Digging beneath the surface
Is it time to rethink diversification in the GCC?
Growth Drivers 2
Executive summary

Diversification is a clear and urgent necessity for all the GCC countries; it is important for both economic and social stability – and for ensuring long-term prosperity. Governments have strategies in place to achieve it, but implementation has been inconsistent during the oil boom. Now, with recent oil price volatility, diversification has returned to the top of the agenda – but new approaches are needed.

There has been progress in most countries, and the simple indicators of the reliance on the oil and gas industry fail to tell the whole story. Our Diversification Tracker measures economic complexity and private sector spending as well as natural resource dependence. Though it remains a challenge to measure all aspects of a nation's diversification fully, the tracker does allow us to explore the comparative position of the GCC and its potential were it to reach the level of other high-income countries.

The tracker shows that the UAE is ahead of other economies, such as Brazil and Canada, in terms of diversification. The GCC as a region, however, trails the high-income Organization for Economic Co-operation and Development (OECD) countries and the large emerging markets by some distance. Saudi Arabia lags overall, but shows a similar level of economic complexity as the UAE, while Qatar shows rapid growth in the share of its non-oil economy, but a tiny contribution from private sector spending – reflecting the dependence on recycled government oil revenues.

If the GCC countries were to achieve the average OECD level of diversification, our research suggests that this would be correlated with an increase in real GDP of 1.6%. In other words, a diversified GCC would see an additional gain of up to US$17.7 billion.

Diversification efforts over the past decade have relied heavily on governments recycling oil revenues into new sectors. That has created several promising new sectors, ranging from construction and transport to telecommunications and manufacturing. But now that government budgets are tighter, and the urgency greater, the focus and aims of diversification must be clarified.

There are three factors to consider:

1. Which sectors have the most potential to stand on their own feet, without relying for the long run on government spending, subsidies and other support?
2. Which sectors are likely to have the greatest impact on other sectors and the economy as a whole?
3. Which sectors can create jobs that are genuine alternatives for public sector employment for Gulf nationals?

EY research on economic multipliers and current trends in the employment of nationals show that there is a “sweet spot” where regional strengths, economic impact and nationals’ employment preferences meet, allowing all three factors to be achieved. Sectors that fall into the sweet spot include transport, financial services, retail and tourism, telecommunications and R&D.

The key is not, however, for governments to pump more public money into these sectors. The public sector needs to shift from being the main investor to being the enabler and driver of business, resetting the incentives, removing regulatory obstacles, encouraging collaboration and providing world-class infrastructure and services.

Diversification will progress very slowly if the GCC region looks inward, focusing on protecting existing companies and jobs, rather than pushing them to be globally competitive.
Everyone recognizes the need to diversify our economies away from dependence on oil and gas. It is an immediate priority and central to the long-term visions that guide GCC development efforts. When the oil price is high, the sense of urgency driving diversification tends to decline, and difficult decisions and trade-offs are often postponed. Now, with oil price volatility, diversification is back at the top of the agenda (see page 5: “A brief history of Gulf diversification”). It is vital that we use the window of opportunity created by the reserves we have built up to stimulate the emergence of broad-based, competitive economies that attract both local and foreign investors and create jobs for nationals.

Understanding why diversification is important is simple. It is crucial for economic stability, since it reduces the boom and bust cycle that comes from reliance on volatile oil prices. It is increasingly important for social stability, since it creates job opportunities for rapidly growing populations who can no longer be fully accommodated in the public sector, which is now both overstaffed and becoming unaffordable in some Gulf countries. In the long run, diversification is necessary for long-term economic survival, with oil and gas reserves depleting and the world trying hard to shift away from its dependence on fossil fuels.

Our Growth Drivers series is focused on tackling the region’s most important challenges and highlighting the next steps for governments and business to consider.

As we explored in our first Growth Drivers report, there have been significant achievements in some sectors and countries, but standard measurements of diversification show that Gulf countries are actually more heavily reliant on oil and gas than they were a decade ago. In 2013, for example, hydrocarbons accounted for about 46% of Gulf gross domestic product (GDP), up from 35% 10 years earlier – that share boosted by high oil prices, as well as increased production levels. This is not an accurate assessment of diversification progress.

This, our second Growth Drivers report, is dedicated to digging beneath the surface of what diversification really entails in order to understand where the GCC countries stand globally, what we have already achieved and what we should focus on now to get the biggest impact. To do this, EY has conducted a series of econometric analyses that measure different dimensions of diversification and analyze their relationship to future growth, prosperity and jobs.

In Section 1 (see page 6), we benchmark the GCC countries both globally and against each other using the EY Diversification Tracker, which provides a standardized basis for assessing the degree to which economies have moved away from dependence on oil and gas, and examine how this relates to economic growth. In Section 2 (see page 12), we look at the impact of diversification on different sectors and focus on the factors that would facilitate the emergence of a dynamic and competitive private sector, while creating jobs that meet the aspirations of nationals. Finally, we highlight the key steps for governments and business to consider to drive forward diversification in their economies (see page 19).

With a legacy of over 90 years in the Arab world, we feel a responsibility to move the growth debate forward by helping governments and businesses respond to challenges in a way that doesn’t just bring short-term benefits, but also helps to build a better working region in the GCC. We believe at EY that, when business works better, the world works better.
A brief history of Gulf diversification

The need for diversification in the Gulf region has been recognized as far back as the 1960s, when Kuwait and Bahrain started investing oil revenues in downstream manufacturing and heavy industry. The first oil boom in the 1970s vastly increased revenues and enabled further petrochemical megaprojects, with Saudi Arabia commissioning Jubail and Yanbu industrial cities in 1975, although a large part of the windfall was invested abroad rather than at home. An important exception was Dubai, which was late to the oil game, only discovering its first reserves in 1968, but which immediately made visionary investments in infrastructure, building on its heritage as a trading hub.

Meanwhile, Bahrain developed a financial services sector almost overnight in 1975, as international banks relocated their regional operations from Beirut to escape the Lebanese civil war. In the mid-1980s, oil prices fell sharply and remained low for 15 years, highlighting the dangers of oil dependency but also limiting the state resources available to invest in diversification. There was a gradual expansion in downstream industrial facilities, but little else of note. By the turn of the century, after years of deficits, the fiscal situation was getting so urgent that Gulf countries were beginning to enact serious economic reforms to attract investment and drive diversification. These included corporate tax cuts, reduced restrictions on foreign investment and privatization of state enterprises.

Before these efforts at reform had progressed too far, the second oil boom got underway, starting in the mid-2000s. This reduced the urgency to attract investment through reform, but progress was steadily made on improving some aspects of the business environment. More importantly, a greater share of the proceeds of the boom poured into the non-oil economy, both through a general recycling of government spending and also through specific investments by the state in infrastructure and industry. Despite the investment at home, Saudi Arabia, the UAE, Qatar and Kuwait also built up substantial foreign assets during the oil boom that should enable them to ride out years of low oil prices, if necessary. Hence, despite the sharp fall in oil prices since mid-2014, most GCC states do not have an urgent need to diversify fiscal revenue through introducing sales or income taxes. However, the case for greater diversification in the long run, to reduce the volatility of oil price-driven booms and busts, has gained new impetus.
Benchmarking the GCC

It is relatively easy to grasp the rough concept of a diversified economy; one that produces a wide range of goods and services and is not over-reliant on natural resources or any other sector. However, it is actually quite difficult to measure diversification. Commonly used indicators, such as the share of oil and gas in GDP or budget revenues, are useful, but they only capture a part of the picture and can be misleading when used on their own. By these measures, for example, the UAE’s level of diversification would seem to have sharply decreased over the past decade, as non-oil GDP fell from 75% in 2001 to 61% in 2013, despite the rapid growth of sectors such as tourism, transport and financial services.

In an attempt to overcome these inadequacies, EY has created the Diversification Tracker, which focuses on three aspects – export complexity, the share of the non-oil sector and private versus public sector spending – to benchmark the GCC countries both globally and among themselves. The three values have been combined to give a percentage of diversification relative to the highest global performer. While the tracker does not fully eliminate the distorting impact of oil price volatility, it provides a more balanced view of diversification progress from a global perspective and allows us to explore the potential were the GCC to reach the levels of other high-income countries (see page 8: “Understanding the Diversification Tracker”).

The GCC has some way to go before it becomes really diversified. It scored 38% in 2012 (the most recent year available), which is below all other regions and well below the global average of 58% and the OECD\textsuperscript{1} country average of 65% (see Chart 1). It ranks below most emerging markets\textsuperscript{2} and other relatively undiversified oil producers, such as Russia at 51%.

However, within the GCC, there is a very wide range of scores. Kuwait has the lowest level at 24%. The UAE comes first with a score of 57%, which is close to the global average and also similar to Brazil and Canada, both of which have strong natural resource bases but also a range of other strong sectors. It comes ahead of Australia and Russia, which are the least diversified among the major world’s major economies. However, the other GCC states are considerably less diversified than most other economies.

\textbf{Chart 1 – GCC diversification compared with other groupings (2012)}

1. The OECD countries include: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

2. The E15 includes: Bangladesh, Brazil, China, Egypt, India, Indonesia, Mexico, Nigeria, Pakistan, Philippines, Russia, South Africa, South Korea, Turkey and Vietnam.
Understanding the Diversification Tracker

The Diversification Tracker is based on three indicators relating to the share of GDP that comes from non-natural resources, the complexity of the economy and the importance of the private sector. Although there are other potentially useful diversification indicators, such as the distribution of the labor market by sector or the share of government revenue from non-oil sources, these are not readily available for a wide range of countries or for a long-time series.

Limiting the tracker to indicators that are widely available enables comparative analysis to be done between countries and regions, both currently and over time. The indicators were normalized and given equal weighting, meaning that the worst-performing country each year will score 0 and the best-performing will score 0.33 for each of the three indicators, giving a composite score of 1 for diversification as a whole. For ease of understanding, we have expressed these scores in percentage terms.

The most familiar indicator in the index is the non-oil share of GDP. However, there are problems with this measure. It generally includes downstream industry, such as refining and petrochemicals, which do add value to raw oil and gas, but are dependent on its production and are often subsidized by feedstock at below-market rates. Non-oil GDP also includes elements from other sectors that are very dependent on the oil sector (from accommodation for oil workers to construction of facilities). Another major problem is that the non-oil share of GDP can be highly volatile, moving inversely to oil prices. In 2015, it is likely to be far higher across the GCC than it was in 2014 as a result of the fall in oil prices, but this doesn’t mean that these countries have suddenly become more diversified. Equally, the fall in the non-oil share of GDP during the years when oil prices were booming didn’t necessarily mean that some Gulf countries were not making important strides to broaden their economic bases. So while important, non-oil GDP doesn’t give the whole picture on diversification.

Another useful indicator is the level of private sector spending. In highly diversified economies, private sector spending tends to drive the economy, whereas in resource-dependent economies the government fills this space, recycling revenue from oil and gas. However, while national account data differentiates between government and private consumption spending, it doesn’t tend to divide other components, such as investment, between these two sectors. As a result, just looking at the split in consumption can give a misleading impression, particularly for Gulf countries where investment – most of it deriving from government oil rents – is a major component of GDP.

A country’s trading profile is another obvious place to look to for signs of diversification. The bulk of non-oil exports for many Gulf countries are actually products from downstream industries that rely on oil or gas feedstock or on cheap energy and are often minimally processed and closely linked to oil prices. While they add value compared with just exporting crude oil, they are of limited value in truly diversifying the economy and reducing the impact of oil price volatility. We have therefore chosen to focus on “economic complexity,” which attempts to assess the relative range and ubiquity of the products that a country exports. Gulf countries can score more highly by adding value to their downstream industries; for example, processing petrochemicals into more complex forms or even into final products such as plastics, or by exporting goods that are unrelated to oil. A limitation of economic complexity is that it only looks at goods exports whereas services exports, are important for some Gulf countries, such as financial services in Bahrain.

While each indicator is deficient on its own, combining them provides greater rigor and enables us to capture three major aspects of diversification that are both relevant to the Gulf states and measurable globally.

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3 Our tracker looks at the share of GDP that comes from all other sources except natural resource rents. In other words, it excludes not only oil, gas and coal, but also minerals and timber. It is based on a data series from the World Bank.

4 The tracker looks at the ratio between private sector consumption and government consumption. Data on government versus private investment is not available across a sufficient number of countries.

5 This is an indicator that was first developed in 2009 by academics at Massachusetts Institute of Technology (MIT) and Harvard, and calculates complexity figures from standardized trade data from United Nations (UN) Comtrade. We have used the version of economic complexity published in MIT’s Observatory of Economic Complexity (http://atlas.media.mit.edu/). Harvard researchers have developed a slightly different measure, published in the Atlas of Economic Complexity (http://atlas.cid.harvard.edu).

6 For a full description of the methodology, please see page 20.
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Chart 2: Snapshot of GCC diversification in 2012

Looking at the contribution made by the three components of the Diversification Tracker (Chart 2) helps to explain why the GCC differs from other economies and how the six states differ among themselves. The most striking difference is the contribution of private sector spending in the UAE, which is more than twice the global average and far higher than in most high-income countries. This is, in large part, due to Dubai, which is no longer a significant oil producer and, instead, depends on sectors such as trade and manufacturing, real estate and tourism. These also boost the non-oil share of GDP. The data required to calculate the diversification index on a sub-national basis isn’t available, but would probably show that Abu Dhabi has a profile similar to the other GCC states, with Dubai looking more like Singapore.

Bahrain’s profile is similar to that of the UAE in terms of the complexity of trade and the size of its non-oil sector (mainly manufacturing, financial services and tourism), but has a much lower relative contribution from private sector spending. Qatar, despite having the largest oil and gas reserves relative to its size, has the next largest non-oil sector, having used hydrocarbon revenues to develop its economy. This development still relies almost entirely on government spending; however, as demonstrated by the fact that Qatar also has the smallest contribution to the index from the private sector, its exports are also the least complex in the GCC. Saudi Arabia shows a higher level of economic complexity than Qatar, but its non-oil sector is smaller, in part because it lacks the oil revenues in relation to size of GDP and population that have driven capital expenditure in the way that they have for Qatar and the UAE. Oman has a similar profile.

Kuwait has the lowest diversification score. Although it led the Gulf in developing its oil sector and building up downstream industry, it was unable to implement most of the projects envisaged in its 2010-14 National Development Plan. However, but momentum did begin building in 2014 and should carry over into the 2015-19 plan, recently approved by Parliament and also supported by new laws that facilitate public-private partnerships and permit 100% foreign ownership across much of the economy.

The trends in diversification in the GCC over time (Chart 3) show a mixed picture. Overall, the average diversification score in the GCC was essentially the same in 2012 as in 2001. This was, however, a period not only of rising oil prices (except for the brief dip in 2009), but also of rapidly rising production. Over the decade, regional oil production increased by a quarter, gas production more than doubled and the value of oil and gas exports increased nearly sevenfold to about US$680 billion. With the oil price now lower, the GCC score is anticipated to rise once again.

Chart 3: Trends in GCC diversification (2000-12)

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7 MIT’s Economic Complexity Atlas only covers Bahrain from 2010 and the UAE from 2001; data for the other four GCC countries are available from 1995.
 Against this growth spurt in the oil and gas sector, the fact that the diversification score had caught up by 2012 is an indication that the rest of the economy was growing almost in parallel with hydrocarbons – an impressive achievement. While oil and gas GDP rose and fell repeatedly over the past 15 years, non-oil GDP growth ranged from 5% to 12% throughout the period (see Chart 4).

Chart 4: Real GDP growth by oil and non-oil sectors, %

There are also clear differences in trajectory between countries. Qatar, which implemented significant development plans at the same time as its oil and gas production nearly quadrupled, has seen a steady rise from bottom place in 2002 to third a decade later. The UAE also shows a trend of increasing diversification, factoring the impact of the oil price boom. Saudi Arabia has seen a decline in diversification over the period, from 37% in 2000 to 21% in 2012. This is despite the significant expansion of new sectors, such as telecommunications, investment banking and insurance. The tracker shows that the Saudi economy has become more complex over this period, but the non-oil sector has not kept up with the growth in the oil industry and the level of diversification has lagged that of other economies around the world, resulting in a decline in our index.

Financing diversification

Could sovereign wealth funds enable faster progress? During the oil boom of the past decade, the Gulf countries invested significantly more public money into their economies than in the 1970s. Budgeted capital spending was eight times higher in 2013 than in 2001. Additional public investment came from sovereign wealth funds and state-owned enterprises. The region also attracted significantly more foreign direct investment (FDI). From 1970 to 2006, net FDI flows to GCC countries accounted for just 0.6% of GDP on average, but the level rose to 3.5% in 2007 to 2013. This high level of investment helped to keep diversification moving ahead despite the rapid growth in the oil and gas industry.

That’s the good news. The bad news is that budgets are now under pressure and spending is increasingly shifting away from investment and toward current expenditure. At the same time, FDI levels are falling in many countries. Saudi Arabia, for example, attracted just US$9 billion in 2013, less than a quarter of levels in 2008 to 2009. Just as diversification needs an extra boost, the revenues to drive it are declining.

Could the sovereign wealth funds fill the gap? Historically, these have invested largely in foreign assets – diversifying externally as a counterbalance to the risk of dependence on oil and gas at home. But there has been a trend over the past decade to look at investments at home or in other GCC states. Our research shows that the sovereign wealth funds invested US$28 billion within the GCC over the past five years – 23% of the total amount invested. Investing a higher share of these assets at home would augment available funds across the GCC. But, as commercial transactions, they would increase the pressure on governments to make business in the region easier. Taken together, that could really accelerate diversification.
The next decade

The Diversification Tracker highlights three important elements: that progress has been made in diversification in recent years, that catchup is possible as in the UAE, but that the GCC currently lags behind most of the world – largely due to the weakness of the private sector. The combination of lower oil prices and accumulated reserves creates a window of opportunity to refocus on speeding up the pace and adjusting the direction of diversification to ensure that Gulf countries remain secure and prosperous. In the next section, we’ll look at the sectors and policies that will help the region become competitive outside of oil and gas over the next decade.

The dollar value

Quantifying the impact of diversification

Diversification has a number of potential benefits. It reduces economic and fiscal volatility, creates jobs and prepares Gulf countries for the post-oil era. But what is the dollar value of diversification? How much bigger might the GCC economy be if the entire region were to shift from today’s 38% to reach the 65% diversification level found in the OECD?

Analyzing the data for OECD members from 1995 to 2012, we found that such a shift in high-income economies would be correlated with an increase in real GDP of 1.6%. Were the GCC able to attain this level of diversification, the region could see an additional gain of up to US$17.7 billion. To put that into context, it is more than three-quarters of the flow of FDI to the GCC region for 2013.

The numbers are compelling – not least because the high hydrocarbon growth rates of recent years are unlikely to be repeated whatever the oil price. There are both demand and supply limits to growing the region’s oil production. The International Energy Agency forecasts a slowdown in energy demand from OECD countries and from China, which accounted for half of demand growth over the past decade. On the supply side, although there are plans to boost oil production in many countries, the maturing of key fields mean that high levels of investment and enhanced recovery techniques are needed to maintain a production plateau, let alone increase it. This reinforces the case that the GCC needs to redouble its efforts at diversification.

To speed up the pace of diversification, the GCC needs to focus on three key accelerators. The first is talent. It is vital to help young nationals aim for jobs in the industries of the future. According to our recent survey of students across the GCC, young nationals are highly motivated to move into dynamic sectors such as telecommunications and technology, but governments need to find new and more progressive ways to support schools, colleges and universities to ensure they get the skills students need to fill these jobs.

It is also important to ensure that promoting nationals does not send the message that global talent is unwelcome. Leading economies compete to attract the best talent from around the world to further drive their competitiveness – and they work hard to retain talented foreigners and make it easy for them to feel part of the success.

If we look at the list of American Nobel Prize winners in science and economics, as an example, an impressive 54% are affiliated to US institutions, but just 35% of the prizewinners were born in the US. The rest were imported talent. The GCC does not need expatriates to run its businesses, but it does need global talent to fill gaps and help young nationals develop in fast-changing diversified sectors.

The second way diversification can be accelerated is to make it easier for foreign companies to bring their capital and expertise to the GCC. Many steps have already been taken – but many have fallen short due to vested interests, fear and complacency. That’s why the value of FDI has fallen to a 10-year low across the region. In Saudi Arabia, for example, investment flows have fallen steadily to just over 1% of GDP. Boosting foreign investment does not harm Gulf companies, it helps them to remain competitive.

The third accelerator is for Gulf countries to view the GCC region’s success as adding to its own. Implementing existing plans for shared infrastructure and collective visas would aid diversification everywhere. But what about harmonizing regulations, and creating centers of excellence and incubators of talent, while investing in each other’s economies? It is time to lift the brakes on diversification and activate the accelerators.

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Rethinking diversification: the sector dimension

The Gulf’s diversification efforts over the past decade have relied heavily on governments recycling oil and gas revenues via the budget and public investment entities. This has been successful in places and there is significant future potential, but the pace has been too slow and inconsistent. Now that money is tighter — and the urgency of diversification greater — Gulf governments have to rethink their strategies. They need to make clear decisions on where best to invest to get the biggest impact and how to use oil revenues to enable rapid change and leverage private investment rather than crowd it out.

There are three factors to consider in determining what strategies are most appropriate in each country:

• Which sectors have the most potential to stand on their own feet, without relying for the long run on government spending, subsidies and other support?
• Which sectors are likely to have the best linkages with the rest of the economy?
• Which sectors can create jobs that are substitutes for public sector employment for Gulf nationals?

Standing on their own feet

Government spending has been instrumental in developing a broad variety of sectors in the GCC – just think of construction and real estate, airlines, telecommunications and banks. Some companies in these sectors are already genuinely value-creating and internationally competitive, but others still remain effectively dependent on oil revenue. Breaking that dependence is now crucial.

In a few sectors, such as tourism, the shift to a self-sustaining private sector dynamic is already underway. The government’s role will then be to keep the destination attractive by creating a transparent legal and regulatory environment to operate in.

“The government has to play a key role in the early stage, investing in creating a destination. But once that is done, investors see that it is promising, and the private sector takes over.”

Yousef Wahbah
Transaction Real Estate, Hospitality & Leisure Leader, MENA

Mostly, though, the fortunes of diversified sectors remain closely tied to government spending. The construction industry, for example, has been one of the fastest-growing sectors across the region. However, most construction activity is funded by governments (barring, perhaps, in Dubai), so is vulnerable to a sharp decline in response to a prolonged period of low oil prices or the completion of the current infrastructure build-out process. That weakness within the industry is exacerbated by the fact that much of the construction work, particularly the high-value design and management, is done by foreign firms. Local firms often only win contracts or participate in consortia because of preferential domestic treatment.
There are some exceptions to this and, indeed, some Gulf construction firms have successfully won international contracts as far back as the 1970s to 1980s, when leaders such as Kuwait’s Kharafi Group, Saudi Binladin group and Arabtec in the UAE expanded beyond their borders, particularly into other Arab countries and Africa. However, the construction boom in the Gulf over the last decade has left them, and almost all the smaller players, mainly focused on their home markets. Ensuring that these companies have the skills and the incentives to flourish once the infrastructure and real estate boom is over will require action now.

To speed up that progress, governments now need to consider how they can remove obstacles to innovation and competitiveness and, instead of protect homegrown companies from international competition, help them to stand on their own feet and become globally competitive. That will require different measures for different sectors.

In the financial services sector, for example, Gulf banks have mostly grown on the back of financing government-backed business and oil and gas projects. Now they need to grow alongside a diversifying economy — developing new areas of financing in partnership with other financial institutions, focusing on emerging growth from non-oil sectors, enabling the development of digital commerce, and beginning to play a role in supporting small and medium-sized businesses. There is also considerable growth potential in underdeveloped areas such as insurance, reinsurance, and asset and wealth management to widen further the span of the financial services value chain beyond banking.

In order to be agile enough to expand while managing the risks of a broader portfolio, financial institutions will need a thoroughly focused private sector agenda — not a government one only. To facilitate this, governments will have to encourage both publicly and privately owned financial institutions to compete commercially on a level playing field, putting an end to the concept of government banks, for example.

Harmonizing regulations at a GCC level could ease this process, bringing greater consistency for foreign and cross-GCC investors and preventing unnecessary regulatory arbitrage.

A similar shift in perspective will be needed in telecommunications too — another key sector that has successfully emerged from earlier diversification attempts, but now needs to focus on maintaining competitiveness as the global industry undergoes rapid change. Transformed from bureaucratic government departments into profitable companies over the past 20 years, they have modernized the GCC’s communication infrastructure. Prices remain high, but are falling as new competitors enter the market.

Despite still having dominant positions, the legacy telecommunications are responding to changes in the global industry that are redefining the core business. They are acquiring content management internet services companies to help them generate future revenue streams as the profitability of infrastructure provision declines. But these are still small ventures and to remain competitive and, enable further change throughout the economy, telcos will have to transform much faster — rethinking their entire operating model.

“In the technical side of the business is becoming commoditized, so telecommunications companies have to become part of the wider value chain. If a telco remains a telco, they won’t get the opportunities. They need to go beyond their core business and continuously innovate by offering value-added services.”

Wasim Khan
COO, MENA Advisory Services

Regulators, too, will need to shift from a restrictive rules-based approach to a more robust yet flexible risk-based, principle-driven one — encouraging both innovation and strong risk management.

“The technical side of the business is becoming commoditized, so telecommunications companies have to become part of the wider value chain. If a telco remains a telco, they won’t get the opportunities. They need to go beyond their core business and continuously innovate by offering value-added services.”

Robert Abboud
Financial Services Leader, MENA Advisory Services

That’s tough for any company, but regulators, still fighting to bring prices down, have blocked a number of promising acquisitions that would allow the kind of radical cross-sectoral convergence required. And policy-makers, themselves operating in ministerial silos, are struggling to grasp the opportunities to drive convergence in a positive way.

As GCC governments plan the next stage of diversification, they certainly need to reignite the kind of privatization and commercialization strategies that created these truly leading-edge organizations. But rather than withdrawing from shaping businesses, they also need to become the enablers of transformation — creating modern regulatory frameworks that provide the right incentives, ensuring that ministries are able to see and support the bigger picture outside their silos, and using government services to facilitate and accelerate diversification.

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Multiplier impact

Sectors do not exist in isolation. If banks or telcos fail to develop, they hold back the rest of the economy. If they become pioneers, they can take other businesses with them. The best drivers of diversification, therefore, are those that have the strongest links with the rest of the economy – enabling other sectors to develop and drawing heavily on domestic goods and services, not just on imports. In the language of economics, these sectors are said to have a high economic multiplier; in other words, a dollar of investment translates into far more than a dollar of GDP due to the stimulation of other sectors.

Our analysis of multiplier sectors in hydrocarbon economies\(^8\) shows that additional investment in oil and gas brings the least additional return to GDP at US$1.30 and affects just seven other sectors (see Chart 5). Construction is at the opposite extreme. It has the highest economic multiplier, averaging an impact of US$1.80 in GDP for every dollar invested in construction activity. Moreover, this trickle down feeds directly or indirectly into almost every other sector – 15 in total – as goods and services are purchased for the construction site and its workforce.

Sectors such as transport, manufacturing, hospitality and telecommunications also have high multiplier values and a broad-based impact. Transport, for example, has a multiplier of US$1.67 and impacts 13 other sectors. This role has been obvious within the GCC, with transport – especially airlines and seaports – enabling the development of other sectors from real estate and tourism to manufacturing, building on the natural advantages of location and tradition.

GCC governments have played a key role in encouraging the creation of ecosystems around transport. Dubai was the first to focus on putting in place the building blocks, creating iconic developments, investing in infrastructure, creating a sense of shared commercial destiny and – crucially – ensuring that the laws and regulations were in place to encourage private investors to drive momentum, creating a self-sustaining model. This kind of overarching strategy for maximizing sector multipliers is key not only to accelerating diversification, but to ensuring that businesses remain viable once the initial government spending push ends.

\(^8\) Kuwait is the only GCC country that publishes GDP input-output tables, from which it is possible to calculate the interrelations between sectors. To define relevant multipliers, we have combined Kuwait’s calculations with those of three other oil producers (Russia, Norway and the Netherlands).
Jobs for nationals

Diversification does not automatically create jobs that are viable substitutes for public sector employment (see Chart 6) – but it will have to focus on doing so in order to absorb the growing number of young nationals entering the labor market. Otherwise, even the more populous Gulf countries will share the experience of Dubai, where the region’s most advanced level of diversification has barely impacted employment for nationals (see page 17: “The Dubai conundrum”).

Chart 6: Nationals employed by sector in Saudi Arabia, 2013

The construction industry, for example, is one of the largest employers in most Gulf states, but most construction jobs are not held by nationals. The vast majority of construction employment is either low-paid labor or requires architectural and engineering skills that are not widely available locally, so nationals tend to fill mainly management and administrative roles. Although construction is responsible for about a third of all employment in Qatar, for example, just 0.1% of nationals work in the sector. The share of employment for nationals is only slightly higher in Kuwait and Saudi Arabia, at about 3%. In Bahrain, where nationals tend to have better vocational skills, 7% of nationals work in construction.

The transport sector has not generated vast numbers of jobs for nationals either. Even enthusiastic champions of nationalization, such as the airlines, have struggled. Just 5% of the workforce of Emirates Airline and 11% of Abu Dhabi’s Etihad Airways are nationals. However, there have been some recent breakthroughs in the sector; for example, the first Emirati female pilots have begun to emerge.

Financial services is the one non-government sector that has attracted Gulf nationals in large numbers. The pay is generally good and, perhaps more importantly, the sector is viewed as prestigious. Nationals of both genders are willing to work as bank tellers despite most other customer service roles tending to be seen as socially undesirable. As a result, the levels of nationalization range from about 24% in Qatar to 69% in Saudi Arabia. Even at these high ratios, it still typically employs only about 2% to 3% of nationals and, despite future growth potential, the trend to digitalization is likely to shrink the number of jobs in branches, not expand them.

In construction, too, the trend toward greater automation in the construction process – potentially all the way up to 3D printing of buildings in the medium term – could gradually shift employment demands in the sector toward roles that are more highly paid, but also more demanding in terms of skills. Clearly, creating private sector jobs will not ensure employment for young nationals unless they are taught the technical skills and professional attitudes that would both motivate and enable them to take on the increasingly demanding jobs that the knowledge economy brings.
Balancing the goals of diversification and jobs for nationals is not easy

Dubai is an example of successful diversification, not only in the Gulf but globally, having leveraged its relatively modest oil reserves to develop a world-class infrastructure and become a regional, and increasingly global, hub for commerce, finance and tourism. Its oil sector accounted for 24% of GDP in 1990, but now only comprises about 3% of its GDP. Nonetheless, the non-oil sectors that have developed are almost entirely staffed by expatriates.

Around 85% of Emiratis in Dubai are employed by the public sector, even more than in Kuwait (where the figure is about 75%), according to 2013 data from the Dubai Statistics Center. Most of these public sector workers are concentrated in the police and civil service, and even the giant state-owned companies that have been integral to Dubai’s diversification have only been able to employ 12% of Emiratis.

At Dubai, the aluminum smelter that is Dubai’s largest public industrial project, only 16% of the workforce is made up of nationals, according to the Dubai Statistics Center. Just 8% of the workers at Dubai World, the holding group that includes its world-class ports, are Emiratis. Meanwhile, although around 2,400 nationals (5% of all employed nationals) work at Emirates, the world’s largest airline by international passenger kilometers, they comprise just 5% of the company’s workforce.

All of this suggests that, as things stand, even one of the world’s most dynamic private sectors struggles to attract Gulf nationals and even the most successful state-owned companies can only create acceptable jobs for a relatively small number of them. In some ways, Dubai has kept the rentier model used to describe many resource-dependent states, even as it moves beyond oil. It now collects economic rent to pay for public sector employment from the expatriate-run non-oil economy rather than from oil exports. This has been possible as a result of Dubai’s unique regional role and its small population of nationals, so this kind of non-oil rentier model could not be replicated by other Gulf countries.

Enabling diversification

To this end, many of the Gulf countries have been working to improve their education systems and have developed innovation ecosystems, encouraging technical research and entrepreneurship, and drawing on experience from countries such as Singapore. Flagship projects in the sector range from the Qatar Science and Technology Park – a free zone for research by major multinationals – to the Badir program by Saudi Arabia’s King Abdulaziz City for Science and Technology, which is establishing incubators to support start-ups in fields such as biotechnology and advanced manufacturing technology. The UAE also has a host of initiatives in this field, such as Abu Dhabi’s Technology Development Committee and the Ibtikari start-up program.

But education and innovative initiatives will not be enough on their own. As we argue in the recent report How will the GCC fill the skills gap?, if governments want diversification to increase the private sector’s employment of nationals, they will need to collaborate with companies to define and develop the skills that will be needed as sectors grow, as well as helping to break negative stereotypes and ensure working conditions are culturally suitable. Training, work experience and closer private sector involvement in education will have to become a vital part of diversification.

Government will also, however, need to ensure they have frameworks in place to support the application and further development of technology, while removing policy and regulatory obstacles and disincentives. Take as an example the solar industry, which has natural advantages in the Gulf compared with centers such as Germany. Several hubs have been created with industrial-scale solar plants, led by Masdar, Dubai Solar and KACare in Saudi Arabia. Excellent university programs have been set up to develop skills and attract international talent. But implementation within the power and water industry is lagging, effectively blocking the opportunity to develop solar technology that is relevant for the region, as well as cutting off the chance to get solar vendors and their suppliers to invest in the GCC and help localize the value chain.

The reason is not a lack of money, but a lack of consistency. Government subsidies still heavily favor the use of subsidized oil and gas as fuels for power plants. Debates around attractive feed-in tariffs for solar energy, incentivizing decentralized rooftop solar photovoltaics, smart grids and using electrical vehicles for storage are still at the discussion stage.
"The GCC could be a hub for the development of solar technology. But that would require making it an investment priority."

Christian von Tschirschky
Energy Leader, MENA Advisory Services

Removing this kind of disincentive will be difficult, but it is essential if diversification is to achieve its nationalization goals. Governments will have to start benchmarking the benefits and demands of the average public sector job at (or ideally below) the private sector average. They will also have to focus on easing the business environment throughout the economy – not just in free zones. Initiatives such as the Dubai International Financial Centre, Marketplace Abu Dhabi and the Qatar Financial Centre, for example, could help diversify the economy and will certainly create jobs. However, in order to enable employment flexibility, these are being structured as free zones and their workforce would be mostly expatriate.

Governments can also play a leading role in boosting competitiveness by rethinking the way they deliver services to the private sector. Beyond simple e-government, smart technology creates the potential for governments to provide resources such as cloud computing, secure payment gateways and other facilities to small businesses, entrepreneurs and public businesses, encouraging them to develop innovative services quickly and cheaply. Rather than being the direct supplier of jobs and financing, the GCC governments of the future could leverage technology to become the utility supplier of advanced services to a fast-growing private sector.

"Most governments are focusing on automating government services, but they are missing a massive opportunity to design for the future and use government services to support diversification. If they invested today, they could create delivery models that would enable them to diversify more optimally in future."

Sa’ed Qussous
Government and Public Sector Leader, Riyadh

The sweet spot

The twin pressures of declining oil revenues and the need to create jobs have increased the urgency of diversification, but if the Gulf countries are to reduce the gap to other high-income economies, they will need to rethink their approach. A number of sectors fall into a sweet spot, combining high impact (multipliers), employment opportunities (jobs for nationals) and a solid existing foundation (strengths). These include transport, financial services, retail and tourism, telecommunications and R&D, all of which offer potential for achieving rapid diversification (see Chart 7).

Rather than pumping recycled oil revenues into these sectors, however, governments need to focus on what is needed to improve companies’ international competitiveness – removing regulatory obstacles and disincentives, encouraging the development of cross-sectoral ecosystems, and nudging companies and education institutions to define and jointly develop both the soft and technical skills needed for the future. The public sector of the future will be an enabler – providing world-class infrastructure and services, a good business environment and incentives and seed capital where necessary – working hand-in-hand with a flourishing private sector. That will ensure a prosperous future for the GCC, whatever happens to the oil price over the coming decades.

Chart 7: The sweet spot: sectors that meet the three criteria of regional strengths, economic multipliers and employment potential for nationals
Diversification tends to be viewed through a very focused GCC lens. Everyone looks at the prospects for the oil price and the fiscal room for maneuver or they worry about the GCC’s specific challenges, be it skills for nationals or the need to maintain stability in a volatile region. But diversification cannot be achieved in isolation. At heart, it is about creating a platform for sustainable growth, and that requires full integration with a very fast-changing global environment.

The big question for diversification is not what is achievable in Saudi Arabia or Abu Dhabi, it is how Gulf companies and governments can find innovative, proactive and profitable solutions to the multiple waves of global changes and challenges – from resource scarcity to demographics and digitalization – that are having a profound impact on how business is done and on where jobs are created. The global economy is no longer constrained by national boundaries and, at the same time, it has empowered the individual like never before.

How companies respond to these challenges is not only crucial to their own survival in the future – as the world becomes more connected, it increasingly affects the fate of other companies and sectors, as well as governments’ capacity to tackle the big issues they face. A utility that embraces the full potential of smart meters and grids, for example, will be able to help tackle the challenge of growing salinity in the Arabian Gulf and enable a shift to solar technology developed in and for the region. Conversely, a bank that fails to understand end-to-end customer service or a telco that fails to grasp the commoditization of communications infrastructure will block the development of digital commerce and the evolution of new services, holding back the entire economy.

Setting the right incentives is important. Diversification will struggle if the GCC region only looks inward, focusing on protecting existing companies and jobs, rather than asking how governments and companies could shape global trends to its advantage. The sectors that are preserved without transformation will no longer be relevant in the rest of the world, never mind competitive. The window of opportunity to break the reliance on oil and gas is now, but it will require new and innovative approaches to make it happen.

It is time to embrace the digital revolution and welcome foreign direct investors who will grow innovation, entrepreneurship and employment. It is also time to reevaluate laws and behaviors that restrict economic competition, since protectionism makes the economy less efficient and effective in a global context. Finally, it is time to truly capitalize the collective strength of the GCC, integrating our economies and harmonizing regulations to encourage long-term, sustainable prosperity and fulfill our global ambitions.
Next steps

For government:

• Ensure publicly owned businesses have a private sector agenda by commercializing or privatizing them
• Identify and put in place plans to eliminate or reduce regulatory obstacles and disincentives
• Work with businesses to understand global trends and best practice, and identify where they need support
• Enable collaboration between sectors and with educational institutions
• Track global best practice in digitalizing government services and build proactively into government strategies
• Cooperate with other GCC countries to harmonize regulations and create shared resources

For business:

• Engage closely with the public sector to identify obstacles or gaps in legislation or regulations that impede development
• Collaborate with educational institutions to define and develop skills needed for the future
• Clarify the impact of reduced government spending on your business and plan what is needed to survive without it
• Follow global trends and best practice closely to remain internationally competitive despite differences in operating environments
• Collaborate with other sectors to identify and realize synergies
Methodology

Objective and rationale of our diversification index

The objective of this study is to track the degree of independence from oil of the six states in the GCC. Traditionally, policy discussions on this topic have focused almost exclusively on the predominance of the oil sector in GCC economies. By broadening the discussion beyond the role of the oil and gas sector, to include the role of government spending in driving economic growth and the business cycle, as well as the structural complexity of the economic base, we believe the results of our study provide an indication of the relative degree of economic diversification in each of the countries and the region as a whole.

In order to achieve this objective, our diversification index is composed of three sub-indices:

- Role of non-natural resource sector: we use data from the World Bank’s World Development Indicators (WDI) to capture the percentage of a country’s GDP that is not derived from oil, natural gas, coal, mineral and forest sectors (rents). The percentage for each country is compared with the global trends, with the country with the smallest natural resource sector being 1 and the country with the largest natural resource sector being 0.

- Role of private sector spending: we use data from the World Bank’s WDI to measure total private consumption (as a percentage of GDP) over final government consumption (also expressed as a percentage of GDP). This index measures the relative size of government consumption compared with private consumption. Each country is normalized compared with all the other countries, with 0 being the most dependent on government spending and 1 being the least dependent.

- Economic complexity: we use the Economic Complexity Index developed by MIT. This index measures the complexity of a country’s export base both in terms of the diversity of the products it exports and the ubiquity of these products (i.e., how rare these products are in comparison with the ones exported by other countries). Each country’s index is normalized on a scale from 0 to 1, with 1 indicating the highest level of complexity and 0 the lowest.

We only include data for countries and years for which all of these three sub-indices are available. One important point to note is that the index does not measure absolute levels of diversification in a country, but its performance compared with the global trend in a given year. Therefore, a decline in the index tells us that the country has been falling behind compared with its peers, but it does not tell us that the absolute level of diversification has decreased. As expected, the global financial crisis is a major point of discontinuity in our data as it resulted in a steep decline in natural resources’ prices (thus reducing their share of GDP) and a contraction in government spending (through austerity measure) and private consumption (due to limited aggregate demand).

Diversification and economic growth

Projecting the economic gains that could arise from further diversification is a complex task. This is because economic diversification implies a large-scale structural transformation in the way value is created in an economy and the way it is distributed across the different sectors. Economic reform programs aimed at promoting more diversification may have additional spillover effects in terms of achieving more competition in the economy and increasing productivity of both labor and capital, among other. Furthermore, there is a wealth of evidence from economic literature on possible causal relationships between variables (whether macroeconomic, microeconomic, institutional, etc.) and GDP growth. Far from being conclusive, this body of economic literature shows the inherent complexity in isolating factors responsible for economic growth.

Given these difficulties, we look at the historic correlation between our diversification index and GDP growth indicators from 46 high-income countries for which complete data was available for the period 1995 to 2012. Specifically, we regressed the natural logarithm of GDP (in constant 2005 US dollars obtained from World Bank’s WDI) as the dependent variable, regressed on the diversification index, based on the following specification:

\[ \ln (GDP_{jt}) = \alpha + \beta (Diversification \ Index_{jt}) + \epsilon_{jt} \] (a)

Where “\( \alpha \)” represents the intercept, “\( \beta \)” the percentage increase in GDP for a unit increase in the diversification index and “\( \epsilon_{jt} \)” represents the error term for country “\( j \)” in year “\( t \)”. Using ordinary-least-square linear regression, we estimate the following:

\[ \ln (GDP_{jt}) = 22.7392 + 5.9540 (Diversification \ Index_{jt}) \] (b)
All coefficients are significant at the 95% level and the R square on the regression is 0.1695, meaning that variation in the diversification index explains 16.95% of the variation in GDP. Using these estimates, we model the potential impact on growth that would be correlated with an increase of the GCC index from its current value (0.3795) to the OECD average of 0.6461. We find that, historically, such an increase in the diversification index in high-income economies has been correlated with an increase in GDP real growth of 1.59%.

Of course, a positive correlation does not necessarily imply causation. First, there may be omitted variables that drive the correlation and are not captured in our regression analysis. This is partially addressed by the way the index is calculated, which controls for commodity-driven growth and government spending expansionary policies (both of which increase GDP but decrease the index value). We run alternative specifications of the model (using per capital GDP growth and regressing values for the GCC countries alone), and we found a significant and positive correlation in all of those cases, albeit with varying degrees of goodness of fit (calculations not shown). Secondly, the causality between diversification and growth could run both ways: economies that are growing faster are able to invest in diversifying their industrial base and countries that are diversifying may experience a faster growth rate.

As a result, our analysis is intended for illustrative purposes only. Given that there have been limited attempts at estimating the dollar value of diversification for the GCC, our aim is to give an indication of the potential magnitude of gains. We hope our analysis might serve as a starting point for more evidence-based and sector-focused investments by governments in the region.

Scatterplot graph showing the relationship between diversification and GDP growth modeled in (a)
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