PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

POLICY BRIEF

19-6 Efforts of Oil Exporters in the Middle East and North Africa to Diversify Away from Oil Have Fallen Short

Adnan Mazarei

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Adnan Mazarei has been nonresident senior fellow at the Peterson Institute for International Economics (PIIE) since January 2019. Before joining PIIE, he was a deputy director at the International Monetary Fund. He is grateful to Alexei Kireyev and Hatim Bukhari for their considerable input into this Policy Brief. He also benefited from assistance from Egor Gornostay and Madona Devasahayam; discussions with Ruchir Agarwal, Olivier Blanchard, and Mahmood El-Gamal; and suggestions by PIIE colleagues.

Faced with fluctuating oil prices and other uncertainties, the oil-rich countries of the Middle East and North Africa (MENA) have made efforts to diversify their exports, in order to reduce their dependence on oil revenues.[1] Some of these efforts have been under way for decades. In recent years, pressures to diversify have been rising and have drawn considerable attention from a world concerned about the economic and political problems of Middle Eastern countries. Although diversification efforts have achieved some success, the results have been disappointing overall, raising concerns about the region's stability and potential risk to the global economy.

1. MENA oil producers include Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Qatar, Oman, Saudi Arabia, the United Arab Emirates, and Yemen.

Three main factors lie behind the drive to diversify exports. First, oil revenues are less certain than they once were. Following the shale revolution in the United States, the price of oil has declined sharply since 2014. Wars, political uprisings, and other disasters have disrupted the flow of oil exports from many countries, making oil prices volatile. Lower prices and greater volatility have prompted oil producers to tighten their budgets, make socially and politically difficult cuts in subsidies, and raise taxes. Some countries have been forced to borrow heavily on international markets. Further downward pressure on oil prices is likely once oil production resumes in Iran, Libya, and Venezuela, all of which have restrained output for various reasons.

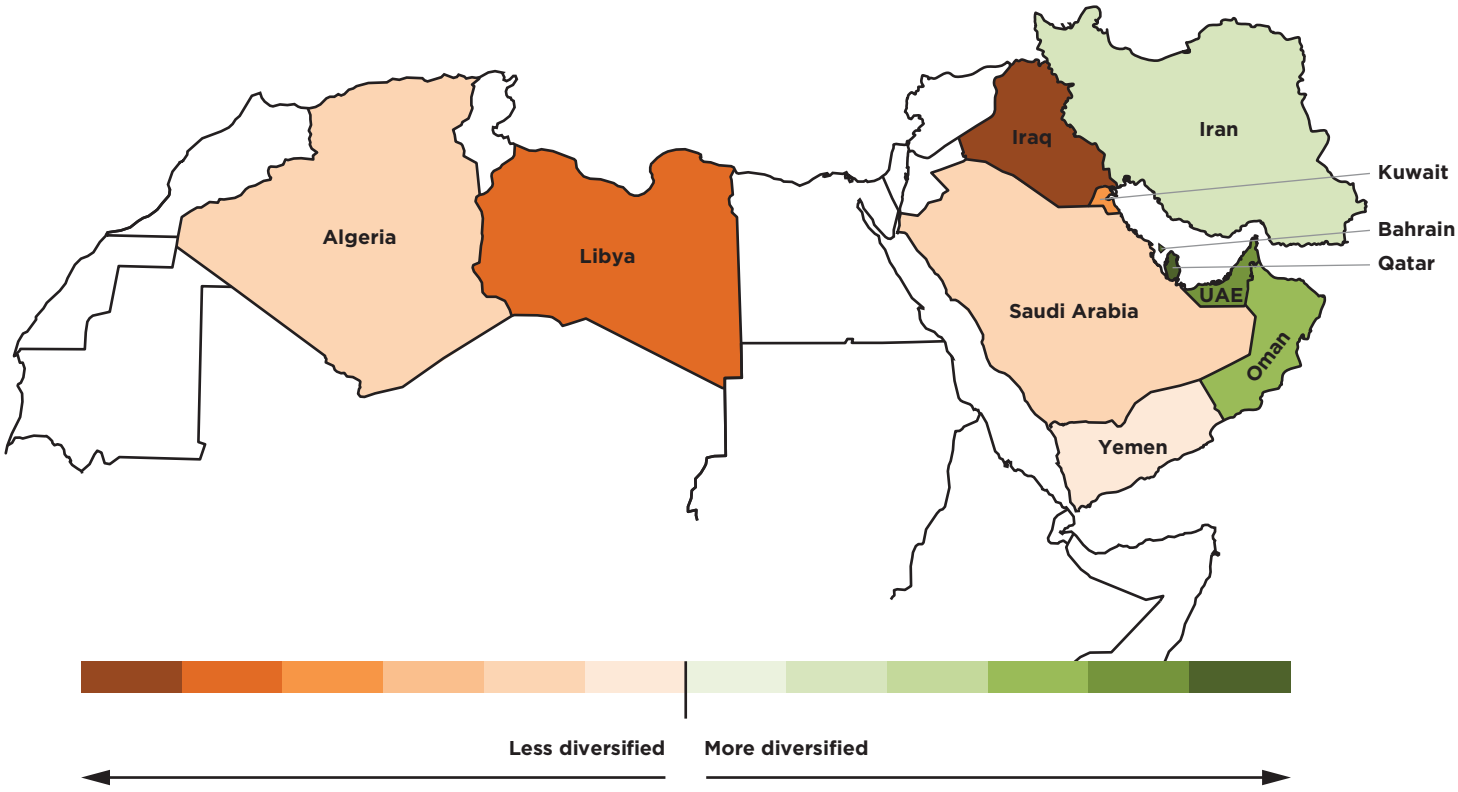
Second, job creation has become a mounting concern in many MENA countries. A growing number of young people are unemployed, which is creating social and political tensions. Members of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—need to create jobs for thousands of unemployed nationals seeking public sector jobs, which pay much more than jobs in the private sector.

Third, countries around the world face growing demands to reduce the use of fossil fuels in the face of climate change and concerns over environmental degradation. Oil-producing countries fear that the shift away from fossil fuels poses an existential risk and that oil reserves will get stranded underground.

This Policy Brief draws two conclusions, based on analysis of several databases that have become available only recently (the IMF Diversification Toolkit, the IMF Trade in Services dataset, and Eora MRIO Global Supply Chain database). First, since the early 1980s, there has been very little diversification in the export of goods from MENA countries (figure 1) but some diversification in services exports. Second, oil exporters have increased their participation in global value chains, but they participate mainly as suppliers of inputs for final goods produced by other countries rather than as producers of final products.

These mixed results sow doubts about the effectiveness of MENA oil exporters in reducing their dependence on oil and generating much-needed jobs. Shortfalls in achieving these objectives are likely to increase social discontent and disruption, perhaps with global consequences, including

Figure 1 Level of diversification of goods exports achieved by oil exporters in the Middle East and North Africa between 2010 and 2014



Source: Author, based on data from IMF (2018).

conflicts in the MENA region and population movements within MENA or to Europe and beyond.

A large body of literature has tried to explain the mixed record in diversification in resource-dependent economies.[2] It cites the following factors:

- inadequate governance and economic incentive systems, including legal frameworks; insufficient human capital formation; labor market restrictions; and inadequate access to finance;
- unhelpful macroeconomic policies, such as overvalued exchange rates;
- inward-oriented trade policies, including restrictions on intraregional trade;
- industrial policies that have failed to create new comparative advantages or capabilities;
- political economy reasons specific to countries with large oil revenues, especially the vulnerability to rent-seeking; and
- geopolitical instability and conflicts.

This literature also lays out various structural reforms, policies for restructuring public finances, and better management of oil income.

It is important for oil producers to better understand the reasons for their record of diversification through transparent, country-specific discussions with domestic stakeholders, especially their private sectors, about diversification and economic restructuring efforts. The prospect of social pressures across the region calls for better economic policies, including policies that have realistic objectives and are prepared with input from various social groups.

BENCHMARKS FOR SUCCESSFUL EXPORT DIVERSIFICATION

The literature on diversification does not suggest any simple benchmarks for success. The appropriate level of diversification depends on the relative values countries place

2. See, for example, Arezki et al. (2018); Callen et al. (2014); Cherif, Hasanov, and Wang (2018); Hausmann, Klinger, and Lopez-Calix (2010); Hendrix (2017); Hvidt (2013); Imbs and Wacziarg (2003); IMF (2016); Robinson, Torvik, and Verdier (2006); and Ross (2017).

on employment, intergenerational equity, and the level of national savings needed to maintain a stable level of national consumption. The difficulty in finding a benchmark also reflects the fact that the main objective of diversification policies has changed over time. In the 1970s, recognition of the exhaustibility of oil drove diversification policies. With the sharp swings in oil prices in the 1990s, the focus shifted toward coping with the volatility of oil revenue. Since the Arab Spring, which began in 2011, concerns about demographics and unemployment have found greater urgency. The most recent worries include the shale revolution and the likely decline in global demand for fossil fuels caused by environmental concerns.

Overall, progress toward increasing export diversification in goods was limited and erratic.

This Policy Brief uses the performance of oil exporters outside the MENA region as a benchmark.[3] The advantage of this approach is that it compares MENA oil exporters with their peers around the world who face broadly similar challenges and have tried to address them. This benchmark does not suggest that diversification policies in other oil exporters have been optimal. It rather highlights broader trends that have materialized there.

DIVERSIFICATION OF GOODS EXPORTS

Diversification in exports can be measured by the inverse of indicators of concentration. These indicators reveal that diversification of goods exports increased only marginally between 1980 and 2014 (figure 2). Data from the IMF's Diversification Toolkit (IMF 2018) reveal that on average, diversification in goods exported by MENA oil exporters was about 5 to 10 percent higher in 2014 than it was in the early 1980s. Overall, progress toward increasing export diversification in goods was limited and erratic.

MENA oil exporters outperformed the comparator group between the early 2000s and 2014.[4] They did so, however, mainly because of the deceleration of diversification in many countries in the comparator group (Bolivia, Chad, the Republic of Congo, Ecuador, Equatorial Guinea, and Venezuela) rather than because of efforts by MENA oil exporters. All of the GCC countries except Kuwait diversified more than the comparator group, with the United Arab Emirates, Oman, and Qatar leading the way. Oman exports vehicle parts; the United Arab Emirates exports or reexports gold, diamonds, machinery, equipment, and electrical appliances. Among other MENA oil exporters, only Algeria and Libya (before the onset of the civil conflict) improved their export diversification (though not significantly). In all other countries, in particular Iraq, Kuwait, and Yemen, no visible progress in diversification was made; there was even some retreat relative to the group's average and comparator countries.

DIVERSIFICATION OF SERVICES EXPORTS

Diversification in services presents a different picture. The pace of diversification was about eight times faster than in goods, based on the number of services categories exported. Between 1980 and 2014, diversification in exported services categories increased by 80 percent (figure 3). This expansion in services can be partly explained by the overall increase in the range of services offered in recent decades, most of which are less constrained by regulations than exports of goods. Although diversification was greater in services than in goods, MENA oil exporters mostly underperformed comparator countries, where diversification in exported services was at least three times as great.

Although diversification in services expanded at a faster pace than in goods, it was limited to a few fields. The United Arab Emirates is probably the most diversified MENA country in terms of services exports, mainly because it is a regional logistics and transportation hub.[5] The Jebel Ali Free Zone, the Dubai International Airport, Dubai World Central, and the Dubai Logistics Corridor provide reexport services to exporters from Asia and Africa (Saidi and Prasad 2018).

3. The peer countries are the 14 countries classified by the IMF *World Economic Outlook* (WEO) as energy-exporting emerging and developing economies: Angola, Azerbaijan, Bolivia, Brunei, Chad, the Republic of Congo, Ecuador, Gabon, Kazakhstan, Nigeria, Russia, Trinidad and Tobago, Turkmenistan, and Venezuela.

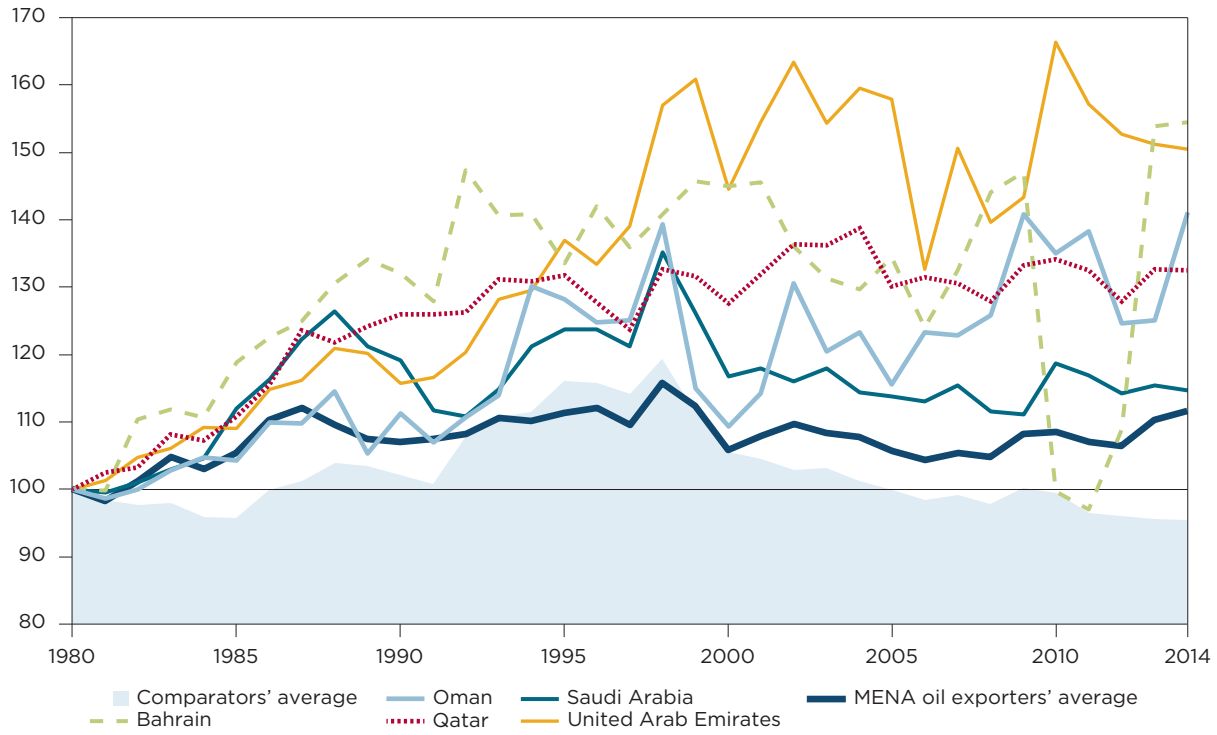
4. Several additional diversification metrics broadly confirm these trends. The World Bank's *World Integrated Trade Solutions* database (World Bank 2018), which is available only from the early 1990s, shows that diversification increased more rapidly in MENA than in comparator countries on average. MENA countries introduced more new export products than their comparators and reached more new export markets. As a result, export market penetration (calculated as the number of countries to which MENA oil producers export a particular product relative to the number of countries that import this product) increased more rapidly in MENA than in comparator countries.

5. The United Arab Emirates is not included in the trade in services dataset because disaggregated information on trade in services is not available in its balance of payments.

Figure 2 Diversification of goods exports by oil exporters in the Middle East and North Africa, 1980–2014

a. Countries with above-average diversification of goods exports

inverse Theil index, in real terms (1980 = 100)

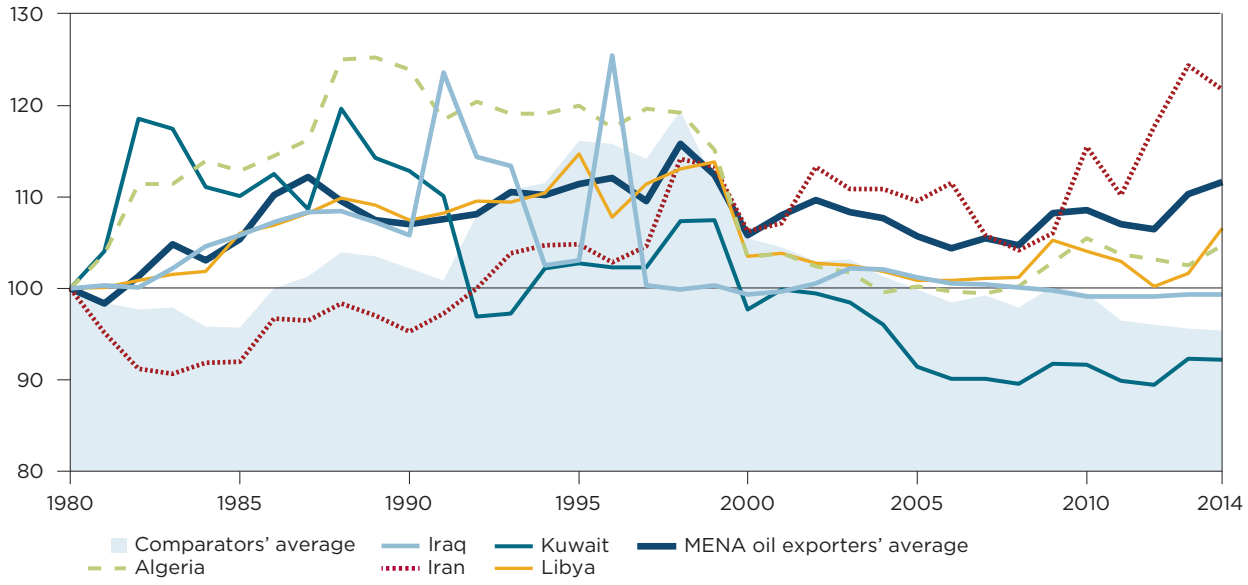


Source: IMF (2018).

Figure 2 Diversification of goods exports by oil exporters in the Middle East and North Africa, 1980–2014

b. Countries with below-average diversification of goods exports

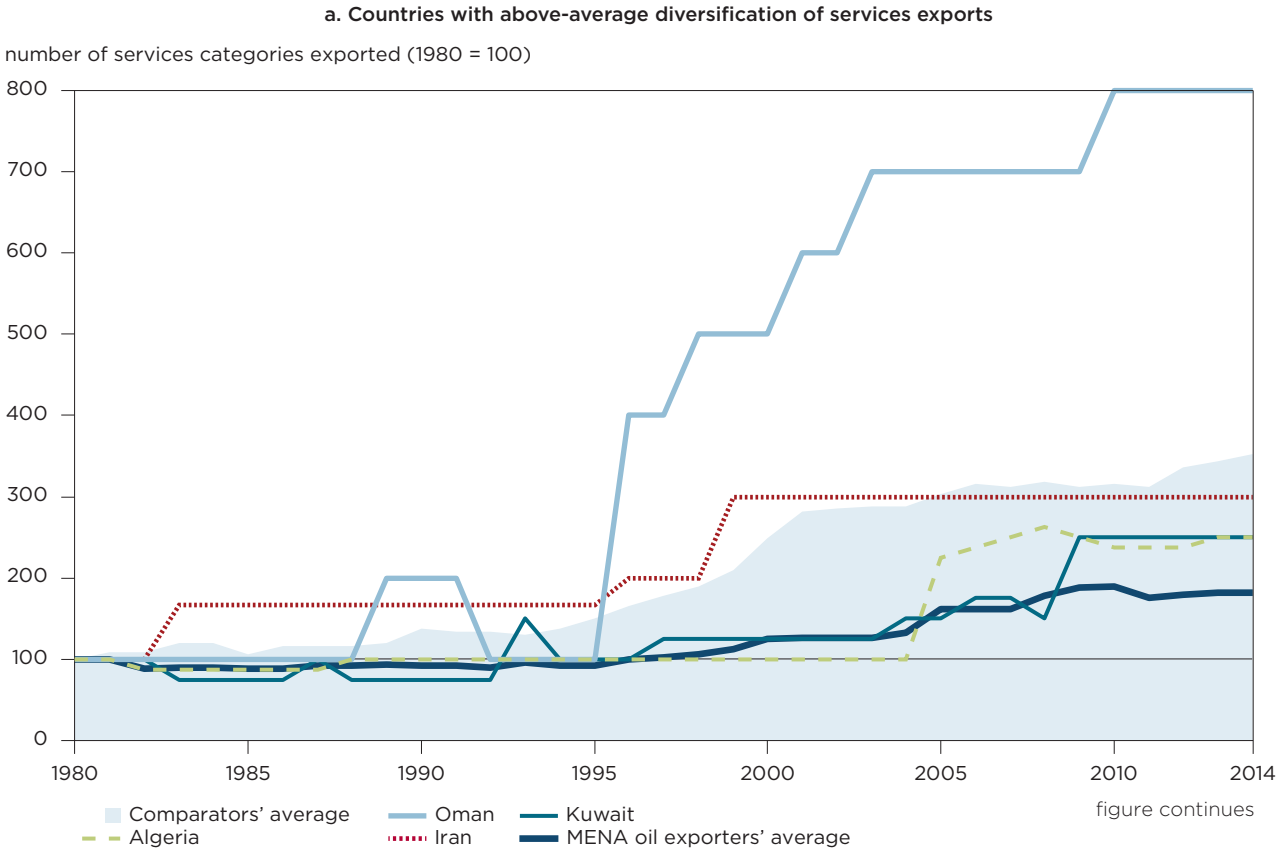
inverse Theil index, in real terms (1980 = 100)



Note: Yemen was dropped from panel b because for the majority of the sample period its index remained below 80. But Yemen's data were included in the MENA oil exporters' average.

Source: IMF (2018).

Figure 3 Diversification of services exports by oil exporters in the Middle East and North Africa, 1980–2014



Note: The United Arab Emirates is not included in the trade in services dataset because disaggregated information on trade in services is not available in its balance of payments.

Source: IMF Trade in Services database, 2017.

PARTICIPATION IN GLOBAL VALUE CHAINS

MENA oil exporters boosted their participation in global value chains between 1990 and 2013.[6] They still underperformed other parts of the world, however (figure 4).

MENA oil exporters also changed their position in global value chains. All of them increased their forward participation, mainly as suppliers of intermediate inputs to other countries. By way of comparison, countries in the Association of Southeast Asian Nations (ASEAN) pursued mainly backward integration into products that use other countries' output as their inputs (by importing parts to assemble computers, for example). Algeria's automobile industry is one example of participation in nonoil global value chains. For many years, Algeria assembled cars using foreign parts. It is now moving into production of parts and components for both the domestic and export markets. Global automotive firms are increasingly interested in Algeria as a hub for parts, components, and vehicles (Azmeh 2018).

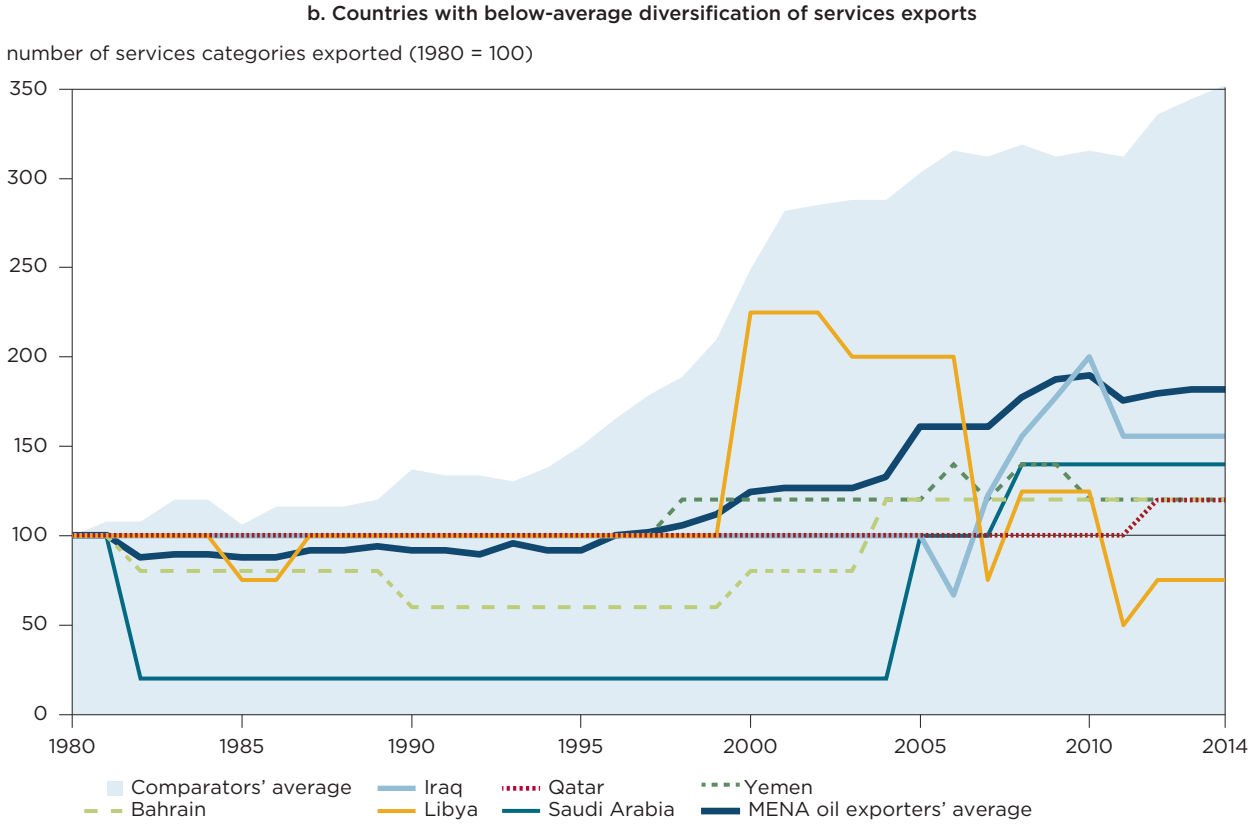
BETTER STRUCTURAL REFORM POLICIES AND MANAGEMENT OF OIL WEALTH

MENA oil exporters have been pursuing diversification strategies for years, with mixed results. Efforts have included state-centered industrial policies to diversify exports and initiatives to expand the role of the private sector.

Some efforts to diversify have succeeded. Dubai diversified horizontally across sectors, for example, and Abu Dhabi vertically diversified in the hydrocarbon sector. There have also been many unsuccessful cases, including high-cost import substitution projects that wasted public resources. Many countries have tried successfully to generate income through investments in their sovereign wealth funds.

6. The *GVC participation* of a country is a measure of its intensity of involvement in global value chains. It is measured as the sum of two components, both as percent of exports: foreign value added in domestic exports and domestic exports that are used in foreign countries' exports. The *GVC position* of a country characterizes how upstream or downstream it is within global value chains. Countries with a larger position index are relatively more upstream, i.e., they contribute more value added to other countries' exports than other countries contribute to theirs. See Aslam, Novta, and Rodriguez-Bastos (2017) for details.

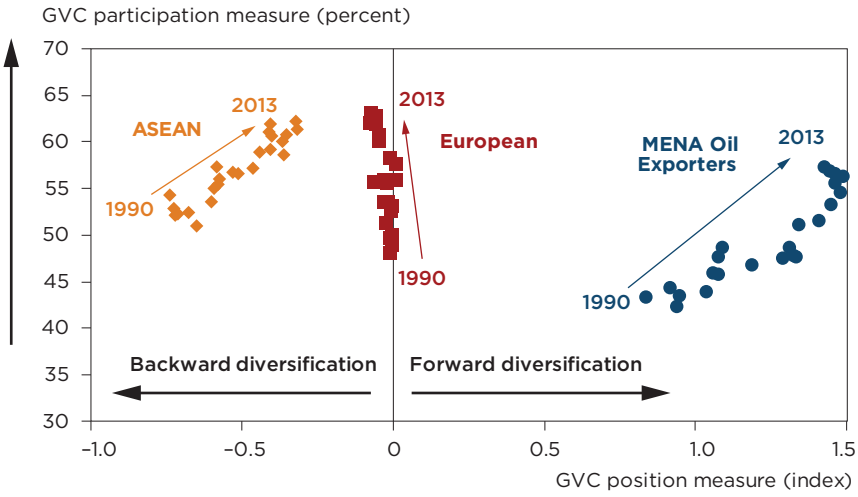
Figure 3 Diversification of services exports by oil exporters in the Middle East and North Africa, 1980–2014 (continued)



Note: The United Arab Emirates is not included in the Trade in Services dataset because disaggregated information on trade in services is not available in its balance of payments.

Source: IMF Trade in Services database, 2017.

Figure 4 Participation and position of MENA oil producers in global value chains (GVCs)



ASEAN = Association of Southeast Asian Nations

Source: Author's calculations based on data from the Eora MRIO database (Eora 2018).

The decline in oil prices since 2014 has intensified pressures to restructure and diversify. Most MENA oil exporters have been developing strategies for putting their fiscal houses in order, promoting more sustainable development, and creating jobs.

Many oil producers have diversification strategies. Saudi Arabia's Vision 2030 is the best known and most ambitious of these plans.[7] Some of its key targets include the following:

- increasing the share of the private sector in GDP from 40 to 65 percent,
- reducing unemployment from 11.6 to 7.0 percent,
- increasing foreign direct investment from 3.8 to 5.7 percent of GDP,
- raising the share of nonoil exports in nonoil GDP from 16 to 50 percent,
- increasing nonoil government revenue from SR163 billion to SR1 trillion, and
- increasing the assets of the Public Investment Fund (Saudi Arabia's sovereign wealth fund) from SR600 billion to more than SR7 trillion, including through a public offering of part of Aramco, the national petroleum and natural gas company.

These plans may be overly ambitious; the initial public offering for Aramco was put on hold in 2018. Moreover, they may create social tensions. Consultation with the population is also recommended (see El-Gamal 2016, Fattouh and Sen 2016, Kinninmont 2017).

The limited progress in export diversification suggests the need to rethink policies. Reducing dependence on oil and creating employment for rapidly growing youth populations is unlikely unless the reasons behind the lack of progress to date are better understood. The mixed outcomes are also likely to raise questions about the governance and distribution of oil revenues, including expenditures on large infrastructure projects. These questions could have serious political and social implications in a region that is already experiencing conflict and dislocation. Social discontent may increase if oil prices decline significantly or the world substantially reduces its reliance on fossil fuels.

The literature on diversification in resource-dependent economies has much to offer (see, for example, Arezki et al. 2018). It calls on such countries to undertake structural reforms and improve their public finances and management of oil income.

On structural reforms, the literature suggests that countries need to

- improve the macroeconomic and regulatory environment for the private sector;
- improve education and human capital development, in order to develop the skills modern economies need;
- increase transparency and reduce corruption, especially in public procurement; and
- remove trade barriers, especially ones that affect intraregional trade.

To improve public finances these countries need to

- enhance fiscal policies and management; reduce budget deficits, including by containing the large subsidies to energy consumption; and increase nonoil revenues;
- use hedging instruments to cope with oil price volatility; and
- invest the proceeds of oil exports, through a sovereign wealth fund.

Achieving diversification will involve difficult policy reforms that will change the long-standing economic models in these countries. Transparent public debates and dialogue are needed, especially with the private sector, about policies that have worked and policies that have not, the costs and benefits of different diversification strategies, and better governance of public resources being used for diversification.

7. The plan is available at https://vision2030.gov.sa/sites/default/files/report/Saudi_Vision2030_EN_2017.pdf.

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