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A Growth Strategy for the Long Term

by Rabih Abouchakra, Mazen Ramsay Najjar, and Richard Shediac

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A Growth Strategy for the Long Term

Economies that depend primarily on a single resource are exposed to ongoing shocks, but an export-based diversification strategy can alleviate the tremors.

by Rabih Abouchakra, Mazen Ramsay Najjar, and Richard Shediac

Hundreds of billions of dollars have been flowing into the oil-producing nations of the Gulf Cooperation Council (GCC), but one of the most important policy debates — how to transform that wealth into sustainable long-term economic development — is just beginning in earnest. It's a debate that has broad relevance not just for the Middle East, but for all the world's large oil producers, such as Russia, Nigeria, and Venezuela. It also applies to other single-resource economies such as Zambia, which depends on copper, and Botswana and Namibia, which rely on diamonds.

Should such countries diversify their respective economies beyond these mainstays, they would be more protected from the exogenous shocks related to a single industry. Furthermore, they could become important competitors in sectors from polymers to semiconductors to aerospace, transforming both their own economies and the global playing field — creating competitive threats as well as opportunities for suppliers, partners, and service providers.

But the heart of the issue is just what "economic diversification" really means. Countries dependent on a single resource are often prone to developing industries only a step or two removed from that original source of wealth. This may mean building out an oil industry into petrochemicals, for instance, or creating a shipping and logistics industry that relies, at least initially, on exporting the country's dominant resource. Instead, countries should seek to build broad, export-based economies that are not subject to shocks from one industry or group of industries. In developing their plans for economic growth, countries should target industries that create wealth and jobs and that encourage the development of new knowledge and technology. By focusing on this goal, single-resource nations would escape their existing model, in which they merely export raw materials, earn capital, and then spend portions of that capital on imported goods and services.

With oil and natural gas prices so high, it may seem an odd time to be concerned about diversifying away from these commodities. But the aim of economic diversification is to move beyond using GDP as the primary measure of a successful economy. Instead, countries should be asking themselves whether the components of their economy — their exports, investments, human capital, technology, and knowledge — are varied, established, competitive, and flexible. The models for successful diversification are Norway and, to a certain extent, Canada, which have broadly mixed economies despite having large energy-related sectors.

So far, however, governments and policy makers in many countries that have traditionally been dependent

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on a single resource have taken only the initial steps toward true diversification. Take, for example, the Gulf region, with its economies that have always relied on oil: Saudi Arabia has long pursued downstream diversification, meaning that the government has invested in refining, petrochemicals, and plastics, most recently by acquiring General Electric's plastics division; the chemicals and plastics industries constitute more than 70 percent of the country's total non-oil exports. But Saudi Arabia is still vulnerable to cyclical downturns because all of this activity is directly related to petroleum.

Another type of diversification has been to move into sectors equally as turbulent as oil, such as shipping and logistics, real estate development, and tourism. The Gulf region is witnessing a spectacular burst in spending on tourism in particular: Dubai, one of the United Arab Emirates, plans to spend US$350 billion over the next dozen years to build a ski resort, a virtual-reality time-travel amusement park, and a Jurassic world populated by robotic dinosaurs, among other attractions. The hydrocarbon-rich emirate of Abu Dhabi is seeking to become a world cultural destination, with projects such as the construction of a Guggenheim Museum. Yet this type of economic development also suffers from a strategic vulnerability — you can build it, but what if they don't come? Tourism is particularly vulnerable to shifts in perception, consumer confidence downturns, and travel costs.

Finally, the region's vast sovereign wealth funds are pursuing their own form of diversification on behalf of the countries they represent. Funds such as Bahrain's Mumtalakat Holding Company, the Abu Dhabi Investment Authority, and the Qatar Investment Authority hold assets worth $3.5 trillion, according to economic consultancy Global Insight. Some of these funds are investing in Western banks and other foreign assets around the world, but those investments do little to change the structure of the Gulf-based domestic economies — which is where change needs to begin.

This is not to say there hasn't been any progress. In Saudi Arabia, for example, manufacturing grew as a percentage of GDP at rates of about 5.4 percent annually from 1991 to 2008. As a result, manufacturing and industrial activity per capita have surpassed the $900 mark, bringing Saudi Arabia's manufacturing sector more in line with those of emerging economies such as Brazil.

Dubai has seen more than twice as much growth in its non-oil sectors as it has in its modest oil sector. Tourism-related service sectors account for more than 25 percent of economic output. Abu Dhabi, the largest of the seven emirates and the main exporter of oil, is earmarking sizable funds and directing them toward the establishment of capital-intensive, export-oriented industries. It is developing large industrial zones and establishing capital-rich national champions in aluminum, steel, and petrochemicals, and even innovation-based sectors such as aerospace, semiconductors, and renewable energy.

Obstacles to Diversification

But the majority of Gulf projects aimed at creating what we consider to be true diversification have not yet reached fruition. Saudi Arabia is currently attempting to develop a $30 billion industrial zone called Jazan on its Red Sea coast, which the government hopes will become home to hundreds of thousands of people. The development of this remote area is intended to create a mix of industries meant to diversify the Saudi economy.

Yet Saudi contractors and producers of building materials are having trouble keeping up with demand, which could slow construction. The infrastructure to deliver electricity is still being developed, so there is concern about whether there will be adequate supplies of energy. And ultimately, there is the question of skilled labor: Thousands of workers will probably have to be imported from Pakistan, India, and China.

This project exemplifies a deeper challenge for the Gulf states — addressing pervasive structural gaps. It is unclear whether enough capital and labor are being routed to productive economic sectors, such as manufacturing, as opposed to so-called support sectors, such as construction and real estate, infrastructure, and logistics, to which abundant resources are being channeled. In the world's most successful economies, capital and labor tend to be balanced across a variety of sectors. In Gulf countries, however, this is not the case. Employment, for instance, is distributed quite unevenly: The oil and gas sector, which produces 47 percent of the Gulf's GDP, provides work for only 1 percent of the region's employed population. The vast majority of the workforce is employed in sectors that are relatively less economically productive and of secondary strategic importance in sustainable development.

At the same time that the Gulf states need human capital to advance their diversification efforts, they have double-digit rates of unemployment. This situation is expected to worsen as a substantial segment of the population reaches working age in the near future and pours into the job market. The root of the problem is that the available workers do not have the skills, knowledge, or motivation needed to match the available jobs. The Gulf's economic diversification must include the development of its labor pool, which will entail increasing education levels as well as importing skilled talent.

Two other lessons seem clear. First, the growth of a country's GDP is not the best way to evaluate how well a single-resource nation's economy is performing. Rather, it's important to measure the risk-adjusted real activity performance, taking into account such factors as growth volatility, exposure to exogenous shocks, and excessive economic concentration. These indicators can offer a more accurate measurement of sustained performance.

Second, governments seeking to make their GDPs more evenly distributed need to understand that it is not strictly an economic challenge. Rather, they need to look at their policies regarding labor force development, education, and health care, and determine the implications of those policies for their economic strategy. They also need to examine their financial regulations, capital efficiency, and overall macroeconomic stability; indirect and portfolio investments must flow smoothly, while the overall system remains disciplined, robust, and immunized against excesses, shocks, and abrupt corrections. They will have to develop export markets for the products they hope to manufacture and the innovation engines that will create the products these markets need. In sum, instigating true economic diversification and sustainable development, and thus entrenching economic resilience, requires achievement of a long and exhaustive checklist of initiatives.

If the leaders of the Gulf states understand what is involved in true diversification, they have a better chance of creating clusters of economic activity or whole industries that are capable of innovation. To be sure, the creation of innovation-based economies cannot be forced and should come as a natural phase in an economy's transformation. But that is the key to creating long-term, sustainable growth in their economies and ensuring stability and a high standard of living for their people. In so doing, they could serve as an example to other single-resource economies around the world and become paragon states of economic resilience. +

Resources

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