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The future of industrialization in the Gulf region

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THE DEVELOPMENT of a strong and viable industrial structure has long been a major economic objective of the Gulf states. For many of these countries, industrial development is the key to successful economic diversification and the main assurance of continued, self-sustaining growth. Since the large increases in oil revenues in the 1970s, Gulf governments have directed a substantial portion of their huge development outlays towards the creation of an adequate industrial infrastructure and the establishment of certain major state-owned heavy industries. The recent turnaround in the world oil market and in OPEC's revenue prospects has produced a challenge for Gulf industrialization: it is being looked to, earlier than perhaps expected, to justify the time, capital and hopes invested in it.

Advocates and critics alike, studying the process of industrialization in the Gulf, have arrived at negative assessments in recent years. For those who advocated industrial development as a path towards greater self-reliance and reduced dependence on foreign inputs, progress has been slow and often extremely costly, relative to the gains achieved by many of the South-East Asian countries. In addition, Arab industry has been burdened with ambitious targets and expectations.

The purpose of this paper is to survey the main industrial developments that have occurred in the post-1973/74 period. Based on this, an assessment will be made of the likely directions of the Gulf states' industrial development in the future. What main structural changes have taken place in industry in the post-1973/74 period? What problems have the Gulf states encountered in pursuing their industrial diversification efforts? What are the main obstacles that must be overcome in the process? What is the likely direction industrial development will take in the future? In the discussion that follows, attention is focused on the member states of the Gulf Cooperation Council — Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Because of their relative size, the Islamic Republic of Iran and Iraq do not share many of the problems related to economic growth in general and industrial diversification in particular.

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Macroeconomic impacts on industrialization

With the fall in oil revenues in recent years, there has been increasing concern that non-renewable resources in the Gulf states may have been squandered unnecessarily, and the much prized diversification away from oil may be unsustainable without the 'prop' of petrodollars and government spending and subsidies. There is also the fear that the apparent prosperity of the oil boom may have masked a number of underlying problems relating to industrial efficiency and productivity.[1]

During the 1970s, and in fact ever since the various moves to nationalize oil production, governments acted as direct producers of goods — with varying degrees of efficiency. They were also determined to encourage non-oil production in the private sector in both manufacturing and agriculture, and offered incentives and commitments to purchase the hidden costs which are only now being fully recognized. By the end of the inflationary period in the Gulf, local governments could, to varying degrees, be criticized as inefficient direct producers of goods and providers of services, and paymasters of an economic diversification effort that implied little risk for the private sector promoters.

During the post-1982 period, government revenues have undergone a profound transformation, with oil revenues having to be augmented by other local taxes, drawings on financial reserves, domestic and overseas borrowing. All these deficit-covering measures are limited in extent, either by their non-neutral impact on growth and business confidence or by constraints on the acceptable level of indebtedness.

These limits will certainly be tested in the next several years. Gulf governments may then be forced to adopt more radical measures. They will no longer be able to rely on the slow deflationary-cum-holding exercises that have postponed many of the inevitable adjustments in industry.[2]

Problems associated with past expenditure

The problems of plenty that have troubled countries with an economically dominant oil or gas sector are referred to in the technical literature as the 'Dutch disease'. The principal symptoms of this disease are usually found in: the erosion of the existing productive sectors (particularly agriculture and manufacturing) as a result of a general cost increase caused by a salary and a wage pull from the oil and government sectors; and a lack of competitiveness against imports and in export markets due to the strengthening of the local exchange rate in response to an oil-generated trade surplus.

While it is true that some countries actually had little by way of directly productive activity before the discovery of oil, and hence had 'little to be damaged',[3] and in spite of the fact that directly productive non-oil assets have expanded alongside the explosion in oil, it is apparent from numerous studies that traded goods (primarily manufactures) expanded at rates considerably slower than would have occurred in the absence of the Dutch disease type incentives for investment in industry.

It is also clear that much of the observed expansion in directly productive activity (DPA) has been the result of the heavy subsidization of inputs (paid for by oil revenues) and/or the creation of artificial markets for the output (i.e. bought by oil revenues). In other words, if the oil revenues disappeared, it is questionable that much of the observed expansion in DPA could continue for long.[4]

A similar conclusion has been reached from a somewhat different approach. This approach seeks to quantify the proportion of oil revenue that should be considered 'rent' as opposed to 'income', and therefore in some way depreciated in national accounts and transferred into lasting assets. It also seeks to establish the 'multiplier effect' on the nominal growth of the spending of 'rent' within the local economy. Effectively, any growth in the non-oil economy that can be attributable to the demand-generated government spending of accrued 'rent' is deemed unsustainable.[5]

The implications of the Dutch disease and rent-generated growth are that the diversification programme of the Gulf states may be ultimately doomed by the impact oil-based expenditure has had on the domestic price system. Unfortunately, the theoretical analysis surrounding the Dutch disease and related macroeconomic problems provides no real clues as how best to limit the damage already caused in the form of bankruptcies, bad debts, over-capacity and so on. Nevertheless, some insights as to the future can be obtained by examining the main characteristics of Gulf industrialization in recent years.

Characteristics of Gulf industrial development

It has been over 15 years since the 1973/74 oil boom provided the funds and impetus for Gulf industrialization. During that period, several features have come to characterize industrial development in the region:[6]

1. Industrial development plans have been directed in the main towards oil and gas-based industries such as refining, chemical fertilizer and petrochemical industries, and/or to energy-intensive industries such as aluminium smelters in Bahrain and the UAE, and steel plants in Qatar and Saudi Arabia. These industries are primarily aimed at export markets.

2. Apart from oil or energy-related industries, most industrial development in the past two decades has been in the field of import

substitution, such as construction materials, and processed foods which are the most important industries in the region after the petrochemical sector.

3. The industries which exist have been set up for the most part by governments and are thus public sector, although some production has been undertaken on a mixed sector basis. But it must be noted that the involvement of the private sector in industrialization thus far has been limited, despite the huge surplus finance held in private sector hands, and in spite of the financial and material incentives offered by the governments to attract private sector involvement in industry.

4. With the exception of petrochemicals, fertilizers, steel and aluminium, most of the finished products manufactured in the Gulf states are consumer goods. The manufacture of industrial goods such as tools, machinery and spare parts is negligible to date.

5. There has been a large import factor in industrial programmes carried out in recent years, because the implementation of industrial projects has depended on imported equipment and machinery, as well as imported services at the construction stage, such as foreign consultants, engineers and contractors, not to mention manufactured processes which rely on imported semi-manufactured materials.

6. Given the limited technical and manpower resources in the region, most industrial plants have been installed by multinational companies and operated with foreign labour, either as turnkey operations or under production start-up contracts. The results have been high installation costs and a built-in dependence on the foreign company concerned for the supply of technical expertise, spare parts and maintenance.

7. Given the limitations of the size of the market in any single Gulf state, and given the problems of exporting manufactured goods, it is rare to find any of the factories in the region operating on ideal economic scales of operation at which production is achieved at minimum cost. Often Gulf factories have idle capacity with consequent increases in production costs and decreases in economic returns on investment. Relevant to this problem is the absence of sufficient levels of protection from foreign competition, since the Gulf

states on the whole follow a policy of free trade, allowing private sector traders to import competitive products and exposing the infant industries of the Gulf to blatantly unequal competition.

8. In general, there has been a lack of linkages between the industries established in the past, with the result that industry as a whole has not made a dynamic impact on the development of other sectors within the country. The industries have become isolated pockets of activity unrelated to any other activities in the country.

9. Industrial development in the Gulf has been arbitrary rather than an element in a concerted programme for socioeconomic progress. As a result, there has been no direct connection between development in the industrial sector, the agricultural sector and the services sector, as there should have been had industrialization taken place within an ideal programme.

10. Industrialization has been carried out without much attention being paid to integration and coordination between the various Gulf states on the one hand, and with the rest of the Arab world on the other. This lack of coordination has had a negative effect in that opportunities have been missed for diversification or specialization and for production on a truly economic scale within wider markets than are available to any Gulf state domestically.

On the basis of this ten-point summary of the nature of the industrialization which has taken place in the Gulf in the past two decades, it can be said that the process was at best peripheral to these states' national economies and has had no effect on the prevailing economic structures, despite the relatively large sums invested. Inevitably these characteristics will be reflected in the problems encountered in the export of industrial goods from these countries.

Assessment of progress to date

Since the mid-1970s, the Gulf region has achieved a relatively high rate of growth in industrial production. But, before attempting any detailed assessment of the process of industrial development, it is important to stress several basic factors which render any precise, objective analysis of the Gulf industrialization experience difficult, at the present time:[7]

1. The first factor is the total time-span from the first steps in modern industry to the present day, which has been too short to allow the

industrial sector to become firmly established as yet; and thus the effect of industrial development on economic and social growth in the region is hard to quantify.

2. There are few if any historical analogies that can be made between industrialization in the Gulf and that in other parts of the world. In contrast to previous industrialization efforts, Gulf industrialization has depended on external rather than internal factors.

3. The fact that industrialization has been an external rather than internal process means that the industries' existence and continued functioning is still dependent on external factors, most of which are outside the control of the individual country and therefore somewhat difficult to forecast.

4. There is no real comprehensive strategy for development on the regional level. Thus, while the success of each state in achieving its self-declared targets has given the semblance of overall development even in terms of industrial growth, the actual growth of industry in each economy has not been related to a regional strategy aimed at the maximum exploitation of regional resources and markets.

5. In the absence of a coordinated regional strategy, excessive capacity was installed in some sectors of industry, while none was installed in others. This imbalance, coupled with the limited size of markets available within any single state, meant that there was no possibility for the growth of integrated industries so long as development took place at the national level rather than in a regional context.

6. The lack of an integrated regional strategy, each element of which would naturally complement a previous stage and initiate a new state of development, resulted in a lack of appropriate planning on a priority basis within the individual state's industrial development programme. Too often the decision to install a particular industrial plant or process was made on the basis of immediate commercial considerations, i.e. short-term profitability.

7. Not surprisingly, there has been uneven development in the region, with the industrial sector in each country differing greatly in size and in its importance to the national economy.

8. As a direct result of the structural social changes which took place in the period immediately prior to the first industrialization, a more sophisticated level of consumerism was appearing in the region. With rising consumer demand for a wide range of commodities from food to luxury goods, the Gulf states have found themselves becoming more and more dependent on the world economy and on foreign commodity imports. The growing consumer tendency was accelerated by government spending policies that were arbitrary, rather than the result of careful planning.

9. Over time, the gap between the consumer-oriented sectors of the economy, like commerce and services, and the productive sectors, like industry and agriculture, has widened. With oil revenues funding the spending spree, the consumer-related elements of the economy have grown in importance, while the contribution of industry and agriculture to gross domestic product has declined in varying degrees from state to state.

These factors have manifested themselves in several fairly striking trends for the countries under examination:

1. The process of industrial growth in the 1970s resulted in a growth in value added by the manufacturing sector, from \$528 million in 1970 to \$14,418 m in 1982 — a compound growth rate of 32 per cent per annum. Intermediate industries played the dominant role in this growth, followed by consumer goods and, in last place in terms of value added, capital industries.

2. In spite of these impressive absolute figures, the role of the manufacturing sector in generating non-oil GDP remains limited. Crude oil continues to dominate all other forms of economic activity, with the result that the manufacturing sector contributes no more than 5—8 per cent to GDP.

3. As a result of the dependence of the Gulf economies on oil, and the rapid growth of consumption patterns unrelated to domestic production, the linkage between the region's economies and the world economy has grown significantly over time.

4. More precisely, if we use, as the dependency factor for purposes of calculation, total imports plus exports as a percentage of expenditure

over GDP, this rose from 85 per cent in 1970 to more than 100 per cent in 1982. Ninety per cent of the region's exports are oil, with only five per cent manufactured goods.

The dependence of the Gulf economies as a whole on a single commodity is an indicator of the extent of vulnerability; any change in the international oil market has a direct impact on all economic activity and development programmes in the region. Moreover, state ownership of the major source of revenue has meant that the state sector has borne the responsibility for planning and executing development in all sectors, while the role of the private sector has been overshadowed, and the use of taxation and fiscal policy as a tool of development totally ignored.

It is clear that the industrialization process in the Gulf states faces many obstacles, which stem from the following conditions:[8]

1. The variation between the level of infrastructural development achieved and the incentives provided in any given state, compared with other states in the region, has created an imbalance, whereby some states have become centres for industry at the expense of others. The states which have developed an industrial infrastructure more quickly have attracted the skilled labour and economic activity required, while other areas have been less attractive to skilled labour and short of capital. This phenomenon on an inter-state basis is even more apparent on a regional basis within a given country.

2. The industrial development process is heavily dependent on transient migrant labour. In 1975, the percentage of foreign labour in the total economically active population reached 80 per cent in Kuwait, while the foreign element was even higher in Qatar and the UAE. The failure to produce an indigenous workforce can be attributed to several factors, of which the most important are:

   (a) The arbitrary distribution of revenues from production, without any direct relationship between income and productivity of the beneficiaries of the distribution.

   (b) The limitations of educational curricula and the inability of the education system to promote the concept and principle of productivity, with the result that large segments of the population seek to establish an identity through conspicuous consumption rather than through the creation or accumulation of wealth.

(c) Social traditions and legal complications which obstruct the participation of women in economic activity, thus further reducing the limited availability of manpower.

(d) The 'cost trap' into which Gulf industries fell in the first stages of development and from which they can only escape through carefully planned controls and policies. The cost trap is a result of weak management.

Prospects for future revenues

Many of the problems currently facing the industrial sectors in the Gulf states can be traced back to the lack of an overall industrialization strategy — problems related to the Dutch disease, the bureaucracy and administrative routine, the instability of the industrial labour force (almost exclusively expatriate), the unbalanced consumer consciousness, the inadequacies of incentives at both production and export levels and the insufficient protection vis-à-vis competition from abroad.

While each of these factors is important in and of itself, perhaps the key factors that will determine the course and nature of the industrialization process over the next decade or so will, as in the past, revolve around developments in oil markets and their resultant budgetary impacts. No assessment of future industrial development in the Gulf can be made without first examining the fiscal environment in which the Gulf governments will design and implement their industrial policies.

Developments in the oil markets

For the purposes of assessing probable developments in oil markets over the next decade or so, the most likely scenario is assumed to be one in which oil markets continue the adjustments that began in the early 1980s. This scenario assumes that oil markets have not yet completely adjusted to worldwide excess capacity in the producing countries, with the net result that prices and/or production levels will continue to fall in 1989.[9]

1. In the 1990s,[10] short-run demand can be expected to rise from the unsustainable combinations of oil consumption and price that characterize the late 1980s. Adjustment will be slow. Nevertheless, together with a growing world economy, and low initial prices, the adjustment will contribute to strong growth in oil demand from the mid-1990s onward.

2. As a first approximation, given the low prices in the late 1980s, the growth rate in consumption in the 1990s should begin to increase

from around two per cent per annum in 1989 to 2.5 per cent by the end of the century.

3. This rate of consumption cannot be sustained throughout the 1990s, however, since it would result in levels of demand greater than the world capacity to produce oil — little capacity is likely to be added, with the low oil prices that will bring about the rapid growth in oil consumption.

4. Clearly, given the demand they are likely to stimulate, 1989 prices cannot be sustained throughout the 1990s. Previous studies[11] have shown that, as OPEC is pushed to full capacity, oil prices rise.

5. Nearly all excess capacity to produce oil is in OPEC. Given a wide range of consumption scenarios, OPEC should come close to full capacity between late 1992 and early 1993. At or below a price of \$25/b, OPEC should reach full capacity no later than early 1993. By that year, a price of \$25/b could prove too low — if world capacity does not rise.

6. Similarly, with world economic growth rates between 2.0 per cent and 3.0 per cent, oil prices could reach \$30—40/b by the year 2000.

Of course, these price forecasts are dependent upon a number of assumptions. If world capacity to produce oil is decreased, if OPEC restricts its production, if oil supplies are disrupted or if economic growth is stronger, oil prices will be higher. On the other hand, if world capacity to produce oil is increased, if economic growth is weaker or if energy taxation is increased, oil prices will be lower than those forecast above.

The preceding assessment of world oil markets contains both good and bad news for the Gulf exporters. Given likely movements in oil prices over the next few years, it is unlikely that any of them will be able to maintain the level of non-oil income reached in the early 1980s. While these results are not necessarily indicative of a 'dismal' future for these countries' citizens, they should alert their respective governments that they will be in for a long period of sustained internal tension. On the other hand, it appears that, if they can survive the next few years, they should be in an excellent position to begin a long and sustained expansion of their economies.

The positive impact of low oil prices in the mid-to-late 1980s and higher demand for oil into the 1990s should be most pronounced on the Gulf countries. The forecasts presented above imply that, by the mid-1990s, IR Iran, Iraq, Kuwait, Mexico, Saudi Arabia and the UAE will account for around 85 per cent of world oil exports. Countries like Algeria, Indonesia, the Socialist Peoples Libyan Arab Jamahiriya, Nigeria, the United Kingdom and Venezuela may be by then either merely self-sufficient or net importers of oil.[12]

By the mid-1990s, the world may become once again heavily dependent on oil from the Gulf. Revenue from crude oil and the sale of petrochemicals, fertilizers and refined oil products will finance high growth prospects in the GCC countries, and the 1990s could well see the region experience boom conditions reminiscent of the 1970s.[13]

Fiscal options

Until oil revenues pick up again in the early 1990s, Gulf governments will continue coping with their revenue shortfalls as in the recent past — by altering the composition of their budgets. They are slowly weaning new industrial and agriculture ventures away from government dependence. There have been several statements from Saudi officials implying that their reluctance to reduce further their financial reserves to cover budget deficits stems not only from anxiety about the falling level of these reserves, but also from concern that — in the light of the curtailment of government investment programmes — their reserves would now be quite openly used to meet government consumption.[14]

Kuwait, which, of all the Gulf states, has the largest income source independent of oil by virtue of previous overseas investments, still prefers not to register this income in its budget, as it is treated as officially inalienable until the year 2001. To a certain degree, export and increased private sector demand for local goods is also helping to reduce dependence on the government as purchaser, although government inputs or subsidies are still important in ensuring competitiveness.

Implications for private expenditure

Private sector demand will still remain largely a function of government employment or other expenditure via the 'rent multiplier'. But questions about the pace at which this cushion of demand can be removed and the cost of removing it have yet to be fully addressed. In the case of Saudi Arabia, several quantitative assessments have been made.[15] For two extreme scenarios:

1. If the Saudi Arabian government opted for annual budget deficits in the $25 bn range over the 1986–92 period, it could expect a positive rate of expansion of non-oil GDP of 1.3 per cent, with rising private consumption and investment.

2. Running a balanced budget over the same period would entail a drop in private consumption of 2.1 per cent per year, a fall in private sector investment of 5.8 per cent a year, and a reduction in private sector output of 4.5 per cent a year.

One implication of these simulations is that private sector demand is likely to remain reasonably buoyant even with low budget deficits and oil revenues, because a significant portion of this demand is financed by past savings. This seems to confirm the more optimistic observations of certain Gulf officials that the fall in oil revenue and government expenditure may have set in motion some degree of cure for any Dutch disease that was in evidence, i.e. with the easing of the government's pull on the availability of manpower, services and goods, and with a greater emphasis on efficiency in both the oil and government sectors, the costs of doing business have fallen and the returns have become more predictable.

The willingness of the Gulf private sector to repatriate incremental income derived from past government spending or to liquidate foreign currency deposits in local banks to finance investment in housing or industry or even to fund certain government projects, will be critical over the next few years.

Clearly, the private sector needs reassurance that the government will not engage in policies likely to restart inflation; it would probably welcome the chance to invest in certain government-owned enterprises. The government, meanwhile, clearly needs to reduce some of its input costs, by charging more for certain services disturbing the fragile business confidence that exists and which it no longer has the funds to prop up artificially.

In terms of the immediate budgetary problems facing the Gulf states, the post-1982 recession had a number of causes: a natural levelling of infrastructural investment; a forced reduction in government spending; a drop in business confidence as a result of intensified regional conflicts. Identification of the primary cause is important in assessing the likely timing and nature of recovery in the region and who will be responsible for it.

In the present context, what seems important is that, when the recession took hold, Gulf governments were forced to rely on the private sector to generate genuine demand with or without subsidies, if the governments were not to encroach further on their economies. The decline in government investment activity might have been softened if the funds had been available, but this would have been opposed by administrators who had acquired the experience and confidence to challenge the contracted mark-ups and trumped-up demand scenarios that called for a seemingly endless list of ports, airports, electricity and desalination plants.

As for the cost of the recession, clearly most of this has been borne either directly by the governments or by the banks, with the latter generally incurring losses not greater than the windfall profits made in the boom year. Governments, on the other hand, have had to step in with 'capital' rescue funds, whether directed through 'lifeboat' schemes on the local stock exchange or in the banking sector or by drawing on budget reserves.

Possible revenue strategies

As the option of drawing on budgetary reserves has become less palatable because of dwindling resources, a persistently weak oil market, or the bias towards current expenditure in the budget, Gulf governments appear to have been pursuing fairly similar strategies to improve the situation.

Strategy in oil

It would appear clear from recent developments in Saudi Arabia and Abu Dhabi that two trends are running concurrently: one to streamline local exploration, production, domestic refining and distribution costs; the other to acquire downstream assets overseas that will ensure outlets for Gulf crude or products. The importance of the first process in spreading an aura of efficiency through the economy and reducing any cost-pull effect has already been mentioned. Attempts to reintegrate the oil industry from the Gulf source with the final consumer could have extremely far-reaching repercussions.

In the short term, these trends would seem destined to result in lower netback oil prices to Gulf governments, because of the price war atmosphere in which the policies have been pursued. Ultimately, however, the possession of downstream oil investments by the Gulf states might be expected to lead them to take equal notice of the value added as well as rent element in the oil industry. To the extent that the former can be maximized worldwide and without many incremental effects locally, the result might be a more sustainable and stable overall oil income.

Privatization and capital market reforms

There is talk, in Saudi Arabia at least, of privatizing the local oil industry once it has been restructured. If Gulf governments were to sell their oil assets for anything like their market price, another cause of the rental ailment might be removed and taxation restored on oil company profits.

If Gulf governments decided to privatize their oil and gas assets in parcels, they would no doubt encourage competition among the various national or joint-venture interests and force them to choose between investing their surplus locally (where it might suffer from the effect of diminishing returns) or overseas (where, as private sector investment, it could be expected to face fewer of the obstacles that confront state investment). It would be surprising if private interests would allow a subsidy on internal gas and oil consumption to be tolerated for long.

Privatization and the establishment of an internationally competitive return on capital would seem to be essential long-term goals of the Gulf economies, if they sincerely aspire to a Western system of economic management. In such a system, taxation of profits at differing levels might be expected to neutralize some of the apparent benefits of certain sectors, without the cost to government of cross-subsidization and its own project expenditure.

Until a deeper capital market is established within the Gulf, these processes will necessarily continue slowly. The respective governments will, meanwhile, rely not so much on capital sales as on borrowing and taxation to bridge their payments gaps. Direct taxation is particularly unpopular in the Gulf, but some of the less well-endowed governments have taken advantage of a fall in inflation to introduce more realistic end-user charges, while import tax regimes in several of the Gulf states have been raised.

These measures have to be weighted delicately against the dangers of making business costs in one member of the GCC uncompetitive vis-à-vis others. Local borrowing schemes have been fairly successful to date, largely due to the unwillingness of local banks to recycle liquidity pumped into the economy through government deficits back into the private sector. But they might clash with private sector credit demand to head off an incipient recovery, unless the general private sector savings ratio could be increased.

Borrowing

The Saudi decision to draw on the funds of agencies such as the Public Investment Fund and the General Organization for Social Insurance to cover immediate budget deficits has interesting implications, besides the fact that direct borrowing is almost as taboo as direct taxation in the Gulf. In drawing funds from the Public Investment Fund, it appears that a process may have been set in motion whereby the more successful industrial projects, such as those within the Saudi Basic Industries Corporation, may be asked to refinance their long-term loans on a commercial basis as a form of indirect taxation.

In tapping state pension funds, the Saudi government may proceed either by indicating its intention to start funding future payment obligations out of current income rather than savings, or by suggesting that it expects private citizens to adjust their own savings patterns over a longer time to make up for government withdrawal from this responsibility. With the thinness of the Gulf capital markets, it would seem rather incongruous to have a government trying to maintain an invested pension fund. There is, however, considerable precedent, if not in oil-exporting economies, for governments exchanging investment assets for current revenue in such a way as to redress the national savings balances and restore the necessary conditions for future economic growth and, consequently, government revenue.

Another option for Gulf governments is to boost local demand without spending any extra revenue. This can be done by a number of methods, such as encouraging the concept of a GCC-unified market, allowing expatriates to bring in their families and possibly settle, and further liberalizing the rules on foreign investment. All three of these measures would have the additional benefit of increasing the net foreign exchange position of respective states, and therefore helping to stave off the situation of either forced exchange controls or large increases in foreign borrowing, both of which would ultimately reduce the flexibility of approach to a particularly difficult situation.

Essentially it would appear that the pursuit of a mixed economy in the Gulf oil states is a flawed but inevitable policy. It is difficult to see the resolution of the present budgetary dilemmas in the near term. The situation is grim, but far from hopeless, and the countries appear to have a number of options not yet adopted that would provide industry with the necessary stimulus, without additional massive expenditure commitments.

Future directions in industrial policy

Along these lines and to counteract the difficulties currently facing the industrial sector, the following shifts in policy are feasible and likely to take place.[16]

1. The setting up of a comprehensive strategic outlook for industrial development at both the national and regional level. This will encompass fundamental decisions, such as import substitution or export-oriented strategies.

2. Priority will be given increasingly to those products ensuring complementarity (through either backward or forward linkages) with existing capacity.

3. The implementation of sliding-scale, protection-tariff formulas directly proportionate to the ratio of value added to total values.

4. More infant industry protection in the form of higher tariff rates and for a period of five years.

5. Government tenders drawn in such a way as to favour locally processed products.

6. Part of the governments' foreign aid provided in kind — domestic industrial products.

7. Trading companies encouraged to assume part of the marketing responsibilities so far assumed by the industrial units.

8. Adjustments to the educational curriculum, to provide more opportunities for technical training.

9. Introduction of unified GCC policies, subsidies and tariff rates.

10. The liquidation of industries which are not viable economically.

11. The enhancement of consumer consciousness towards locally produced commodities.

12. Streamlining the bureaucracy and administrative routines that normally delay the start of new ventures.

A new development strategy

The Gulf states are basically at comparable stages of development; they have similar resource and structural bases and share a common strategic outlook. They are all moving from public sector-led growth and overdependence on oil to private sector initiatives and a diversified production base. The general objectives of the evolving development strategy of the region will continue to include:[17]

1. Diversifying the region's economic structure, in order to minimize its exposure to external factors and allow a bigger share of the industrial sector.

2. The development and optimal utilization of the region's human resources by increasing human productivity and enhancing the relation between reward and productivity.

3. Increasing the value added of local natural resources through downstream processing.

4. Meeting local market demand as much as possible, with an outlook towards increasing exports by capitalizing on the region's relative advantage in certain products.

5. Creating an industrial and technological base that is self-sustaining and reasonably independent of the oil sector.

6. Working towards the geographically balanced development of the region in order to enhance cooperation.

The first stage of economic development in the region is almost completed. This stage lasted from the early 1970s until the early 1980s and made use of rising oil revenues to help build the basic infrastructures — physical, human and financial. The second development phase has actually started. It involves a larger participation of the private sector and relies more on attracting foreign investors as joint-venture partners, including the transfer of the appropriate technology, management skills and international distribution system. In other words, the existing infrastructure must be used to build new industries that have a clear commercial viability.[18]

Prospects for new industries

There is still ample scope for the development of new industrial ventures in the GCC region that enjoy a comparative advantage for the foreseeable future. Tentatively the following areas can be identified:[19]

1. The industries that depend on the by-product of the refining industry. The local oil-refining capacity has increased considerably to meet local consumption and export requirements. The numerous by-products of the refining industry can be collected in appropriate quantities to support significant industries in the fields of petrochemicals in particular and the chemical industry in general.

2. The downstream industries in the petroleum and petrochemical sectors. These include petrochemical intermediaries, plastics, solvent fertilizers, tyres, rubber products, paints, nylon and polyester fibres, detergents, animal feeds and other miscellaneous petrochemical-related products. These industries can draw on relatively cheap basic products as well as cheap intermediate and finished products, including those capable of being developed on an export basis. They also enjoy a major comparative advantage in the region, namely the abundant and low-cost source of energy such as gas and hydrocarbon fuels.

3. The industries based on mineral resources which exist in economic quantities in Saudi Arabia, Oman and UAE. These include iron, potash, copper phosphate, gold, limestone, etc. These industries are characterized as being capital and energy-intensive. Developing such mineral-based primary industries normally creates external economies and forward linkages that would render investments in derived secondary product industries more profitable. Such industries would include the steel-related secondary industries.

4. Industries in the consumer products field. The easiest way to seek opportunities here is to look at the leading brands in the market and then see if these can be produced locally. Once the established brands start being manufactured locally, they will immediately enjoy a secure market. The manufacture of these products locally would also create demand for a whole range of other related products and minerals.

5. Industries in the synthetic and assembly fields. These depend on the proceeding industries or are characterized by the presence of large markets for their products in the Gulf area in particular and the Arab region in general. Examples include: the manufacture and assembly of certain types of automobile, industrial requirements that serve other sectors such as the oil industry, agriculture, light industries, the manufacture of household durable commodities, and metal products.

6. The industries that serve the construction process of infrastructure in the GCC region in particular and the Arab world in general. The Arab region is still in need of large efforts to achieve the appropriate standards of local and regional infrastructure, such as the projects of desalination, transportation and communication. Among the infrastructural projects are also included power, electric interconnection, education, and information communication and linkage. Numerous opportunities exist, as do the local capabilities for undertaking them.

7. Industries that serve the national and regional defence and security sectors. The requirements in these two sectors are large and regenerating. Defence expenditure in the region has reached a point where dozens of industrial projects are possible that are capable of serving this sector and hence minimize dependence on other countries for obtaining all the manufactured requirements.

8. Industries that serve the oil industry. This is by far the largest industry in the region and its needs and requirements are numerous during the different stages of oil production (exploration, extraction, transportation and refining). Since the beginning, this industry has been contributing to the development of a large associated business sector and many industrial products would emerge to serve this industry.

9. Engineering industries. The virtual absence of engineering industries is a major weakness of the region's industrialization strategies. The development of selective high technological and engineering industries would make it possible for countries in the region to attain a certain degree of technological independence and would help in the transfer and assimilation of technologies.

Joint ventures

The Gulf is still a tax-free region and has not yet experienced the bureaucratic bottlenecks that have hampered investment in other developing countries. It provides a tension-free industrial atmosphere, solid government support and ample financial backing which should attract many foreign investors to seek partnership with national industrialists.

The environment in the Gulf for joint ventures today is different from the 1970s, when rates of return on assets of 35 per cent were common. Now it is more sophisticated. Development is related to countries' absorptive capacity and profits levels are therefore more normal.

The changing economic situation is decreasing the importance of Gulf countries as markets for simple exports of goods and services. Instead, the significance of the role of the joint venture between the former supplier of such goods and services and the local partner will be on the rise. There has been significant growth in these patterns in recent years. Ultimately, this could turn out to be the only way in which foreign suppliers can maintain, or possibly even expand, their share of these important markets.

The joint venture has become a major business development tool in the GCC region, where government policies have, in many cases, given broad encouragement for overseas partners to participate. While the package of incentives differs from one country to another, the one provided by Saudi Arabia is the prototype and countries that are not already emulating it will most likely do so in the future. It includes the following:[20]

1. Fifty per cent of the invested capital is provided by the Saudi Industrial Development Fund at very low rates.

2. Fully serviced sites are provided in the industrial cities for very low rentals.

3. Raw materials are exempted from customs duties.

4. Preferences are granted to locally manufactured products for government contracts.

5. Financial grants and free training facilities are provided to train Saudi staff.

6. There are no restrictions on the repatriation of profits or foreign currency transactions.

7. A ten-year tax holiday is given to industrial products, and there are no personal income taxes on expatriate staff.

Future trade between the GCC countries and other Arab economies

Theoretically, there are three principal approaches to economic cooperation within a regional framework:[21]

1. The classical approach, which involves 'across-the-board' trade liberalization for all/most products through the formation of customs unions or free trade areas.

2. The neo-classical approach which suggests a variation of the above, i.e. trade liberalization for certain existing industries or product groups in the context of a deliberate planned rationalization of production.

3. Inter-country agreements for the establishment and promotion of investment in new regionally based industries that enjoy economies of scale, so as to meet more efficiently the collective demand of the participating countries.

In each case, the objective is to bring about successive economic integration through profitable specialization. The difference is that, in the case of (1) above, the procedural emphasis is on the operation of market forces by the negotiation of a suitable tariff structure, which is expected to work broadly in the desired directions.

With the other two, the emphasis is on first determining the appropriate scope of cooperation in existing/new industries, perhaps on the basis of detailed feasibility and social cost-benefit studies, and then utilizing a variety of policy instruments, such as tariffs, fiscal incentives and administrative controls, to implement the desired objectives of cooperation through specialization in the patterns of production.[22] The economic development strategy of the GCC is likely to continue as a blend of (2) and (3) above.

Soon after the GCC was established in 1981, its six member countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE) signed a sweeping agreement designed to bring down trade barriers between them, standardize regulations, coordinate industrial activity, encourage the free flow of labour and capital and harmonize fiscal and monetary policies.

On paper, the Unified Economic Agreement (UEA) looks as ambitious as the Treaty of Rome, which has served as the model for the GCC. In practice, it is proving similarly troublesome to implement.[23] In this context, the GCC member countries have agreed upon and, to varying degrees, implemented:[24]

1. A large number of common standards and regulations in areas ranging from customs to ship registration and from banking inspections to enviromental protection.

2. The elimination of customs duties on domestically produced goods and the imposition of a minimum four per cent tariff on imported foreign goods. In addition, goods passing in transit through GCC states are exempted from fees and taxes.

3. Equal treatment for GCC citizens as investors, property owners, workers or professionals. Companies from one GCC state can undertake most activities in another without restriction; professionals from other GCC states are subject to the same legal jurisdictions as nationals; citizens can own residential property up to 3,000 square metres in any member state and can obtain loans and set up retail trading businesses.

4. Arrangements for preferential purchasing by governmental agencies of locally-produced goods.

In addition, member states have been studying a variety of initiatives to integrate their infrastructures — which, despite their rapid development in the last couple of decades, are hardly interconnected at all — and to harmonize policies.

The most ambitious infrastructural project under consideration is a $2 bn plan to build a power grid linking national electricity systems as far apart as Kuwait and Oman.

In the field of policy, the most interesting initiative is an agreement to coordinate GCC currencies, with the aim of working a unified exchange rate system in the Gulf.

Both positive and negative factors affect the growth of free trade in the Gulf states. The positive factors include:

1. Geographical proximity and reduced transport costs.
2. High per capita income and high demand for imports.
3. The absence of exchange controls in most states in the region.
4. The absence of customs barriers or quotas in most states.
5. A high tendency to import.

The increase in the volume of trade in manufactured goods between the Gulf states in the past decade is directly related to the huge increase in the national revenues of these states as a result of the oil revenue increase. Higher per capita income levels created a radical change in consumption patterns, with an enormous growth in demand for consumer and capital goods.

Even though the greater part of the new demand for commodities was met by imports from the advanced industrial countries, the Gulf states themselves gained a share of the market from re-exports and from trading the products of their own industries. Thus these industries were beginning to make an impact, despite the lack of coordination in industrial development in the region until recently.

Despite the growth in trade in recent years, the negative factors impeding the growth of such exchange will remain powerful, and include:

1. The similarity of industrial output in each state and the lack of coordination.
2. The development of identical industrial plants in neighbouring states (petrochemicals, fertilizers, steel), which has led to increased regional competition.
3. With each state at a similar stage in its development and with similar industrialization strategies, the huge demand for capital goods which are not manufactured in the region.

4. The Gulf market being wide open to the international market.

5. The high domestic demand for some manufactured products, leaving no surplus for export.

6. The absence of an export promotion system.

7. The lack of information on export opportunities in neighbouring states.

8. Minimal import duties on foreign goods from outside the region, leading importers to continue importing with higher profit margins instead of trading in regional goods.

9. The dumping policy practised by some foreign companies.

10. The high cost of production in the Gulf states.

Of these factors, the first is probably the most important. If we take a look at the relationship between the market and the productive capacity for industries established in the Gulf states, we find a common pattern throughout the region.

1. There are export-oriented industries set up with production capacities much bigger than local or even regional demand. Such industries include petrochemicals, fertilizers and aluminium. Production in these enterprises is linked to export distribution.

2. There are a number of industries established primarily to meet domestic demand with production geared exactly to local demand, such as the food and beverage industries. In general, these industries do not produce a surplus for export.

3. There is a category of industries with design capacities unable to match domestic demand. The state has to supply extra demand through imports, or the factories greatly exceed design capacity, thereby creating production beyond the economically optimal level.

4. Finally, there is a category of industries to meet the needs of local consumers while offering surplus output for export. Given limited local markets and the problems in finding additional markets, such industries usually experience considerable idle capacity.

Although the real solution to increased trade between the Gulf states will require long-term coordination in industrial development, there are a number of short-term measures which can be introduced to improve current levels of trade with tangible results. These include:[25]

1. The abolition of import duties for products originating in other Gulf states, removing all obstacles to the free flow of goods between states in the region. The six states of the GCC agreed to such measures under the terms of the GCC Unified Economic Agreement signed in 1981 and scheduled to be fully implemented in 1988.

2. Action against unfair competition from foreign imports by the imposition of protective tariffs to raise the price of imports to at least equal the price of locally manufactured goods, especially if the goods are of equal quality and standards. The GCC decision to impose minimum duties on foreign imports of four per cent and a maximum of 40 per cent from September 1983 was not adequate to meet the problem which exists.

3. The preferential purchasing of national products by government departments, especially where the local products are of similar specifications and quality to the imported alternative. Under this point comes the question of price differentials and of import licence quotas to force importers towards commodities manufactured within the region.

The removal of customs barriers is not alone sufficient to promote increased trade between the Gulf states. What is required is a drive towards a developed regional economy based on integrated production, with a coordinated strategy in foreign trade relations to withstand competition from other regional trade groups.

Inter-Arab trade is generally modest for a number of reasons, including:

1. The lack of an integrated manufacturing base.

2. The identical parallel development of industries in mutual competition, instead of cooperation.

3. The growing disparity in income between oil producers and non-oil producers.

4. Bureaucratic problems, such as differential customs tariffs and quota systems.

Such problems cannot be solved quickly, and need a massive programme of industrial development in all parts of the Arab world within a planned programme of cooperation, using the division of labour to create large markets for viable industries.

Still, an agreement signed in 1981 for the promotion of trade between the Arab states provided a basis for solving many of the problems and, if fully applied, could provide a new opening for the Gulf states to export their industrial products to other Arab countries:

1. Linking free inter-Arab trade with Arab economic integration.

2. Separating trade relations from political relations between Arab states, so that trade is not affected by political factors.

3. The coordination of Arab economic and trade relationships to withstand the pressure from other geographic or economic groups, and agreeing to a level of protection for Arab products against foreign competition.

In addition to the 1981 agreement, other avenues exist for increasing the flow of inter-Arab trade, such as bilateral agreements which allow a higher degree of flexibility according to specific circumstances that can be covered in more general international agreements including all Arab countries. There is no doubt whatsoever that the non-oil producing Arab countries could form an important logical market for the industries of the Gulf states in the future.

The Gulf states enjoy strong relationships with many developing countries, especially in Africa and southern Asia. Though such relations have long historical origins, they have become more important since the Gulf states and many of the other developing countries gained political independence. Trade already exists between the Gulf states and the developing countries in the form of oil exports and food imports, and a logical basis exists for expansion into the manufacturing area.

In addition to the external factors, which limit the potential market for Gulf exports at present, there are domestic restraints which are represented by the lack of any clear link between investment and production policy on the one hand and export strategy on the other, although all the Gulf states have an expressed desire to increase their industrial exports. With the exception of the petrochemicals industry, there has been a lack of a sound assessment of export potential.

In short, increased Gulf and inter-Arab trade and the identification of regional needs hold the key to further Gulf industrial cooperation, and to a greater rationalization of the region's manufacturing base. The awareness of neighbouring markets and productive capacities has created a practical logic for the kind of industrial cooperation and integration that was previously appreciated only at theoretical and institutional levels.

Conclusions

This assessment of future industrial development in the Arab Gulf region has implicitly placed a great deal of emphasis on the role of the private sector in the process of future Gulf industrial development. At the same time, it is clear that the private sector alone will not be able to sustain high overall rates of growth in investment in manufacturing activity. In part, the private sector's confidence has been shaken by the post-1982 decline in government expenditure. More important, however, is the fact that the time horizon of this sector is relatively limited to the immediate future and to quick returns.

There are numerous new and profitable investment opportunities in the region. But many of these require a long-term view and the taking into consideration of all economic externalities. Because of revenue shortfalls on the part of many existing firms and reluctance on the part of commercial banks, these projects will probably have to be undertaken by governments with the cooperation of the private sector or joint ventures between the private and/or local governments and foreign investors.

In this regard, it is clear that, in spite of the short-term financial problems facing the Gulf states, a number of previously unused or underdeveloped revenue options are available to these governments, and if exercised, should enable the countries to stave off a serious decline in industrial output and investment.

For the medium term, as Abed notes:[26]

> "... available indications are that, during the coming decade the Arab oil-producing region may gradually approach a constellation of favourable conditions in the world energy market that will permit oil revenues to rise considerably, thus creating a second 'window of opportunity' for improved access to resources for development. The ability of the Arab world to exploit this opportunity for broad national development goals will depend critically on its success or failure in resolving certain fundamental issues related to the nature of the Arab society, the choice of political

systems, a redefinition of relations with the rest of the world and issues related to Arab integration. If the Arabs fail, the second opportunity may be squandered even more wastefully than the first. If on the other hand they succeed, they will have a better than ever chance to set their economies on a course of genuine self-sustaining economic and social development."

References

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3. *Paul Stevens, "The impact of oil on the role of the state in economic development: a case study of the Arab world", Arab Studies (1986).*

4. *Stevens, op. cit.*

5. *T. Stauffer, "Accounting for wasting assets: measurement of income and dependence in oil-retainer states", Journal of Energy and Development (1986).*

6. *See also Ramzi Zaki, "Growth potential hindered by lack of coordination", Arab Industry 1986/87, pp. 17—18.*

7. *Cf the discussion in Abdulla Hamad Al-Moajil, "Industrialization in the Arab Gulf states", Arab Gulf Industry (January 1986), pp. 8—24.*

8. *Abdulla Hamad Al-Moajil, "Industrialization in the Arab Gulf states", Arab Gulf Industry (January 1986), pp. 17—18.*

9. *This fall should be at a much more modest rate than in 1986. A slightly more optimistic forecast is given in Yasuhiro Watanabe, "Supply and demand for petroleum — results for 1986 and forecasts for 1987", JIME Review (Spring 1987), pp. 1029.*

10. *Following the approach of Brown and Phillips, op. cit., pp. 4—6.*

11. *Dermot Gately, "A ten-year retrospective: OPEC and the world oil market", Journal of Economic Literature (September 1984), pp. 1100—14.*

12. *Azzam, op. cit., p. 32.*

13. *A conclusion also shared by Azzam, op. cit.*

14. *This section draws heavily from Barker, op. cit.*