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The Oil Boom in the GCC Countries, 2002–2008:

Old Challenges, Changing Dynamics

Ibrahim Saif

Despite the global financial crisis, Gulf Cooperation Council countries have pursued the same economic policies. A strong and consistent commitment to economic reform is needed. Will these states implement painful labor reform and diversification measures in the current climate or will they remain in a holding pattern?

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Summary

The recent oil boom (2002 to mid-2008) generated a large volume of revenues for the six Gulf Cooperation Council (GCC) countries: Bahrain, Oman, Kuwait, Qatar, the United Arab Emirates (UAE), and Saudi Arabia (SA). Estimated at an annual average of U.S. $327 billion over the period 2002–2006, the revenues more than doubled their average as compared with the preceding five years.[1] The abundant revenues were instrumental in boosting economic growth; and macroeconomic indicators such as growth and investment in the GCC were also robust over the period 2002–2007. On the other hand, other indicators pertinent to the labor market, the structure of the economy, and governance were less positive.

Despite the great oil windfall, the GCC countries faced the same challenges as they had in previous periods. Efforts at diversifying their economies and reducing high oil dependency resulted in limited change despite the multi-track approach that these countries were pursuing. The labor market suffered from over-dependence on cheap foreign labor at the expense of GCC nationals, which negatively influenced productivity. Governance indicators were weak; and improvement in public finance performance required enhancing accountability and the rule of law—both of which were markedly absent.

GCC countries pursued the same policies they had pursued in the previous period, without adapting to changed dynamics. They increased public spending in order to distribute the new oil windfalls, but this proved unsustainable in the long run given the oil price volatility. Monetary policy remained conservative and was not able to respond to domestic changes promptly.

The recent global financial crisis and the fall in oil prices demonstrate that the GCC countries cannot count on steadily high oil prices. Therefore developing merit-based competitive economies will remain the key challenge facing them. This needs a strong and consistent commitment toward economic reform from the heads of state irrespective of current economic conditions. Failing to commit to reform in a sustained manner means that reforms will be attempted only in times of crisis. But this does not work because most reforms—labor reform and diversification measures—are painful and also need time before they can have an impact.

Introduction

High oil price levels between 2002 and the autumn of 2008 strengthened the key macroeconomic indicators in the six GCC countries: Bahrain, Kuwait, Oman, Qatar, SA, and the UAE. Real gross domestic product (GDP) growth reached an average of 8 percent a year over the 2002–2007 period, with foreign reserves, investments, and budgets showing equally solid performance.

As a result, average GDP per capita across the six countries grew about 32 percent in the 2002–2007 period. According to International Monetary Fund (IMF) estimates,[2] average per capita income measured in purchasing power parity (PPP) increased from U.S. $12,000 in 2002 to above $20,000 in 2007. However, average per capita income concealed wide variations among countries, ranging from a per capita income of $16,000 in SA, the Gulf's most populous state, to $36,000 in Qatar. This level surpasses the Euro Zone, which is about $33,000.

Several common features characterize the GCC economies: high dependency on oil, a dominant public sector with a significant fiscal surplus, a young and rapidly growing national labor force, and high dependency on expatriate labor. The GCC countries face the urgency to address common challenges: diversifying their economies; addressing low productivity and labor market setbacks; developing the non-oil private sector; and improving the capacity of administrative and public sector institutions. For years, the GCC countries have been debating the need to adopt collective action to face these common challenges. In January 2008, the GCC countries launched a common market that aims at broadening and deepening the scope of economic exchange beyond the movement of goods and services to facilitate both capital and labor mobility. It is yet to be seen what kind of institutional arrangements will be developed to efficiently enforce agreements in that direction.

GCC countries face common challenges but in varying degrees. The existing differences among them in terms of natural resources and economic policy should not be underestimated. Countries with relatively limited oil and gas resources, such as Bahrain and Oman find it increasingly difficult to sustain past levels of public spending. On the other hand, SA, despite its huge oil production, faces a different structural problem related to stagnant oil-production-per-citizen rates exacerbated by a rapidly increasing population. With an unemployment rate estimated at 15 percent in 2005, SA faces urgent pressures to reform its current economic and social model. The UAE and Qatar with unemployment rates of only 3 percent and per-citizen-oil production almost six times that of SA, can coast along despite suboptimal policies. Moreover, some countries such as SA and the UAE suffer from intra-country inequality that has forced them to attempt remedial social support and spending programs.

During the period of high oil prices, the accumulating wealth posed an inevitable question: could high oil prices provide solutions to all problems? The high oil prices prevailing in the market provided all the GCC economies, at variant rates, with huge trade and current account surpluses. From there, the upper hand in determining the future of the GCC economies was that of policymakers. The GCC countries were given a real opportunity to achieve remarkable change in their economic structures by utilizing the accumulated oil revenues before the recent plummeting of oil prices.

This paper aims at exploring the different inter-country dynamics that outline the reform agenda of the GCC countries regardless of oil prices. It is the first in a series of papers that will explore the different implications arising from the various GCC economic policy challenges outlined here. The papers will also examine the effect that different GCC policy choices will have on other non-oil Arab countries such as Egypt, Syria, Lebanon, and Jordan.

Economic Developments 2002–2008

Soaring oil prices between 2002 and mid-2008 strengthened the dominance of oil revenues in the GCC economies. The oil share in the economy increased from 30.8 percent of GDP in 2002 to 40 percent in 2006. Oil revenues constituted 86 percent of total government revenue in 2006 in comparison to the 2002 figure of 77.4 percent. Over the same period, the oil contribution to exports also increased from 61 to 67 percent. These figures suggest that, despite efforts at diversification, the GCC countries are increasingly dependent on a single source to generate revenues, thus making them continuously vulnerable to oil price fluctuations. However, the aggregated averages conceal important inter-country differences. While the share of oil revenues to total government revenues has increased in Bahrain, Kuwait, SA, and the UAE, it has decreased in Oman and Qatar.

Table 1: The Role of Oil in GCC Countries' Government Revenues, Exports and GDP (2002–2006)

	Bahrain		Kuwait		Oman		Qatar		Saudi Arabia		United Arab Emirates		GCC	
YEAR	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006
Government revenues	67.3	77.0	88.4	90.8	73.1	64.8	63.7	55.2	78.0	89.7	71.5	80.5	77.4	85.9
Exports	30.7	54.3	91.5	83.3	71.3	76.2	62.7	66.1	76.0	81.7	31.9	38.8	60.9	67.6
GDP	24.2	26.0	38.4	55.2	29.9	22.7	56.8	57.3	30.0	32.4	21.2	38.2	30.8	40.1

Sources: Central Bank of Bahrain, 2008 report; Central Bank of Kuwait, 2003 & 2006 reports; Central Bank of Oman, 2003 & 2007 reports; Central Bank of Qatar, 2003 & 2006 reports; Saudi Arabia Monetary Agency, Public Finance Statistics, Annual Government Revenues and Expenditures.

The increased levels of public spending channeled at modernizing the infrastructure has been a significant factor in the diversification of GCC countries toward the non-oil sector. Moreover, the deregulation of important sectors such as the financial sector, education, and tourism has attracted a wider spectrum of investors, thus compelling the private sector to strengthen its competitive capacity.

It is important to note that these statistics only measure the direct role of oil in the economy. If the indirect impact of oil revenues on the service and industrial sectors is factored in, the contribution of oil to GDP will be much higher, thus further underlining the importance of oil in the economy. The indirect contribution of oil revenues will be explored by shedding light on the role of oil revenues in the development of the non-oil sectors and the implications of that for public policy, monetary policy, and fiscal policy.

Persistent Dependence on Oil

The relationship between the oil and non-oil sectors in the GCC economies is interactive and dynamic. Driven by oil revenues, the non-oil sector in some countries has succeeded to reduce dependence on oil. However, it is still not clear to what extent growth in the non-oil sector is independent of growth in oil revenues. Given the uncertain nature of future energy prices, this raises serious policy challenges regarding the enabling conditions that must be nurtured for non-oil growth to be less dependent on oil revenues. The dynamics of this relationship will be explored further when we address the challenge of diversification in the following section.

The continuing dependence of GCC countries on oil exports and oil revenue during this period is the result of high oil prices, not of a failure to develop the non-oil sector of the economy.[3] In fact, the annual growth rate of the non-oil economy (sometimes referred to as the non-hydrocarbon economy) over the period 2002-2006 surpassed that of the oil economy as Figure 1 illustrates. The annual growth in the non-oil sector averaged 7.72 percent. This growth resulted in an increase of the non-oil sector share to the total share of the economy from a low level of 4.4 percent in 2002 to 7.8 percent in 2007.

At country levels, Figure 1 indicates that the growth of Qatar, Kuwait, and the UAE has been associated with a strong growth in the non-oil sector where the average per capita of oil and gas is much higher than the rest of the GCC countries. These economies have been keen about adopting economic policies toward the diversification of their revenue sources. On the other hand, the Saudi government has been trying to encourage non-oil sectors through various means, but it continues to exhibit a relatively modest growth rate with the oil sector surpassing the non-oil by only a slight margin.

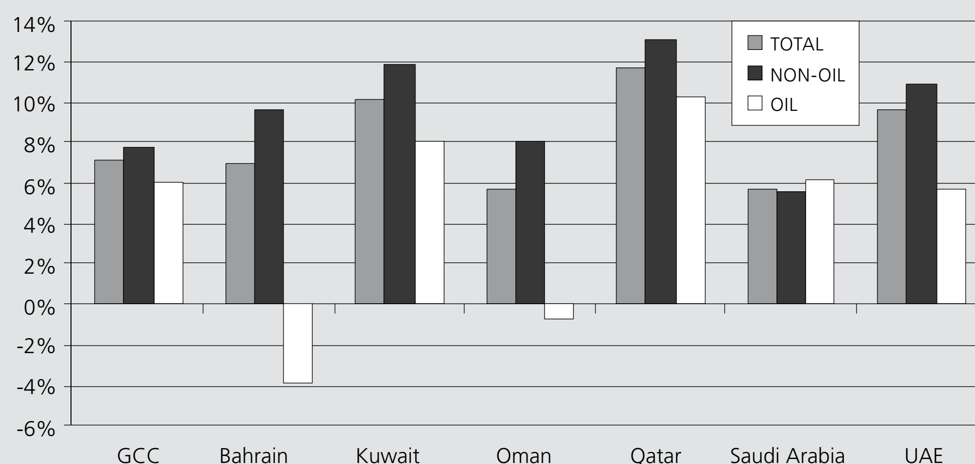
Bahrain and Oman reflect a rather different picture. Their oil sector registered negative growth rates over the observed period, thus suggesting that poorly resourced countries are unable to benefit from the hike in the prices

of oil and natural resources. Both countries suffer from a rapid decline in oil reserves and a small production capacity. Oil experts emphasize the need for the two countries to invest in enhanced oil recovery methods. The observed growth rate in Bahrain and Oman was mainly driven by non-oil sectors such as financial services and construction.

The non-oil sector greatly benefited from better targeted public spending and sharp increases in capital spending channeled toward modernizing the industrial infrastructure and the deregulation of key sectors. A rapid population growth, especially in SA (4.6 percent) and the UAE (3.1), required higher capital expenditure on housing and utilities. New roads, railways, ports, and airports were constructed in order to accommodate growing volumes of trade inside and outside the region. Moreover, the non-oil sector benefited from the deregulation of the finance, tourism, and education sectors. For example, SA granted ten licenses to foreign banks to open branches in the country after 2003. Prior to this date, banks were regulated by a 1976 law that required banks operating in the country to have a majority of Saudi shareholdings. Qatar and the UAE both undertook deregulation in the education sector with the opening of several branches of reputable international universities; a step that is expected to pave the way for establishing a niche market in education at the regional level.

Unlike the 1970s oil boom, the private sector played a more active role in the 2002–2008 boom. The non-oil growth in the GCC countries was driven by a newly emerging private sector. The private sector evolved from a merely *rentier* private sector into a sector run by competent entrepreneurs who find

Figure 1: Gross, Oil and Non-Oil GDP real Growth in GCC countries, annual average 2003–2007



Source: Regional Economic Outlook 2007, International Monetary Fund.

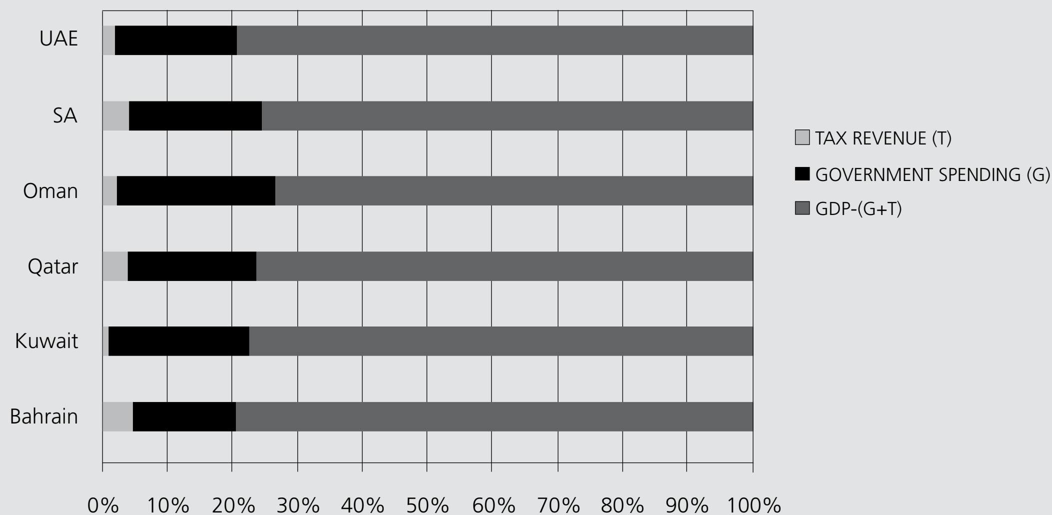
themselves forced to compete more aggressively in order to win contracts and ensure business access. Also, partnerships between the private and public sectors became more widespread, which improved the quality of the projects being implemented in the region. During the 1970s oil boom, the rapid increase in revenue led at times to the implementing of hastily planned and poor quality infrastructure and service delivery projects. Recent projects in infrastructure and utilities were more carefully selected and according to a predetermined framework and were linked to the macroindicators.[4] This difference has roots in the weak institutional capacity of the GCC countries in the 1970s, which resembled that of early-stage developing countries. GCC countries now have in place systems that can cope with the oil windfalls with significantly lower public debt ratios.[5]

Public Spending and the Social Contracts

Fiscal policy in the GCC countries has been expansionary and has been utilized to sustain the social contract between state and society. Public spending has been the primary tool used to influence economic performance. This has remained the case even after oil prices dropped from an average of $108 in 2008 to a forecast US$75 per barrel in 2009. The fiscal surplus will drop nearly 28 percent; however, the GCC countries will finish the ongoing projects without difficulties.

Public spending is instrumental to understanding the dynamics of growth and oil revenue distribution in the GCC countries. As was previously noted, oil revenues constituted 86 percent of total government revenue in 2006 in comparison to the 2002 figure of 77.4 percent. As Figure 2 shows, domestic taxes

Figure 2: Government Spending vs. Tax Revenue (based on 2007 figures)[6]



Source: 2008 Index of Economic Freedom, the Heritage Foundation.

constitute a minimal source of government revenue and spending. On average, domestic taxes amounted to less than 5 percent of the GDP, thus constituting a very low share of the governments' revenue. In Kuwait, for example, the tax revenue makes up around 1 percent of GDP. This means that GCC countries rely on rent made from the export of oil in order to generate revenue for financing public spending.

One can reasonably conclude that public spending rather than taxation policy has been utilized as a distributive mechanism in the GCC countries. During the 1970s oil boom, GCC countries launched ambitious programs of public spending on infrastructure and services. With the relative decline in oil prices during the 1980s and 1990s, GCC countries faced increasing problems that led to intensifying budget deficits, thus crippling the government's ability to face turbulent social problems. Unemployment rates were remarkably high: 15 percent in SA and 17.5 percent in Bahrain and Oman. Governments found themselves in a vicious spiral driven by the necessity to reduce budget deficits—thus public spending—and the social pressure to provide public services. This unsustainable situation exerted an increasing pressure on governments to rethink their economic and social policies.

For better or for worse, the 2002 spike in oil prices allowed GCC countries to avoid going into a domestically challenging area of restructuring. Governments resorted to simply increasing domestic spending on current and capital expenditures by allocating more resources to health, education, and wages for nationals. Hence, the oil boom delayed some of the economic reform measures that the GCC countries had contemplated prior to 2002: increasing the level of domestic taxation, opening up some sectors, and implementing policies aimed at increasing nationals' employment in the private sector.

The relaxed fiscal policy was reflected in a policy of minimal taxation. GCC countries have a very narrow domestic tax base; yet, given the accumulated foreign reserves, it is very unlikely that this source of government revenue will be tapped more significantly in the near future—even with the recent drop in oil prices. According to the Index of Economic Freedom 2008,[7] most of the GCC countries enjoy a very high degree of "fiscal freedom" measured by tax revenue to GDP. The rate is highest in Bahrain with 5.5 percent, 5.1 percent in SA, 4.6 percent in Qatar, 2.1 percent in the UAE, and only 2.8 percent in Oman—even though Oman is not an oil rich country. In Kuwait, this ratio was 1 percent, the lowest in the region.

This minimalist taxation policy is part of the informal social contract between the state and society in most GCC countries, where states choose not to tax their citizens. In return citizens do not participate effectively in decision-making but enjoy the benefits of oil revenues. The absence of real participation has important implications on transparency and good governance.[8] Kuwait, which has regular meaningful elections and a powerful parliament, is the exception to this rule—although quality of governance there, too, remains low.

Despite the rise in energy prices that lasted a relatively longer period (2002 to mid-2008) than the volatile rise and fall of oil prices between the 1970s and 1980s, most of the GCC countries were nevertheless conservative in expanding public expenditures and accumulating reserves and were keen on paying back some of their internal and external debt. Therefore, the 2002–2008 public spending expansion was associated with a relatively stricter public policy to reduce public debt. After 2002, GCC countries managed to control public debt—reduced it to an average of 20.4 percent of GDP in 2006 compared with an average of 69.9 percent in the 1998–2002 period. SA registered the highest debt-to-GDP ratio in 2006 with a 28 percent level; they were followed by Bahrain with 23.3 percent; Kuwait had the lowest at 8.5 percent. This conservative approach stems from past lessons from the 1970s oil boom when the GCC countries found themselves accumulating high levels of external and internal debt relative to their GDP.

Given the accumulated current account surplus, GCC countries could easily afford to repay their domestic debt. However, they did not do so. This was in order to preserve stock of government securities and bonds that could be used at later stages for monetary purposes, like setting a benchmark for interest rates and absorbing excess liquidity from the financial markets.[9]

Although GCC countries followed a more prudent policy with the use of oil revenue, their fiscal policy still needed to address a number of key challenges: 1) designing measures to avoid the inflationary pressure of public spending; 2) enhancing the efficiency and transparency of public expenditure; and 3) adopting steps to diversify sources of revenue away from oil. In order to respond to these challenges, the GCC countries needed to strengthen their fiscal administrative capacities by introducing international best practices concerning budget preparation and expenditures monitoring. These issues did not seem to have primacy given the relaxed fiscal position the GCC countries enjoyed during the period under review.

The Efficiency of Constrained Monetary Policy

Monetary policy in the GCC countries has been constrained as a result of the tight link between the GCC and the U.S. economy through the pegging of their currencies to the U.S. dollar. Additionally fiscal, not monetary, policy has been the primary tool that has been utilized to influence economic performance.

With the exception of Kuwait, the exchange rates of the GCC country currencies are pegged to the U.S. dollar. Though this policy prevents central banks from utilizing domestic interest rates as a monetary tool to control inflation, it does have merits. Given the importance of oil revenues, the pegged regime serves to stabilize exports as well as government revenues. Moreover, it has a significant role in enhancing the credibility of monetary authorities and restricting currency speculation.

However, during 2002–2008 there was a widening discrepancy between the business cycle in the GCC countries and the U.S. economy—coupled with the sharp decline in the value of the dollar in comparison to the Euro and other major currencies. This triggered a debate over the appropriateness of the current monetary policy. The U.S. economy had begun to slow and show signs of impending recession as early as mid-2007; this led to the easing of monetary policy and the reduction of interest rates. The GCC countries were thus forced to reduce interest rates as well though their economies were already overheated and suffering from inflationary pressure. A high rate of inflation and a low nominal interest rate resulted in a negative real interest rate, thus spurring rapid credit growth and adding fuel to already rapidly expanding domestic demand. With the even more severe economic slowdown of 2008, it is expected that the GCC countries will register a slowdown in credit growth during the second half of 2008 and into 2009. This, combined with the recent strengthening of the dollar and the decline in commodity prices, should dampen inflation and make monetary policy more efficient.

The GCC countries are not expected to alter their current exchange rate policy given that, as an IMF report (2008) argues, nominal effective exchange rates have not shown a high degree of appreciation vis-à-vis other currencies. This implies that the impact of the exchange rate on inflation is limited and the current trade-off in favor of stability is worth pursuing. This line of argument is even more convincing after the global financial crisis and the strengthening of the U.S. dollar against other currencies.

Another explanation for this decision is related to political considerations, i.e., close GCC–U.S. relations that make it more difficult to abandon the peg or even to diversify the asset portfolio. While this is understandable, it should still be possible for GCC countries to at least partially diversify their assets, which will reduce both vulnerability and market volatility.

Table 2 shows that the GCC countries maintained a constant average of 46 percent of GDP of domestic credit extended to the private sector over the period 2002–2007. However, it is important to highlight varying rates among the countries. Except for SA and Oman, the rates have been increasing at different speeds. Credit growth was highest in Kuwait, where credit exceeded GDP by 4 percent. It was followed by the UAE with a credit-to-GDP ratio reaching 80 percent. SA witnessed a decline in this ratio from around 41 percent in 2002 to around 18 percent in 2007; this was mainly due to a correction in the stock market, which shows that a large part of that credit was used for speculation in the stock market.

Most credit in the GCC countries is in the form of personal loans, indicating public confidence in the performance of the economy and an increased demand. This is triggered by higher wages that encourage consumption and enhance the creditworthiness of individuals before credit institutions.

Even though credit ratios have been increasing over the past years, they are still considered low if compared to developed countries. In the EU and the United States, for example, credit-to-GDP exceeds 100 percent and 141 percent respectively. Rapid credit expansion can undermine the quality of banks' portfolios if the capacity of these banks to assess the creditworthiness of borrowers fails to keep pace with the growth of lending;[10] these warnings proved accurate in the financial meltdown of September-October 2008. In the GCC, the estimates of capital adequacy (the ratio of capital-to-risk-weighted assets) ranged from 16.7 percent in the UAE to 21.9 percent in SA. This figure stands at a much higher level than that required by the Bank of International

Table 2: Domestic Credit / GDP 2002–2007

	2002	2003	2004	2005	2006	2007
BAHRAIN	46.10%	44.78%	48.27%	49.93%	48.56%	61.73%
KUWAIT	79.38%	78.59%	74.15%	77.17%	86.05%	104.31%
OMAN	40.30%	38.00%	34.28%	27.98%	28.48%	33.84%
QATAR	39.78%	38.63%	33.68%	35.28%	36.98%	46.37%
SAUDI ARABIA	40.94%	43.31%	41.71%	30.00%	23.00%	17.90%
UNITED ARAB EMIRATES	44.87%	46.86%	50.82%	57.98%	66.61%	81.87%
GCC	46.16%	47.67%	46.50%	41.60%	41.17%	46.01%

Source: International Financial Statistics Database 2008, International Monetary Fund, http://www.imfstatistics.org/imf.

Settlement upon which the soundness of the banking sector is assessed. The over-conservative attitude by banks reflects the region's higher economic and geopolitical risks. In the wake of the global economic crisis, GCC banks have remained well capitalized and profitable, with a ratio of nonperforming loans to total loans of less than 5 percent. And with a few exceptions, they have limited exposure to complex products based on mortgages. Moreover, monetary authorities reduced interest rates and introduced measures to provide liquidity to the banking system. Some of these measures were in contrast with measures introduced earlier: an increase in reserve requirements and guarantees on bank deposits. These were adopted to cool down the overheated economy and to absorb some of the excess liquidity in the market.[11]

Deposits in the GCC countries are mostly of a short-term maturity, making it difficult for banks to make long-term loans. During most of the period under study, banks preferred to extend loans in seemingly secure markets, such as real estate where they were guaranteed with strong collateral. This resulted in an overexposure to the real estate market, and thus correcting this market was made more difficult since banks portfolios were not adequately diversified. In response, GCC governments need to facilitate the development of new tools that allow banks to engage in issuing corporate bonds and venture capital.

Also there is a need to create credit bureaus that can more effectively assess risk. This must be associated with strong regulatory institutions in order to avoid fluidity or abuse in the bond market. This has become more pertinent after the global financial crisis that has revealed how devastating the weakness of regulations can be.

In sum, monetary policy in GCC countries suffers by varying degrees from serious limitations in its ability both to influence business decision makers (banks) and to contain inflation. Partially for these reasons, the GCC countries still rely on fiscal not monetary policy as the main macro tool to control inflation.

A Resilient Cushion of Foreign Reserves

The GCC countries in 2002–2008 handled oil revenues in a more prudent and conservative manner when compared to previous oil booms. The increase in oil prices had a dramatic impact on the external economic position of the GCC countries. This allowed them to accumulate considerable current account surpluses and to become important international exporters of capital and investors in the rest of the Middle East and the world. At the same time, countries of the GCC became more attractive to foreign investors, thus attracting high levels of foreign direct investment (FDI).

The relative slow increase in imports in comparison with their exports allowed the GCC countries to enjoy a period of current account surplus. Imports of goods and services in the GCC countries increased from $56.7 billion in 2002 to $184 billion in 2007. As a share of GDP, imports increased from 18.15 percent in 2002 to a level of 23.27 in 2007.

The fact that import growth remained below that of export earnings in some countries could be interpreted in two different ways. First, it may reflect, as previously indicated, a more conservative response to the increased oil revenues than in previous oil boom periods. Second, it might be more structurally related to existing bottlenecks in the supply-side: a shortage of available raw materials especially for the construction sector and a scarcity of cheap skilled labor, which limits the tendency to import. It is more likely that a combination of these two factors led to this relative lag in imports.

The recent economic slowdown and decline in oil prices will influence the external position and the current account surplus. However, GCC countries will be in a position to continue accumulating foreign reserves though at a lower level.

Imports by Region: Heading East

There is a noticeable shift in the source of GCC imports, with Asia expanding its share at the expense of the United States. GCC imports from the United States have declined from 16 percent of total imports in 1997 to 11 percent in 2006. Meanwhile, imports from Asia have reached 31 percent of the total in 2006 compared to 26 percent in 1997. The rise of imports from Asia reflects the growing role of China as the world's center for low-cost manufacturing. GCC

imports from China rose from 4.4 percent of the total in 1997 to 8 percent in 2006. Imports from the EU remain in first place with a share of 32 percent.

Clearly, the surplus in the GCC countries was the result of an expansion in the export of commodities. Indeed, most of the GCC countries registered trade deficits in the services balances as a result of high levels of service imports, with the exception of Bahrain that had a surplus due to its role as a financial hub in the region. GCC countries also ran a deficit in their net current transfers, which reflects high remittances outflows by expatriate workers. It also reflects formal development assistances extended either to other Arab countries or to the international community: the $500 million pledges by SA to the World Food Program and a similar amount to fund the "Energy for the Poor" initiative.[12] Most of the GCC countries have surplus in net factor income from abroad, reflecting the return on their holdings of foreign assets through, *inter alia*, the Sovereign Wealth Funds (SWF) and investment abroad.

The final outcome is that GCC countries enjoyed a comfortable foreign reserves surplus. They were in a good position to invest domestically, regionally in other Middle East and North Africa (MENA) countries, and internationally. After September 11, 2002, there was an increasing tendency to invest in the MENA region in response to restrictions imposed on Arab investment in international financial markets. This boosted the economic role of the GCC countries in the MENA over the last five years through direct investment that both the GCC governments and the private sector undertook there. Through their SWFs, the GCC countries allocated part of their investments to other Arab countries like Egypt, Morocco, Jordan, and Syria. The channels of investment covered various sectors from industry to real estate to infrastructure projects.

Similarly, the private sector in the GCC countries, which is the richest in the Arab Middle East region, entered in partnerships with their counterparts in other GCC countries as well as in the Maghreb and Mashreq countries. GCC private businesses underwent a qualitative shift from being dependent on the state to acting as sophisticated entrepreneurs willing to compete and invest in a more challenging environment. It is estimated that in the 2002–2006 period, capital outflows from the GCC to the other MENA countries amounted to around $60 billion.[13] The bulk of the investment was directed toward Egypt, Morocco, and Turkey.

The role of the GCC region was not limited to being capital exporters; the region witnessed a net FDI inflow as foreign investors were increasingly attracted to the energy and construction sectors. The increased FDI was also the result of the greater openness of most GCC countries, which became more receptive to foreign investment in sectors that were traditionally limited to it. In particular, most GCC countries opened the construction sector to foreign investment and allowed participation in some infrastructure projects by adopting new finance schemes such as the Build-Operate-Transfer (BOT)[14]

approach in the UAE. Moreover, the GCC countries became attractive to international energy-intensive industries because the differential in energy prices was in their favor. Low energy prices in the Gulf, coupled with relatively cheap foreign labor,[15] made the cost advantage of operating in GCC countries very compelling. It is very likely that we will be observing the opening of new plants in the aluminum, petrochemicals, and steel industries in the GCC countries.

Challenges Facing the GCC Countries

Despite nearly six years in which high oil revenues created favorable macroeconomic conditions in the GCC countries, they were still not able to tackle their long-term economic challenges. The oil windfall actually pushed back attempts to address some of the challenges to the back burner, while the global financial crisis has reminded policymakers in the GCC that structural challenges must be addressed at a time when macroeconomic conditions are favorable and not when the economies are slowing down.

The challenges can be classified into two broad categories. The first are of a structural nature such as the need to diversify the economy and the labor market. The second is of a policy nature and is related to issues of inflation and governance.

Varying Policies Toward Unsuccessful Diversification

As observed earlier, the non-oil economy in the GCC countries grew at a rate faster than that of the oil economy. However, more efforts are needed to stimulate the diversification of the production base. First, well-targeted policies should be adopted to accelerate reform and facilitate the involvement of the private sector in the economy. Second, both the private and public sectors need to rethink their investment decisions within a comprehensive macro framework.

GCC countries are adopting three main approaches to diversification. The first focuses on creating a parallel economy to overcome the existing rigid structure and burdensome regulations. This is the case in SA and Kuwait. The second aims at promoting a competitive position in sectors such as finance, tourism, and education. This is the case in the UAE, Bahrain, and Qatar. The third approach, common across all the GCC countries but to varying degrees, is related to the economic reform process. The GCC states have all embarked on an economic reform process that aims at encouraging private sector involvement and stimulating non-oil sectors by removing regulatory and administrative barriers.

Creating a Parallel Economy in SA and Kuwait

SA adopted a two-track approach to reform the economy: fixing the old and creating a new. Kuwait has been trying to speedup the process of privatization and further deregulate the economy.

To fix the old, SA cut down import duties, privatized telecommunications, and proceeded with the liberalization of the aviation industry. The country joined the WTO in 2005. To create the new, it embarked on a series of initiatives to develop economic cities with regulations that are conducive to the private sector. These cities, designed to focus on a specific economic activity, would serve as "centers of excellence" that attract new investments. This step ought to reduce the centralization of power and foster the development of productivity zones.[16]

More importantly, this initiative would allow the creation of a parallel economy that would sidestep the existing bureaucracy, which hindered private investments in the past.[17] However, the rising challenge is how to maintain the balance and harmony in this emerging dual system without widening the gap and further exacerbating income and regional disparities in SA; for unlike the smaller GCC countries, intercountry inequality is a serious and critical issue in SA.[18]

Kuwait, on the other hand, has focused its efforts on speeding-up the process of privatization and introducing further de-regulation to the economy. Approval of a framework for Build-Own-Operate contracts was issued in the late nineties, as well as a decision to significantly cut taxes on foreign companies from 55 percent to 15 percent. A law was also passed by the parliament allowing the privatization of Kuwait Airways. Like other GCC countries, Kuwait has also been involved in large residential and tourism projects on the Kuwaiti islands of Bubiyan and Falaika, which also includes developing a deep sea port on Bubiyan and an $85 billion plan for Madinat al-Hareer (City of Silk).[19] These projects and investments mean that the public sector is injecting money into the economy and also opening opportunities for the private sector to play a more active role.

Creating Market Niches

In other GCC countries, there was a more premeditated shift toward non-oil sectors, particularly in finance and tourism over the past five years. Dubai and Qatar launched financial centers, the Dubai International Financial Center and the Qatar Financial Center respectively, to compete with Bahrain that is ranked the first financial hub of the region. Bahrain, in turn, gave new impetus to its own position with the launching of the "Bahrain Financial Harbor."

Developments in the tourism sector were even more remarkable. Dubai captured the most attention with the construction of attractive destinations such as the world's tallest tower and largest shopping mall. Abu Dhabi also launched massive tourism projects, including the development of islands similar to those developed in earlier years in Dubai. In this direction, the UAE paid $548 million to use the French Louvre's museum name and is expected to pay an additional amount of $788 million to the Louvre and other French museums for management and advice.[20] In Qatar, there has been an extensive focus on attracting top universities to open branches in the small country in order to

host students from around the region. The Qatar Foundation set up the Sidra Medical and Research Center in Doha with a nearly $8 billion endowment.[21]

In Oman, the government initiated reforms that aim at opening up the economy. In line with this reform effort, the government passed a new Tax Law in September 2003 and a new Privatization Law in July 2004. The government also opened key economic sectors such as telecommunications, power, utilities, and tourism for private sector participation.[22]

Many of the diversification efforts were duplicated across the region, thus raising the risk of oversupply. Most countries offer the same services and similar attractions (shopping, tourism, business conferences) and demand must come from abroad if these investments are to achieve high return on the equity invested. This is the case in the financial sector with four countries competing to become the regional financial hub. Moreover, tourism would be particularly exposed to any serious escalation of geopolitical tensions, and demand from within the region would not be enough. The diversification efforts suffer from serious limitations and an unclear vision, and it remains to be seen how successful the policies will be over the longer term.

Outsourcing Economies

In their attempt to diversify their economies and address domestic supply problems, GCC countries explored opportunities outside their borders. In particular, these countries sought to enhance their food security by investing in agricultural production abroad. The UAE and SA both invested in the agricultural sector in Sudan and Egypt. More recently, SA created a holding company to buy farms and fisheries overseas. The Saudi holding company is planning on buying rice farms in Thailand. Qatar and the UAE are considering buying underdeveloped farmland, especially in Pakistan and Sudan. The Kuwaiti government has been considering Myanmar, Cambodia, and Laos as potential targets for its investment.[23]

These outsourcing initiatives come in response to existing limitations on the expansion of the agricultural sector domestically. For example, high costs of production forced SA to abandon its domestic production of wheat, though it had achieved self-sufficiency in this crop. The government has embarked on a plan to phase out production by 2016,[24] due to the costly desalinated water used in irrigating the wheat fields. Other GCC countries are expected to follow the same steps. While the Saudi decision makes environmental and economic sense, it also represents a drawback on the diversification efforts; for it will lead to the shrinking of the agricultural sector and a further increase of dependence on oil-related industries and services.

Concentrating Access to Credit

Diversification in the GCC countries was also hindered by the nature of its financial markets, which are not set up to channel resources to small and medium

enterprises (SMEs). Small business suffers from limited access to credit as a result of an under-developed financial infrastructure, such as credit bureaus and local credit rating agencies. This makes assessing risk by local banks extremely expensive and difficult, encouraging them to reduce lending.[25] Hence, the financial system channels funds almost exclusively to large government projects and to well-established business elites. This leaves SMEs that are instrumental in enhancing a culture of entrepreneurship and innovation in a disadvantageous position.

The case of the financial sector highlights the need for GCC countries to adopt a comprehensive framework to guide the process of economic transformation. Detailed policies are needed to achieve the desired goals proclaimed by governments. Along with that, there should be a financial model and reasonable assumptions based on which an action plan can be developed. The starting point of such a plan is clarity about the structure of the desired economy and decisiveness on the intended goals and tools needed to achieve the desired transformation. So far, a framework that covers all markets does not exist and rhetoric alone will not change the facts on ground.[26] This suggests that this issue will continue to saddle the GCC economies for decades to come if it is left to the natural course of development in the absence of public policies designed to invoke the desired changes by establishing the right set of incentives. This set of incentives depends on which way each country would like to go and which sectors it desires to promote in order to enhance its competitiveness. This includes having the right infrastructure and education policies and credit facilities.

The Labor Market Predicament

The labor market predicament in the GCC countries is characterized by four main features. The first is the high rate of unemployment among the youth, a problem exacerbated by the high rate of population growth. The second is the limited role of the private non-oil sector in generating employment opportunities accepted by GCC nationals. The third is the status of foreign labor, which in most GCC countries constitutes the majority of the workforce. The fourth is the low female participation among the GCC nationals.

The GCC region faces a difficult demographic profile, with one third of the GCC national population under the age of sixteen. This makes developing human resources and employment a top priority.[27] Population growth registered world records with the UAE reaching up to 7.2 percent annual growth in 2007; even Bahrain, with the lowest growth percentage of 2 percent in 2007, exceeds the average rate of 1.2 percent of all developing countries.[28] On average, GCC countries' national population growth is estimated at 3.1 percent annually—one of the highest in the world.

According to statistics published by the Arab Labor Organization, the percentage of non-national labor of the total labor force has registered an average

of 71 percent in 2005. The UAE registered the highest rate at 82 percent, followed by Kuwait at 81 percent, Oman at 66 percent, SA at 65 percent, Bahrain at 59 percent, and Qatar at 57 percent.[29] The national labor force participation faces an even more challenging situation in the private sector. In 2004, out of the total private sector workforce of 850,000 in Kuwait, the nationals accounted for only 1.8 percent. In Qatar, Oman, and the UAE, the nationals make up around 10 percent of the private sector workforce; in Bahrain 27 percent, and in SA just over 30 percent.

The structural weakness of GCC states to generate employment opportunities attractive to its nationals brings medium-term risks to political and economic stability. Unemployment among nationals might engender disillusionment with the government. It would also raise the possibility of resentment toward foreign workers amongst nationals. GCC countries' leaders expressed their fears regarding guest workers in their last summit in Doha in December 2007.[30]

The policy of trying to substitute foreign workers by natives has become a common policy across the GCC countries. More importantly, available cheap labor might contribute to what is known in labor economics as the race to the bottom. The worsening labor conditions would encourage the private sector to employ the cheapest labor available worldwide rather than investing in human capital of the GCC national work force. In the long run, this will reduce labor productivity and harm the potential of the young national labor force that is incapable of competing with cheap labor.

The increasing talk about labor conditions of expatriates in the GCC countries comes at a time when international organizations like Human Rights Watch (HRW) have given more attention to the status of expatriates. Their World Report 2007 addressed the expatriate working conditions of GCC countries and described that of the UAE as one characterized by "abuses against migrant workers including nonpayment of wages, extended working hours without overtime compensation, unsafe working environments resulting in deaths and injuries, squalid living conditions in labor camps, and withholding of passports and travel documents."[31]

The nationalization attempts in the private sector have been negatively impacted by the fact that employment in the private sector is usually unattractive for nationals. It is therefore important that the GCC governments correct the distortions created by inflated public wages and concentrate on making both skilled and unskilled private sector jobs more attractive to their citizens. Sweeping steps are required, such as legislating better work conditions for expatriates. This will increase the cost for employers by introducing minimum wage levels, which will narrow the cost-gap between employing a national and a non-national. Allowing for some forms of collective action might also be helpful. This option however is quite difficult to calibrate, given the political structure in the GCC countries and the almost complete absence of formal collective action.

The Threshold of Intolerable Inflation

Inflation is possibly a temporary phenomenon in the GCC countries caused mainly by external factors and might not reflect a serious structural imbalance. Since mid-2008 inflationary pressure receded, though it still poses serious challenges to governments throughout the GCC. It also had serious negative impacts on GCC nationals and expatriates alike prior to June 2008.

Over the period 2002–2008, inflation in the GCC countries has mainly been driven by: 1) a depreciating U.S. dollar; 2) strong domestic demand accompanied by a growth in money supply and credit; 3) bottlenecks in the economy and lack of supply, especially in the non-traded sectors such as real estate; 4) rising world food prices; 5) rising raw material prices, for example for steel and cement; vi) and rising labor costs. The global financial crisis resulted in a slowdown in credit and world food prices declined. This was combined with the strengthening of the U.S. dollar against other currencies, especially the Euro. As a result, in late 2008 there appeared to be little reason for GCC policymakers to worry about inflation. However, policy makers need to be more proactive; the same conditions mentioned above could resurface and lead to the same consequences as before.[32]

The inflation rates in both Qatar and the UAE were particularly high in the 2002–2008 period. First, the two countries had adopted more liberal regulations concerning property ownership for non-nationals, thus driving up prices in the real estate sector. What worsened this issue was the concentrated ownership of land by the state in these GCC countries which limited the private sector's ability to respond to the increasing demand and meet housing shortages.[33] Another reason for the registered inflation rates by Qatar and the UAE is that both countries received a large number of expatriates as their economy grew at a faster rate compared to other countries.

If inflationary pressures recur, containing inflation will not be an easy task for the monetary authorities. First, monetary policy is constrained given the fact that the GCC currencies are pegged to the U.S. dollar, as already discussed. Indeed, the only policy tool available if boom conditions returned would be limited to the interest rate; but lowering the interest rate at a time when the economy is rapidly growing contradicts the norm (to increase the interest rate during such times in order to cool the economy). In parallel, the GCC countries are generally maintaining expansionary fiscal policies that also fuel inflation. Associated with inflation is the increase in the cost of domestic labor: workers are demanding higher wages to keep up with inflation. This combination has serious implications for it can easily trap some of the economies in a wage-inflation spiral, which would present a serious impediment to economic growth.

Alert to these dangers, the GCC countries have resorted to adopting administrative measures that might help in curbing inflation. Several central banks

have increased the reserve requirements and tightened loan-deposit ratios in order to slow down private credit growth. All countries are trying to increase the supply of real estate while at the same time monitoring the market, in order to avoid dramatic price increases. SA, for example, has introduced new regulatory measures to control the real estate market in the country. The Riyadh Chamber of Commerce launched a real estate pricing scheme that targets various stakeholders involved in this sector. SA has also introduced new subsidies on some food items and is keeping the price of gasoline in the domestic market low. During Ramadan 2008, the Kingdom allocated 1.15 billion Ryal ($330 million) for low-income families. Qatar and the UAE have introduced ceilings on rent increases.[34]

The adopted measures by the GCC countries show that though the authorities were well aware of the severity of inflation, they believed that they could do little to control it. As such, they have been focusing on trying to mitigate its public impact by increasing public spending, expanding the scope of social measures, and developing well-targeted social schemes.

In response to the financial crisis, GCC monetary authorities have reduced their key interest rates and introduced measures to ease monetary policy. They are doing this by reversing earlier decisions regarding higher reserve requirements and deposit guarantees in order to encourage more liquidity into the market. These policies are likely to have little impact on the market and inflation because of the deflationary mode that dominates the markets today. As a result of these developments, inflation is expected to remain low in the near future.

The Challenge of Governance

Issues of governance continued to hinder economic growth in the GCC countries; and despite advances in some areas, the governments still have a long way to go to remove governance obstacles. Attempting to analyze the governance situation is critical and suffers from the interference of various misleading figures. One should be wary of the economic freedom aggregates that tend to conceal important disparities among the indicators. Hence, this section will address governance in the GCC countries by adopting a multi-dimensional perspective on the issue. The governance structure of the GCC countries will be examined by looking at sub-indicators separately, in order to provide a more complete picture.

The examination of subgovernance indicators calculated by Kaufmann, Kraay, and Mastruzzi[35] illustrates the weaknesses of GCC countries in terms of governance. This is true of political indicators, which measure accountability, political stability, and absence of violence; economic governance indicators, which measure government effectiveness and regulatory quality; and institutional governance indicators, which measure rule of law and control of corruption.[36]

Political Governance

GCC countries have different systems of political governance, but in general political governance in the GCC countries is weak. With the partial exceptions of Kuwait and Bahrain, the rest of the GCC countries lack effective elected bodies that have an impact on decision making. Other countries have followed various representation formulas such as the Shura Council in SA or the consultative bodies in the UAE and Qatar. This is illustrated by Figure 3, which ranks Kuwait on top, followed by Qatar, Bahrain, the UAE, Oman, and SA. However, all the GCC countries score negative values for "voice and accountability" estimates, suggesting that the region needs to rethink its political representation scheme.

Similarly, Freedom House, which measures political rights and civil liberties, classified Kuwait as "partially free" and the other five GCC countries as "not free." Insignificant tax rates, particularly on personal income, might provide a fair explanation to why citizens have been tolerating poor performance by the government. One can even stretch this argument further by suggesting that the high levels of public spending observed earlier serve as an informal insurance against the rise of public accountability.

Economic Governance

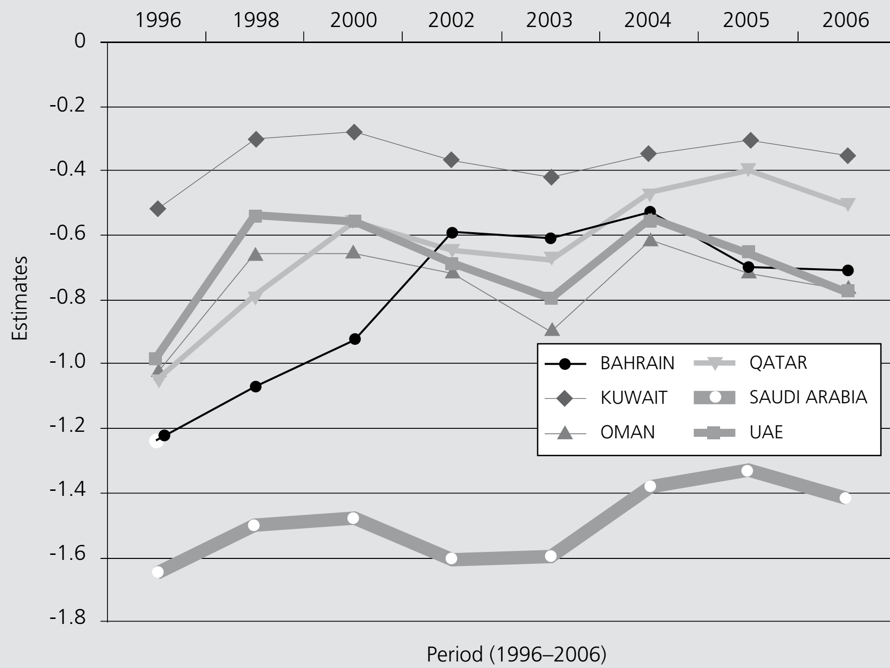
Economic governance in GCC countries scored higher than either political or institutional governance. Qatar emerges as the best performer followed by the UAE and Oman. Other GCC countries Bahrain and Kuwait scored high rates, with the exception of SA (with a score rate below 50). Based on this record one can argue that the GCC governments have been successful in implementing the formulated economic polices.

Figure 4 exhibits the performance of GCC countries in terms of "government effectiveness over the observed period. This indicator measures the quality of public services, the quality of civil service, and the degree of its independence from political pressures. It also covers the quality of policy formulation and implementation and the credibility of the government's commitment to such policies."[37]

Accordingly, the UAE, Bahrain, Qatar, and Oman score the highest in government effectiveness, followed by Kuwait. Noticeably, SA lags well behind. This indicator has important implications for the quality of public services provided by the countries. For example, though spending on education might be remarkably high in SA, this has not been reflected in the quality of graduates (potential labor). The Kingdom is not oblivious to this situation and has just recently launched various assessment schemes to its provision of public services.

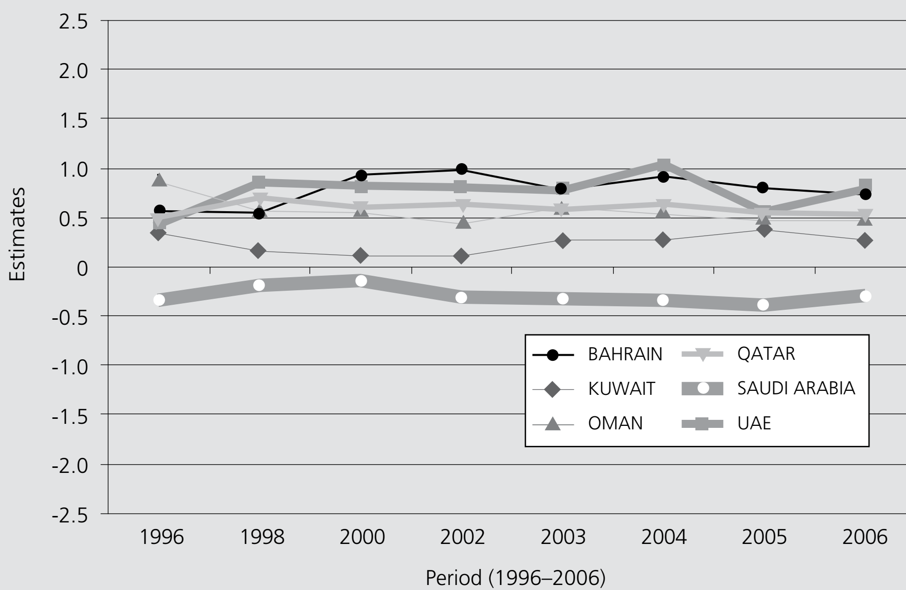
Efforts of diversification will not be successful if the will is not complemented with policy measures to promote private sector development. Regulatory

Figure 3[38]: Voice and Accountability for GCC Countries



Source: Statistical Appendix of *Governance Matters VI: Aggregate and Individual Governance Indicators 1996–2006.*

Figure 4: Government Effectiveness



Source: Statistical Appendix of *Governance Matters VI: Aggregate and Individual Governance Indicators 1996–2006.*

quality, an indicator that measures the ability of the government to formulate and implement sound polices and regulations that permit private sector development, has been tracked in Figure 5. As the figure shows, regulatory quality has not improved substantially since 2002 and efforts are needed to improve the regulatory framework for enhancing private sector involvement.

Remarkably, among all indicators, the best scores have been achieved in government effectiveness and regulatory quality. However, as the GCC countries have increasingly invested abroad, particularly through the SWFs, it becomes important to follow stricter disclosure measures and a greater clarity of SWFs objectives. Furthermore, in order to continue attracting FDI, the GCC countries need to ensure stronger corporate governance standards that improve the perception on corruption.

Institutional Governance

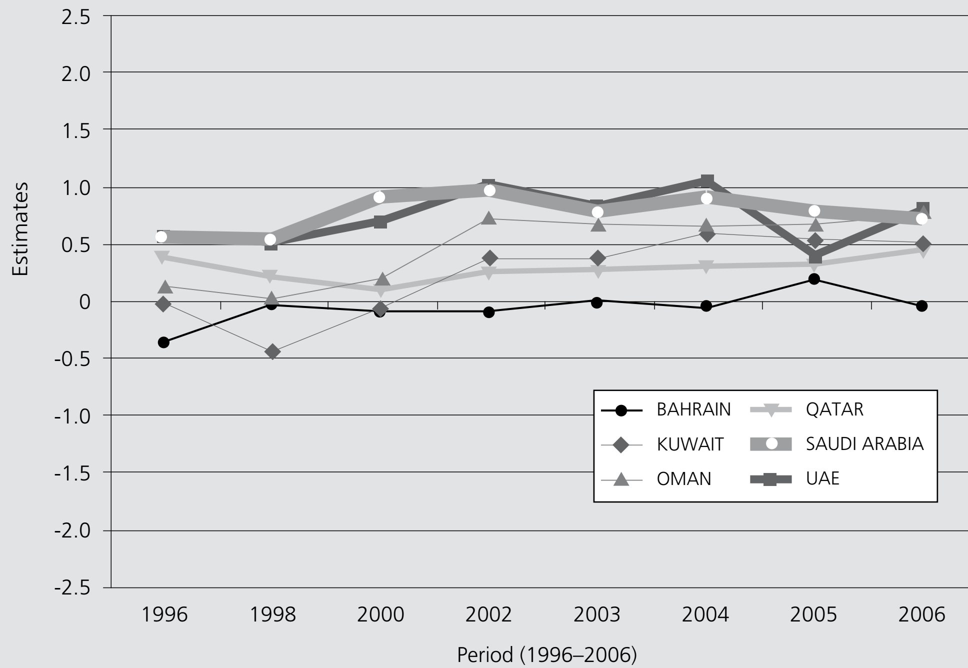
As for controlling corruption, Qatar tops the GCC countries with a score of 32 out of 180 countries surveyed in Transparency International's 2007 Corruption Perceptions Index. Qatar is followed by the UAE (34), Bahrain (46), Oman (53), and Kuwait (60); SA (79) ranks at the bottom of the GCC countries. There is virtually no transparency in how these countries prepare their budgets and allocate their revenues. In the absence of an active parliamentary body, the potential to mishandle public funds is high and corruption can easily take place. Enhanced fiscal discipline can be facilitated by improving the institutional framework in which fiscal policy operates. That is done via more effective budgetary management and transparency and also by adopting clear fiscal regulations.

The GCC countries also need to enhance the legal infrastructure, particularly the quality of contract enforcement and the independence of courts. More serious efforts would enhance the public's confidence in the rules of society. These important elements of governance have been addressed by the rule of law indicator.

Figure 6 presents the change of rule of law over the 1996–2006 period. Remarkably, Qatar was able to undergo major changes and managed to flip the coin by ranking first in 2006. However, the fact that Qatar ranks first poses a question on the status of rule of law in the whole region. For despite constitutional guarantees, Freedom House describes the judiciary as "not independent in practice." Though the Qatari constitution protects individuals from arbitrary arrest and detention and bans torture, Law 17, issued in 2002, grants the right to suspend these guarantees for "the protection of society."

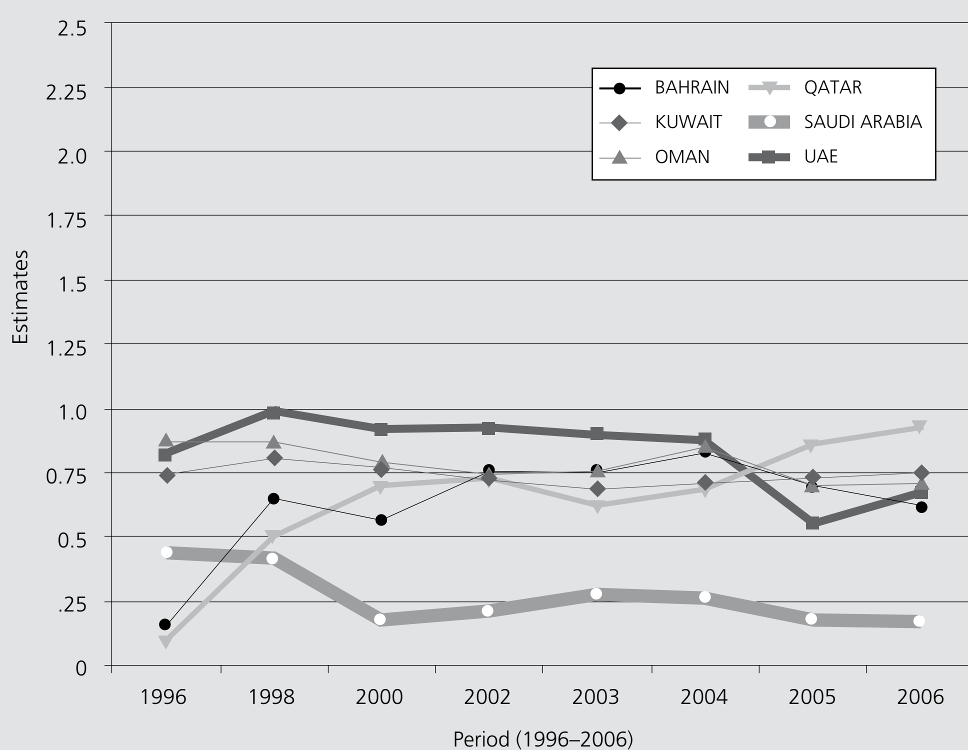
The GCC countries are aware of the problems ahead of them. However, introducing the necessary reforms requires a political will. Presently, that will is weak, and hence the overall governance situation is also weak.[39]

Figure 5: Regulatory Quality



Source: Statistical Appendix of *Governance Matters VI: Aggregate and Individual Governance Indicators 1996-2006.*

Figure 6: Rule of Law



Source: Statistical Appendix of *Governance Matters VI: Aggregate and Individual Governance Indicators 1996–2006.*

Conclusions and Policy Recommendations

The GCC countries receive a huge volume of oil revenues; and despite the recent decline in oil prices, abundant revenue inflow is expected over the next few years. The breakeven prices of oil per barrel that balance 2009 budgets are: $36 for the UAE, $38 for Qatar, $48 for Kuwait, $51 for SA, $71 for Oman, and $73 for Bahrain. Hence Oman and Bahrain might be at some deficit risk, but other countries should be able to maintain a balanced budget quite easily.

Given the accumulated reserves and the solid macroeconomic fundamentals, the GCC countries are still very likely to achieve strong growth in 2009, though at a lower rate than those registered over the 2002–2008 period. The top priority in these countries should be enhancing institutional capacities to manage oil revenues by balancing between creating jobs and improving living standards.

Abundant oil revenue provided favorable conditions for growth in the GCC countries. However, the GCC countries have missed the opportunity to aggressively reform their economies by dealing with the key challenges facing them: diversifying the economy, addressing labor market distortion, and increasing productivity. The GCC countries also need to revisit their education curricula to reflect labor demand needs, especially in the emerging private sector. This calls for engaging the private sector more in higher and technical education by allowing it to intervene further in the provision of education services. A merit-based culture must be encouraged in the appointments of public positions; and the public sector must make it clear that it can no longer act as the employer of first resort for its nationals. The GCC can introduce a set of incentives to encourage the employment of nationals: tax breaks or allowances and subsidized training programs rather than subsidized wages.

Moving to the structure of the economies, diversification efforts face challenging limitations. Diversification in agriculture is already being redirected away from domestic to international investments. Outsourcing the diversification efforts in agriculture might prove viable. In other sectors, such as tourism and financial services, the diversification plans have been exhausted across the region, thus raising the risk of oversupply. A collective approach in coordinating these efforts can help in avoiding duplication and may enhance integration by creating niche markets for each country. Moreover, the GCC countries need to aggressively pursue liberalization efforts to provoke the desired changes in the structure of the economies. In parallel, there is a need to develop merit-based access to small and large credit, the reduction of red tape, and strong and independent courts able to intervene in arbitration.

In terms of fiscal policy, the problem is that public spending has been the main instrument for promoting growth and redistributing oil revenues; but this expansionary fiscal policy is vulnerable and might not be sustainable in the long run. Non-fiscal policy instruments should be brought into play to

encourage growth and achieve redistribution. In addition there is a need for improvement in managing public spending. This will require a higher degree of transparency, more accountability, and civic engagement by involving various stakeholders in budget preparation and inviting independent institutions to monitor spending.

Monetary policy until mid-2008 proved to be inefficient and highly constrained as a result of the pegging of the GCC currencies with the U.S. dollar. So far, the peg to the U.S. dollar regime provides stability. The global financial crisis has eased inflationary pressure with the credit market slowing down and international prices declining. However, the same factors that have led to high inflation still exist; and if the global economy regains momentum, we may well see the GCC economies suffer again. This suggests that policies to address the root causes of inflation and weak monetary policy instruments should be introduced, regardless of the current rate of inflation.

While the GCC countries are becoming more open, governance indicators are still weak; and developing a framework to improve the legal and regulatory environment is needed. These and other efforts present long-term objectives that need careful planning and determination. If GCC economies are to achieve balanced and sustainable growth and to be less immune to the volatility of the energy markets, the leaders of these states must make renewed commitments to more fundamental governance, fiscal, monetary, and economic policy change.

Notes

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