, alongside more conventional diversification.
One important long-term development has been the utilization of gas resources – both gas associated with oil that was previously flared and non-associated fields. Gas now accounts for 25% of hydrocarbon energy and production is over 2,000% higher than it was in 1977, compared with an increase in oil output of 45%. Qatar is responsible for about half the absolute increase, but the growth rates in Saudi Arabia, Oman and the UAE have also been impressive.

The substitution of gas for oil in domestic power generation has freed up large amounts of oil to export, a trend that looks likely to be replicated with renewables and nuclear power, particularly in Saudi Arabia, which is looking to generate a third of electricity from solar power by 2032. At the same time, Qatar, Oman and the UAE have exported gas by pipeline or in liquid form, diversifying their revenues from oil.

**Infrastructure: building what is needed to create a growing, diversified economy**

Visitors returning to some of the major Gulf cities, after a break of a few years, are generally struck by the rapid pace of development. Airport capacity is expanding rapidly, roads are being widened, metros are operational or under development, and the cities have grown outward and upward. Less immediately visible, but also significant, are improvements in telecommunications coverage and port capacity, which help these growing cities to function. The framework for the ongoing developments was laid out in a series of long-term visions and medium-term development plans across the region.

Oman and Saudi Arabia have been implementing five-year plans since the 1970s and were the first to develop longer-term 2020 visions (in 1995 and 2002 respectively). The other states published their own long-term strategy visions in 2008–10, aspiring to become diversified economies, driven by vibrant private sectors.

This infrastructure development continues apace, with Qatar focused on the 2022 World Cup, Dubai on the 2020 Expo, and other cities such as the King Abdullah Economic City in Saudi Arabia and Duqm port in Oman being created from scratch as catalysts for sectoral and regional economic diversification. All of these megaprojects create opportunities for engineering and construction firms, and all of the support services required by them and their workforces. At the same time, the improvements in infrastructure contribute to an improving operating environment for businesses in many sectors.

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**Focus: Saudi Arabia**

- 10% non-oil and gas as a share of budget revenue
- 12% non-oil and gas as a share of exports
- 56% non-oil and gas as a share of GDP
- 8% non-oil real annual average growth 2010–13

**Focus: UAE**

- 21% non-oil and gas as a share of budget revenue
- 45% non-oil and gas as a share of exports (excludes re-exports)
- 61% non-oil and gas as a share of GDP
- 4% non-oil real annual average growth 2010–13

**Focus: Qatar**

- 9% non-oil and gas as a share of budget revenue
- 12% non-oil and gas as a share of exports
- 46% non-oil and gas as a share of GDP
- 11% non-oil real annual average growth 2010–13

Outlook for 2030

- **Downstream investments** will continue and are seen as a hedge against disruptive technologies — such as cheap solar — that could reduce demand for crude oil and gas; in any energy scenario, demand for plastics, fertilizers and metals is likely to continue to grow.

- Unless significant new discoveries or extraction technologies emerge, Dubai and Bahrain may have entered the post-oil era, and Oman could be approaching it. This is likely to trigger even greater emphasis on diversification in these states.

- As fiscal constraints become more apparent, some Gulf countries will reduce **fuel and electricity subsidies** for much of the commercial sector (and for expatriates). This will significantly change the cost dynamics in some industries and encourage more localization of production.

- Regional concerns about **food security** are likely to intensify, encouraging diversification for import substitution into technologies such as vertical farm hydroponics and food processing, as well as strategic storage facilities.

- **Tourism** in the region will benefit from a growing Asian and African middle class looking not just for leisure but also for niche travel, such as health care, with direct flights to the Gulf from hundreds of major cities.

- The regional **real estate** sector is likely to see more booms and busts, but long-term interest by foreign buyers will continue in locations with political stability and international connectivity such as Dubai and Doha.

- The **trans-Gulf rail network** should be operational, facilitating regional trade and boosting tourism both within the Gulf and from external visitors.

- **Gulf sovereign wealth funds** will increasingly help to diversify their domestic economies, taking strategic stakes in relevant companies on the understanding that they develop operations in the Gulf and transfer knowledge and technology.

Supporting new sectors: creating innovative and competitive industries

Vertical diversification remains an area of expansion because the majority of the GCC’s hydrocarbons are still exported in an unprocessed form. Kuwait was an early mover in this field, and also the only Gulf state to extend its reach all the way to foreign consumers through its own chain of petrol stations in Europe. Kuwait is finally moving ahead with updating its aging refineries through its Clean Fuels Project, awarded in February 2014, and is also planning a major new refinery. Other downstream activities include petrochemicals and fertilizers, with recent developments including a major ramp up in Saudi Arabia and Qatar’s petrochemical facilities.

Overall production in the GCC of both **fertilizers and petrochemicals** has more than doubled since 2003. More capacity is under construction, and there are plans for yet more plants ranging from the Tacaamol aromatics complex in Abu Dhabi to an expansion of Bahrain’s Sitra fertilizer plant. Asian demand, which has driven the recent capacity increases, is expected to continue growing strongly. New competition from the US, where cheap shale gas is reviving the downstream sector, could put pressure on margins, but the GCC will remain the lowest-cost producer. A key trend is to diversify petrochemical production to a wider range of more complex chemicals and add further value by processing some of them into plastics and other products, at least for the domestic market. Saudi Arabia’s SABIC is also developing techniques to create petrochemicals directly from crude, bypassing the refining stage.

Cheap energy has also encouraged diversification into **metals production**. The Gulf already has 4 of the 10 largest aluminium smelters in the world (and will add a fifth if Qatar goes ahead with an expansion of Qatalum). There are also major steel plants, with new projects under way, including an expansion of the Sohar complex in Oman. As with petrochemicals, there is a growing focus on creating clusters of downstream manufacturers to utilize some of the metal produced. In Khalifa Industrial Zone Abu Dhabi (Kizad), for example, a vertically integrated metal engineering zone is being built around the existing Emal aluminium smelter.

Vertical diversification into gas, downstream and heavy industry creates wealth, but the commodities produced are closely correlated with oil prices, providing little hedge against volatility. These sectors are also capital rather than labor intensive, and therefore don’t create many suitable jobs for Gulf nationals.

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**Key considerations**

**For government:**
- Streamline regulation to ensure that the overall business environment continues to improve
- Improve coordination with other GCC states to build regional centers of excellence and increase scale
- Focus on deepening comparative advantage through investment in R&D

**For business:**
- Understand diversification priorities and align strategy with these
- Focus on leveraging global talent to develop local skills as the business grows
- Develop partnerships and synergies with a broad range of Gulf companies in key sectors
As a result, there has been an increasing focus on the services sector over the last decade. Parts of the services sector, such as construction, depend directly or indirectly on government spending, and hence on hydrocarbon revenue. But there are some sectors where real value is being created, such as aviation, trade, tourism and financial services.

Aviation has been a significant success in Gulf diversification, leveraging the region’s strategic geographic location, easy access to fuel (whether subsidized or not), excellent airport infrastructure and surplus capital. Emirates was founded in 1985, but its dramatic ascent to the top of the industry began in earnest during the last decade, at the same time as its main regional competitors, Qatar Airways and Etihad, were founded. In 2013, Dubai International Airport was the second busiest in the world for international passenger traffic, and growth rates suggest that this year it will even surpass London Heathrow, while the giant new Dubai World Central airport offers room for further growth, particularly for cargo and logistics. Doha currently sees a third of Dubai’s traffic, but that still places it 22nd internationally, and the opening of Hamad International Airport this year gives Qatar Airways room to grow further. The UAE has already begun to leverage its aviation expertise into the provision of maintenance services and production of aircraft parts, with a focus on training national aviation engineers.

The move into aviation follows a longer-term focus by some Gulf states on sea trade, dating back to the pre-oil era, again benefiting from the Gulf’s location on the route between Europe, Asia and Africa. Dubai and Oman have invested heavily in port facilities and services, and their locations are ideal to facilitate transhipment for the region and trans continentally. There is a risk of port overcapacity in the region, but provided global trade continues to grow in line with consensus projections, there should be enough market for all. Kuwait also aspires to play in this field and has developed strong logistics firms, such as Agility.

Tourism is another growth sector for the region. Saudi Arabia has always had religious tourism, and this is growing strongly, driving the economy in the Hijaz region, particularly as the expansion of the Grand Mosque in Mecca and hotel capacity increases the number of pilgrims that can be accommodated. There is a close synergy between tourism and aviation, as direct and frequent flights to the Gulf hubs makes visits more appealing. This is particularly the case in Dubai, where tourism (in turn linked to the real estate sector) is one of the main drivers of growth. But tourism is also important in Bahrain, where it caters mainly to Saudis, and in Oman, which offers a variety of unusual tourist attractions from a monsoon-swept coast to high mountains. Qatar and Abu Dhabi are marketing themselves to high-end niches such as cultural, eco and health tourism.

The challenge with both aviation and tourism is to ensure that they create jobs that are of interest to Gulf nationals. That partly explains the push, particularly in the smaller Gulf states, to develop sectors that create high-income, high-status jobs. An easy win has been financial services, generally the part of the private sector with the highest level of nationalization.

But there is a limit to how much it can grow domestically, and fierce competition between regional hubs means most will have to focus on specific niches. A broader focus is on catalyzing the development of a knowledge economy, but the educational gap between Gulf states and countries that are leading in the knowledge economy is significant, and progress in this field will be slow.

Business-led growth: empowering the private sector, family businesses and entrepreneurship

Gulf countries have taken many policy measures to encourage investment by the private sector, both domestic and foreign, with the aim of driving diversification. These range from corporate tax rate cuts to public-private partnerships (PPPs) regulations, a reduction in bureaucracy and an easing of foreign investment laws (although this is constrained by entrenched local interests opposed to greater competition). One way around these concerns has been the boom in free zones that offer tax advantages, shield firms from a considerable amount of bureaucracy and permit 100% foreign ownership. Dubai has led the way here, but other examples include the Qatar Financial Center (2005), Salalah in Oman (2007) and Kizad (2010).

There have also been efforts to reduce the costs and delays caused to firms by government bureaucracy. The World Bank’s Doing Business Index is a benchmark of this, and most Gulf countries score highly on it and have improved in recent years. In 2014, the UAE leads the Middle East and North Africa region, taking 23rd place globally, followed closely by Saudi Arabia in 26th place.

Gulf capital markets are becoming larger and more liquid – demonstrated by the decision to include the UAE and Qatari markets in the MSCI Emerging Market Index from May 2014. This provides new opportunities for local firms to raise capital for growth, although there is a tendency for the larger family firms that dominate much of the region’s economy to remain private, and much of the market capitalization is represented by partly privatized state firms. Finding ways to support family businesses so that they expand, excel and have a knock-on effect in the economy remains a crucial need.

Meanwhile, there is a welcome focus from governments on encouraging new entrepreneurship. The Saudis, for example, introduced a US$200 million financing guarantee program for small businesses in 2006. It had guaranteed 7,280 loans by the end of 2013, but over one-third of these were issued in the last year alone, as the scheme gathers scale. Enterprise Qatar launched TechWadi in 2013, a Silicon Valley-based incubator offering training and support to selected Qatari entrepreneurs, who receive seed financing on their return. In Oman, a decree stipulates that 5% of bank lending by the end of 2014 must go to small and medium-sized enterprises, which have often struggled to get financing and grow.
Gerard Gallagher
Managing Partner, Advisory Services
gerard.gallagher@ae.ey.com

The economic fundamentals in the GCC are currently very strong. International companies are attracted by the resurgence of demand in the region’s markets, while GCC companies are investing heavily both at home and abroad. Nevertheless, there are significant barriers to realizing the economic potential of the moment – and without concerted action, that moment may pass.

The barriers are well-known: complicated regulations and a shortage of home grown talent. Governments around the Gulf are indeed tackling these challenges, but possibly in a short-term and reactive way.

The region’s forward-looking visions, while bringing important progress on physical and social infrastructure, still need to address the core long-term foundation for ensuring that the GCC countries are able to attract global business when the world’s appetite for oil runs out.

As a result, government policies are often inconsistent, limiting the ability of both global and local companies to accelerate the process of translating oil wealth into sustainable growth, driven by local talent.

So what is the long-term vision that will ensure that global businesses remain interested in the GCC, regardless of oil revenues and the fortunes of other larger emerging markets? How can the GCC become a hub for innovative, global talent?

The key is to welcome the world into the GCC – not just as tourists or expatriates, but as global talent, with a stake in the long-term economic future of Gulf markets and the desire and ability to motivate and nurture the region’s young people. That means building an open community made up of world-class talent, home grown and otherwise, with similar hopes, aspirations and opportunities.

The Gulf opportunity is large, but it is time-bound. Now is the time to take advantage of the region’s short-term attractiveness to become a long-term global magnet.

**Global positioning**

**Driver 3**

Gulf countries have benefited from the shift in global economic power.

The Gulf region has been outward looking for millennia, connected to Asia and the Mediterranean world by trade routes, and attracting Muslim pilgrims from around the world. The oil age launched a new era of internationalization, focused initially on the US and Europe, but opening up to the Asian giants as they developed. Now, the Gulf states mirror the emergence of the globalized economy – their workforces known for international diversity, their strategic location translated into new trade and investment partners, and their importance as global investors growing. But fine-tuning this global positioning, in societies that are still conservative, remains a potential source of tension that businesses need to be aware of.

**Trade and investment patterns: making the most of the global shift of economic power**

The Gulf region is used to adapting to the changing fortunes of the world economy. Its oil exports, initially directed at the US and Europe, started flowing to fast-growing Japan in the 1960s. Japan remains the single largest market for Gulf exports with a market share of 15%, but that is just half its peak in 1985. Korea became the next Asian Tiger to develop, and it still enjoys a share of 10%, pushed into third place by India in 2012 and still just beating China, which also hovers around the 10% mark.
Over the past decade, Asian demand has risen rapidly not only for oil and gas, but also for the products of Gulf diversification such as petrochemicals, metals and fertilizers. Indeed, marking the shift in world trade patterns, Asia now absorbs 59% of GCC exports. Europe’s share has fallen from 37% in 1980 to just 7% now. The US also registers 7%, just half of what it was in 1990. Emerging markets, which purchased only 20% of Gulf exports in 1980s, have purchased the majority since 2009.

Trends in imports tell a similar story, with the relative decline of the Organization for Economic Co-operation and Development (OECD) countries and the growing importance of emerging markets, particularly those in Asia. In 2012, China and India were the biggest sources of imports for the GCC, at 12% and 11% respectively. Their combined contribution was just 5% 20 years ago. Other emerging markets, such as Turkey and Brazil, have also grown in importance as sources of imports. The European Union (EU) remains strong at 22%, but this is a fall from 34% in 1990.

Just as trade flows have been shifting, so too has investment. The GCC countries traditionally invested much of their assets, both public and private, in Europe and the US. New funds do continue to flow to those established markets, such as the sizable slice of prime real estate in London that has been purchased in recent years by the Qatar Investment Authority (QIA). However, there has been a growing recognition of the need to invest further afield to diversify portfolios, participate in fast-growing markets and also to build relationships with important emerging partners, such as Morocco, Algeria and Malaysia.
Capital-rich Gulf companies have also begun to globalize in recent years. Initially, their focus was largely on the MENA region, but increasingly, they are playing further afield in Latin America, Asia and Africa.

The expansion began during the oil boom in the mid-2000s, with landmark deals such as DP World of Dubai’s acquisition of P&O in 2005, which had ports in countries from Peru to China. In the same year, Kuwait’s mobile operator Zain bought Celtel’s network across 13 African countries (although it sold these operations in 2010). Recent examples include Ooredoo of Qatar securing a license to launch a mobile network in Myanmar and the Al-Futtaim conglomerate of Dubai purchasing an automotive retail chain in Kenya in 2013. Similarly, Gulf banks have been establishing more of a presence both in the MENA region and globally, particularly Qatar National Bank, which now has operations in 26 countries from Mauritania to China.

At the same time, inward investment into the GCC is coming from a wider range of sources than the European, US and Japanese investors who have been active for decades (and remain the main source of inflows). For example, Chinese, Korean and Turkish companies are active in the construction sector.

There are also growing portfolio investment inflows, as foreign investment limits are raised and the UAE and Qatari equity markets enter the MSCI Emerging Markets Index in May 2014. Asian banks have played a growing role in loan syndications and bond financing, for example, as many European banks disengaged from the region following the economic crisis.

**GCC integration: creating a strong economic bloc**

On the surface, the GCC states look like easier candidates for integration than the EU, given their shared language, economic models and political systems. But since the formation of the GCC in 1981, its progress toward greater political and legal cooperation has been mixed. The Customs Union remains only a partial success and monetary union is on the backburner. Intra-GCC trade represents just 5% of the total exports of the six states combined, a share that has hardly changed in a decade.

One reason is the lack of economic imperative to take this path – although the benefits in terms of foreign direct investment and, consequently, diversification would be substantial. The other is competition between countries and the emergence in recent years of diplomatic differences in dealing with the changing dynamics of the Middle East.

**Outlook for 2030**

- **China and India** are expected to roughly double their share of global GDP over the next 15 years. Their weight in the GCC’s trade and investment portfolio is likely to increase proportionally.

- **Sub-Saharan Africa** is likely to become an increasingly important trade partner, providing imports ranging from food to electronics. Its share of GCC imports was just 1% in 2012, unchanged in a decade, but this should grow substantially in the coming period as its population booms and its economy develops.

- More GCC companies will function as **multinational** companies, and some multinationals from elsewhere in the world may choose to relocate their headquarters to the GCC, to benefit from both its geographic connectivity and lower corporate tax rates. In particular, fast-expanding companies from Africa and Asia are expected to use GCC hubs, especially Dubai, to expand beyond their home regions.

- The GCC will be more **interconnected** than ever, with fast rail links or flights between most of the major cities. This will facilitate the environment for services companies that operate out of a hub city, but serve clients across the region.

- Improving **port facilities** in most GCC countries, together with the rail network, will facilitate trade in both directions with the rest of the world.

**Key considerations**

For government:
- Understand the motivations, strategies and needs of international companies as they locate in specific GCC markets
- Sustain momentum within the GCC toward becoming an integrated economic bloc
- Use large-scale international events to build public engagement with the world by tackling risks ahead of time

For business:
- Make use of the Gulf’s strategic position to rethink global supply chains and corporate structures
- Ensure regular dialogue with both the broader business community and government to articulate corporate strategies and needs as the region develops
- Focus on ways to make use of the growing physical integration of the GCC markets
Nevertheless, the GCC is steadily becoming more economically integrated in practice. The period of rapid growth over the last decade has created bottlenecks and shortages in some states that required more cooperation with neighbors.

Gas shortages in the UAE, Oman and Kuwait are being partly addressed through pipeline and liquefied natural gas (LNG) supplies from Qatar. At the same time, a shortage of port capacity in Qatar has been addressed through increased shipments by land, as imports come via Saudi Arabia and the UAE. The growth of the major Gulf airlines has increased the frequency and decreased the cost of intra-GCC travel. Another development has been the integration of GCC electricity grids, helping to smooth out supplies during peak demand in the summer. The next step will be a rail network linking the major coastal cities from Kuwait to Muscat, which is likely to be operational by the early 2020s.

**Country branding: improving regulatory environments and opening to the world**

The GCC’s global economic prominence has risen rapidly in the past decade, with its share in world GDP doubling to 2.2%. As its trade and investment have spread internationally, the region has worked closely with international organizations to benchmark itself against global norms and standards. The GCC states joined the World Trade Organization, for example; most soon after its launch in 1995. The Gulf states have also worked hard to improve business regulations as measured by the World Bank’s Doing Business Index, and most score relatively highly (Kuwait is an exception). The UAE, for example, moved up from 59th place in 2007 to 23rd in 2014, where it leads the MENA region, followed by Saudi Arabia in 26th place.

Some GCC states have recently begun to participate actively in international events as a way of defining their country’s image in a fast-changing world. Sporting events have led the way, with Bahrain and then Abu Dhabi hosting Formula One races, for example, and Qatar turning itself into a champion of sports, with the hosting of the Asian Games in 2006 and the successful bid for the 2022 World Cup. The UAE has invested heavily in its presence at World Expos, and Dubai will now host the World Expo in 2020, cementing its branding as a cosmopolitan global city.

This public engagement with the world is a natural step as the Gulf states gain in global stature and the image boost brings enormous benefits in terms of increased trade, investment and tourism. But it also involves outsiders taking a critical and uncontrollable look at all aspects of local economies and cultures. Learning to accept and respond with confidence to that international scrutiny will be one of the challenges of the next few years.

**Transport infrastructure**

The growing connectedness of the GCC countries creates considerable opportunities for transport infrastructure, aviation and logistics. One of the prime opportunities is the growing logistics nexus between Jebel Ali Port and Dubai World Central airport.

**Marketing and consulting**

As the GCC countries seek to position and brand themselves within the global arena, they are looking to firms with global expertise to advise and assist them in this endeavor, as well as to identify new opportunities and advise on market entry.

**Financial services**

Investment banking opportunities are growing again as capital-rich Gulf companies expand internationally, through acquisitions and organic growth. Sovereign wealth funds that are increasingly diversifying their assets away from familiar developed markets need third-party funds and advice to help build these portfolios. A big game changer would be if Saudi Arabia decided to diversify its very conservatively managed portfolio.

**Retail**

As the GCC market becomes more integrated, there are opportunities for cross-border expansion and consolidation in a number of sectors, particularly in retail.
Preserving social and political stability is one of the key drivers of policy in the GCC. Prior to 2011, the central focus of the implicit social contract that the Gulf rulers have with their citizens was prosperity through economic growth. But since the Arab Spring, more emphasis has been placed on ensuring that oil wealth translates into social welfare and both economic security and opportunity for nationals. This means creating attractive jobs and providing a high-quality and affordable social infrastructure for the fast-growing Gulf populations.

Gulf countries’ spending on education has been increasing very rapidly in recent years, and expenditure per student is among the highest in the world. However, the results of this spending are often poor and, across the GCC, state schools tend to lag those in other regions. Two GCC countries participated in the OECD’s Programme for International Student Assessment (PISA) tests in 2012 – the UAE ranked 46th out of 65 countries across maths, science and reading, while Qatar averaged 63rd. In the UAE, the Ministry of Education estimates that students are 14 months behind their peers in developed countries.

Private sector solutions will not be sufficient to tackle the challenge. A number of well-regarded private schools have emerged, especially in the UAE and Qatar, where the children of wealthy nationals pursue British or US curricula in English alongside expatriates. This provides them with the international outlook and capacity for critical thinking that is missing in state-run schools, preparing them well for the Gulf labor market. But it divides the national population into those who are well prepared to cope with the new economic realities of their countries and those who are not.

To realize the promise of diversification and nationalization policies, while maintaining social stability, Gulf governments must continue to reform both their schools and universities, modernizing their skill base while retaining their cultural identity.

The Gulf states face a difficult balancing act. They must maintain a sense of security and contentment for their citizenry, during a period of economic growth and social change. Their success at maintaining stability over the past few years is a result of constant attention in multiple directions. Understanding the underlying priorities and challenges facing the Gulf states can help companies to be prepared for unexpected changes in the legislative and operating environment intended to ensure continued stability.

**Social welfare: looking after citizens’ needs**

One of the greatest social challenges facing Gulf countries is ensuring that nationals receive acceptable levels of education, health care and housing. Public provision of social infrastructure is regarded as a right – part of the social contract between rulers and their citizens. But higher expectations of quality and strong pressure on resources from the fast-growing Gulf population has meant that the public sector is struggling to deliver. Governments across the Gulf view tackling the social infrastructure challenge as key to maintaining stability and social cohesion.

The tensions are particularly visible in the health care system. In the past, the vast majority of health care was delivered by the public sector. However, the old model has been strained by two factors. First, the cost of treatment for nationals is rising, as chronic disease becomes common even among those in their 20s and 30s, while high standards of care are increasingly expected. Secondly, the rapid growth in the expatriate population has put pressure on medical facilities, meaning that the GCC, as a whole, now has less than two hospital beds per 1000 people, less than half the OECD average, along with a shortage of doctors.
The net result has been a tendency for nationals to insist on treatment abroad, leaving the quality of public sector provision to dwindle. Gulf countries are responding to this by moving increasingly to a market-based model where the private sector delivers many health care services and also pays for them through mandatory insurance schemes, which have been introduced in most GCC states. These ensure that employers cover expatriate treatment, while the state generally picks up the bill for nationals either through free treatment or via the insurance scheme. Simultaneously, Gulf governments are developing primary care systems to ensure that chronic diseases can be prevented and treated outside of hospitals.

The private health care sector therefore presents tremendous growth prospects. But it also faces some significant obstacles: the world’s highest levels of diabetes and obesity, the lack of national doctors and nurses and the lack of critical mass needed to build know-how in highly specialized areas of medicine. Nevertheless, private clinics and hospitals are now growing rapidly. An emerging model in some states, such as Dubai and Sharjah, is health care free zones, to spur private sector investment with a view to health tourism as well as the domestic market. Private sector players have also been brought in to manage public hospitals, particularly in Abu Dhabi, which has management contracts with the international arms of two leading US hospitals, Johns Hopkins and Cleveland Clinic.

Housing represents a similar challenge. The huge investment in real estate projects across the GCC in the last decade obscures the fact that there is a serious housing crisis for many Gulf nationals. Demand for housing has increased given the high birth rate among the Gulf population which, although now slowing, has resulted in a large youth bulge. In addition, the population has urbanized as economic activity in the region has become focused on a few major cities.

This would push up land and house prices in any market, but the additional influx of expatriate workers has further strained the system. Denser housing projects for rent to expatriates are usually more profitable than using the same land for the large stand-alone houses that nationals prefer. Weaknesses in zoning and planning have accentuated the problem.

As a result, nationals have looked to their governments to provide them with affordable housing. All the GCC states have legal commitments of various kinds to provide housing. This has usually been done through mechanisms such as land grants and concessional loans, or housing projects.
developed directly by the state. For example, Kuwaitis are entitled to a 400-square meter land plot and a loan of about US$250,000 to build a house. However, these initiatives have failed to keep up with demand, mainly because of land shortages. The waiting list for subsidized homes in Kuwait is said to be over 100,000, about 20% of the adult population, and over 55,000 in Bahrain. The biggest gap is in Saudi Arabia, where the majority of nationals rent their homes and there is thought to be a shortfall of about 1.6 million affordable houses.

A survey prepared for the Kuwait parliament in 2013 found that housing was the leading concern among nationals, and the issue took the spotlight in 2011 as unrest spread through much of the Arab world. In this context, GCC governments announced ambitious house building schemes, such as a US$5.6b plan in Bahrain and a US$67b plan in Saudi Arabia for 500,000 affordable homes. However, implementation has been slow.

Increasingly, the private sector is being seen as the solution to rapidly boosting the housing stock for nationals, as well as financing opportunities. In 2013, Saudi Arabia announced that it was developing legislation to enable PPPs in housing, and would hand over land and provide incentives to encourage private financing of housing schemes. Kuwait is also looking to PPPs, with plans to tender four major projects totaling 120,000 housing units.

**Government spending: using subsidies to sustain growth and maintain legitimacy**

Another anchor considered as vital to maintain political and social stability in the GCC is the system of subsidies. The most prominent of these are free electricity and water and heavily discounted fuel, although subsidized food is also available in some states. The precise cost of these subsidies is not broken out in most GCC states' budgets, and they are sometimes even extra-budgetary. Kuwait records that about 15% of its expenditure is spent on subsidies, and the IMF estimates levels could rise as high as 28% of government revenues.

While some subsidies are directly targeted to nationals, others may be mainly used by expatriates and businesses, such as subsidized fuel at petrol stations. Subsidies also encourage wastage. Common examples in the Gulf are buildings with lights and air conditioning left on when the occupants are away, or precious desalinated water being used to sprinkle lawns in the desert and wash cars. Saudi Aramco estimates

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**Key considerations**

**For government:**
- Ensure that reactive initiatives do not contradict long-term goals that are essential to stability
- Speed up the implementation of long-term visions
- Address the insecurities created by rapid social and demographic change directly

**For business:**
- Build an understanding of possible sensitivities and policy contradictions and delays into business planning
- Focus on articulating how business solutions are relevant in crucial areas of social infrastructure provision and services
- Ensure that corporate responsibility initiatives align with stability needs
that, without a change in energy consumption, the country could lose three million barrels of oil per day in exports. Both Saudi Arabia and the UAE are looking to solar energy and nuclear power to avoid using precious oil to produce electricity, but changing behavior will be vital too.

Gulf countries periodically run environmental campaigns to encourage voluntary restraint but, without a cost incentive, these have proved ineffective. In 2008, Qatar passed a law banning the use of hoses to wash cars and leaving on outdoor lights during sunlight hours, but there has been little enforcement and the fines are very low. However, the idea of conservation is at least on the table in the region, and there is an impetus for companies and government agencies to show leadership by implementing initiatives to reduce their consumption levels. This is creating opportunities in energy-efficient building construction and retrofitting.

Removing subsidies, however, will only take place over a very long period, and primarily where they only affect expatriates and businesses. Both Bahrain and Kuwait openly discussed subsidy cuts at the beginning of 2014, but both abandoned the attempt following protests. Oman is, however, currently considering gradual fuel price increases.

**Military forces: maintaining security**

Located within a volatile region, Gulf states have put a substantial focus on security in an attempt to insulate their citizens and economies. They have done this through international alliances, significant spending on high-tech military hardware and sizable security forces. The military is also an attractive employer for young nationals. In a first for the region, in 2014, Qatar introduced compulsory national service for all men aged 18–35, albeit only for a four-month training period. This will impact companies who will have to make their staff available for national service as requested.

The Gulf countries have long talked about greater military cooperation, but progress has been slow. The joint Peninsula Shield Force is formally based in Saudi Arabia, close to the borders with Iraq and Kuwait, although most soldiers associated with it are stationed in their home countries. At the most recent GCC summit, in December 2013, closer cooperation was agreed, including the establishment of a joint military command, a GCC police force and a defense think tank. However, implementation is likely to continue to be slow, given differences between the states.

**Financial services**

Banks will see growth in the mortgage market, as new regulations support growth from a small base, especially in the UAE and Saudi Arabia. There will also be growing opportunities in health care financing, providing direct loans and project financing to PPP projects, while helping structure IPOs and bond issues to providers.

**Health care**

Insurers will struggle to achieve profitability as the fragmented market consolidates and companies try to get a handle on appropriate premium prices, despite complex and rapidly changing demographics and the absence of good actuarial data.

**IT**

The growing focus on security creates opportunities for the IT sector, to develop systems to assist the police and other security services in their tasks. IT is also important for data-gathering and health monitoring in the health care sector.

**Construction**

The demand for housing among Gulf nationals, and the growing availability of state subsidies to assist them, is expanding the market for villa construction, with potentially large profit margins. There are also significant opportunities for firms involved in the construction of health care facilities, as both the public and private sector expand rapidly.

**Life sciences**

The growing focus on private health care and insurance, along with the high level of chronic diseases, means fast-growing opportunities for pharmaceutical companies. Nevertheless, pressure on prices remains high.
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