Diversifying Oil Economies in the Gulf

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In a world of falling oil prices, there are winners and losers. Consumers enjoy cheaper prices at the pump. Countries that import oil benefit from lower import bills.

Among the chief losers from falling oil prices are the countries of the Gulf Cooperation Council (GCC). Oil accounts for over two thirds of exports and nearly 80 percent of fiscal revenues on average in the GCC. When oil prices fell sharply in the 1980s and stayed depressed, the GCC experienced slow growth for two decades.

The sudden decline in oil prices in recent months has added urgency to the longstanding need for the GCC to diversify away from oil. Although the GCC's vast oil wealth has led to improved living standards, the lack of economic diversity has resulted in relative economic decline. In Kuwait, for example, GDP per capita in the 1980s was nearly three times that of the United States, whereas today it is roughly equal. Other GCC economies have experienced similar declines.

Unsustainable growth model

An economic model based overwhelmingly on oil is unsustainable. In Bahrain and Oman, oil reserves are projected to be depleted within 20 years. In other GCC countries, the time horizons are much longer, but the need for change remains. Research suggests that sustainable growth is driven to a large extent by export diversification and sophistication. Put differently, export diversification pushes countries to constantly produce new goods and adopt new technologies—crucial elements for sustainable growth.

How can GCC countries achieve a more diversified, sophisticated export sector? One lesson from oil-exporting countries that have successfully diversified is that diversification takes a long time. Malaysia, for example, took more than 20 years to reach a level of export sophistication on par with advanced countries. Even GCC countries with long resource horizons should start diversifying now.

The standard prescription for diversification is that governments need to improve institutions, build infrastructure, and reduce regulations. GCC countries have made considerable progress in addressing these so-called government failures, yet diversification has not followed. A

recent paper[1] by two IMF economists suggests that fixing government failures, while important, is not enough. Governments must also tackle market failures.

Tackling market failures

An important market failure in the GCC relates to what economists refer to as externalities. Imagine a firm that must decide whether to invest in a traditional area, such as retail services, or a more modern, high-technology sector, such as manufacturing. Investment in manufacturing has benefits for the economy as a whole (positive externalities) because it leads to innovation and productivity increases. But manufacturing also implies international competition and uncertain returns. A firm that benefits from high oil revenues might decide to play it safe and invest in retail services. If other firms do the same, the economy gets stuck in a low-technology, low-productivity state.

Another type of market failure has to do with coordination among firms. An investment in a given industry may be profitable only if other firms are investing simultaneously in related industries. For example, a firm may be interested in manufacturing car engines, but only as long as other firms are producing the body, the tires, and the seats. Only when many firms invest together is the economy able to reach a higher level of productivity and development.

Changing incentives

To overcome these market failures, GCC governments need to change the incentive structure of workers and firms. Most GCC nationals are employed in the public sector, where salaries are high and benefits are generous. GCC governments could stimulate private sector activity by limiting the size of the public sector, capping public sector wages, and providing workers with better training and support.

Firms, meanwhile, need incentives to look beyond domestic markets and seek export opportunities. Governments can encourage exports by offering export subsidies and creating development banks and export promotion agencies that provide financing and business support. Some governments have acted as venture capitalists, creating special economic zones or industry clusters that have the potential to bring large benefits to the broader economy.

In short, with the right policies, diversification is possible. In the face of falling oil prices, it has become increasingly urgent.

[1] *The paper, titled "Soaring of the Gulf Falcons: Diversification in the GCC Oil Exporters in Seven Propositions," was presented in April 2014 at a conference on diversification*

organized by the IMF and Kuwait's Ministry of Finance. A related paper by IMF staff, titled "Economic Diversification in the GCC—Past, Present, Future," has just been published.

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