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A Study on Economic Diversification in Saudi Arabia

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ABSTRACT

Saudi Arabia's economy has grown very strongly in recent years as it has benefited from high oil prices and output, strong private sector activity, increased government spending, and the implementation of a number of domestic reform initiatives. Rising oil prices and oil production have also resulted in large external and fiscal surpluses, and government debt has declined to very low levels. The economic outlook remains favorable. Nevertheless, the substantial drop in oil prices since the summer of 2014 is an important risk to the outlook.

The Saudi Arabian economy remains very dependent on oil revenues to support growth and fiscal and external balances—over 90 percent of fiscal revenues and 80 percent of export revenues come from the sale of oil. Developments in the global oil market are therefore central to the economic outlook. Lower oil prices will have an immediate negative effect on the fiscal and external balances, and over time will also likely lead to slower growth.

INTRODUCTION

Saudi Arabia's economy has evolved significantly over the past decade, but further diversification is important. As stated in the Ninth Development Plan of the Kingdom of Saudi Arabia: "With successive development plans recognizing the risks inherent in one-sided heavy reliance on production and export of crude oil, diversification of the production base of the Saudi economy has been, ever since the beginning of development planning, a prime target for economic development."

The government has used rising oil receipts to increase investments in human resource development and public infrastructure. The share of non-oil output in GDP has increased steadily, although export diversification has been more limited. While non-oil exports have grown quite strongly, they remain a small share of total exports and are largely concentrated in products closely related to oil. Experience from other oil-exporting countries suggests diversification is a long and difficult process.

Saudi Arabia does not appear to suffer from traditional Dutch disease problems holding back the development of a competitive nonoil tradable sector, although oil revenues may crowd out tradable production in other ways. The relatively higher wages available in the public sector mean this is often a more attractive employment choice, particularly for lower-skilled workers, than the private sector.

For firms, producing goods and services to meet the consumption and investment needs of the domestic market is a more reliable profit source than gearing business plans

toward riskier export activities. Addressing these incentives while undertaking further reforms to strengthen the business environment and improve the education and skills of the workforce will be necessary to meet the government's goal of further economic diversification.

The non-oil sector in Saudi Arabia has grown strongly over the past decade. While oil GDP rose, non-oil output almost tripled during 2004–14 in nominal terms and doubled in real terms. On average, nominal non-oil output now constitutes half of total GDP, with the share of private sector (non-oil) activity in total output amounting to over a third, on average. However, in real terms, the share of non-oil economic activity increased by some 10 percentage points of GDP between 2004 and 2014, reaching almost 80 percent by 2014 due to stronger private sector activity.

Real growth in the non-oil sector has outpaced that in the oil sector, yet decelerated starting in late 2010. Real growth in non-oil GDP averaged 7.7 percent during 2004–14, compared to oil GDP growth of 1.6 percent. The contribution of non-oil output to overall GDP growth over the past decade has averaged 5.7 percentage points compared to the smaller and more volatile contribution of oil GDP to overall growth.

Nevertheless, non-oil growth has steadily decelerated since 2010, beginning with wholesale and retail trade in 2011, and followed by slower growth in other sectors over the past two years (manufacturing, construction, transport and

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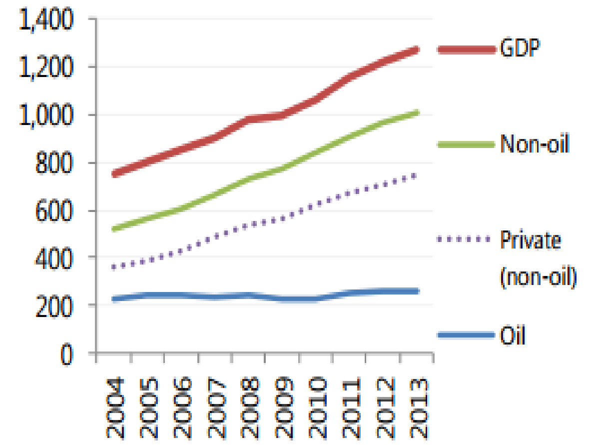
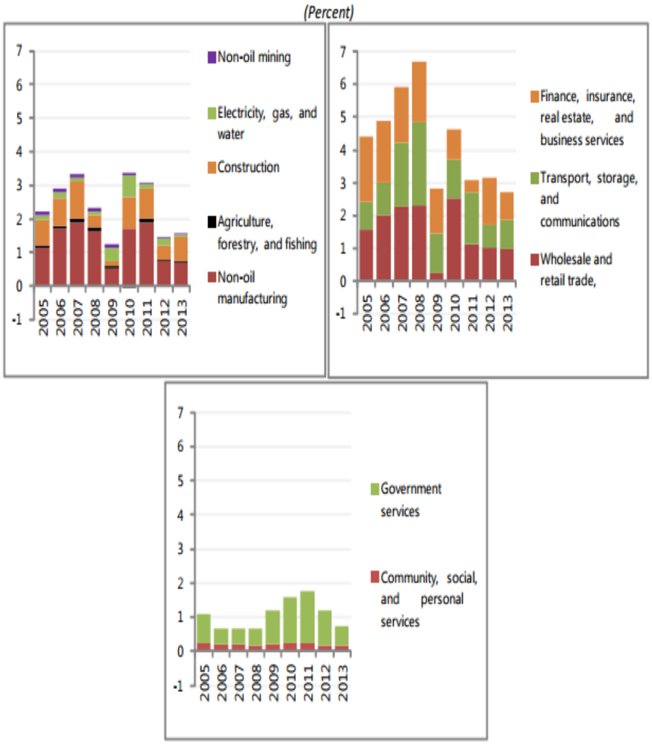
communication, and to some extent, government services). Within the energy sector, efforts are ongoing to diversify energy sources away from oil through the development of gas, solar, and other sources.



Source: Central Department of Statistics and Information (CDSI).

The correlation between oil and non-oil activity is strong in nominal terms, but weaker in realterms. The correlation between the two sectors is 0.9 in levels and 0.7 in growth rates for nominal components (oil and non-oil, respectively), and 0.5 and 0.17 for the real components.



Source: Central Department of Statistics and Information (CDSI).

In terms of employment, diversification in the jobs held by nationals is limited. Saudi Arabia has created over 2.7 million new jobs since 2008, of which 1 million were filled by Saudi citizens, yet most of the latter were in the public sector. In construction, 800,000 new jobs were added, while in the services sector, the number of workers increased by a cumulative 1.5 million, particularly in social and community services, trade, and tourism.

Out of this total, 37 percent—or approximately 1 million new jobs—went to Saudi nationals. However, most of the Saudi new employment was concentrated in the administrative, educational, and health sectors (social and community services), which are typically associated with the public sector.

ONGOING EFFORTS TO DIVERSIFY SAUDI ARABIA'S ENERGY SECTOR

Energy use per capita in Gulf Cooperation Council (GCC) economies is much higher than in other countries and regions. All GCC countries rely almost exclusively on fossil fuel consumption for their energy needs, compared to relatively lower ratios for a number of advanced economies (as well as India and Brazil). While Saudi Arabia consumes the lowest amount of energy per capita in the GCC, fuel consumption has almost doubled since 2000.

Given rising energy needs on the back of a rapidly expanding economy and population, the Saudi government is taking steps to diversify out of fossil fuels. Saudi Arabia is estimated to need three to four giga-watts of additional electric power capacity annually to meet rising energy demand. This will require large investments in both transmission and distribution networks.

As such, the authorities have established the King Abdullah City for Atomic and Renewable Energy to diversify the economy's energy mix (particularly from nonrenewable sources), and are contemplating the involvement of the private sector in about one-third of the total planned investments. In the electricity field, investment in and ownership and management of a few electricity and water plants has been opened up for foreign and private investors.

The authorities have adopted an Electricity Industry Restructuring Plan to oversee the breakup of the Saudi electricity company into three subfields of activity; transmission, generation, and distribution. This is a step to restructure the sector and introduce competition among firms to liberalize electricity prices. Saudi Arabia is a major

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investor in the GCC electricity grid, which has potential for regional expansion.

The GCC grid spans more than 800 kilometers and links power networks in Saudi Arabia with Bahrain, Qatar, United Arab Emirates, Kuwait, and Oman. The World Bank has carried out a feasibility study on linking Saudi Arabia's power networks with those in the European Union to harness the different peak load times between the regions.

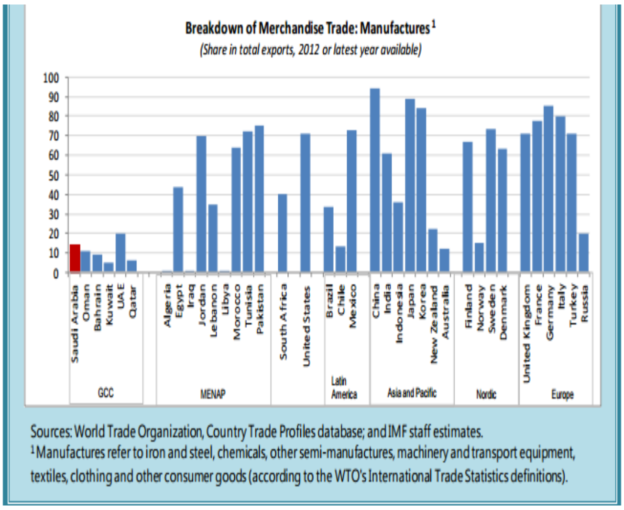
SAUDI ARABIA, GLOBAL TRADE, AND THE WORLD TRADE ORGANIZATION

Saudi Arabia joined (acceded to) the World Trade Organization (WTO) in December 2005. The country is a member of two main regional trade agreements: the Gulf Cooperation Council (GCC), which entered into force in January 2003 as a customs union covering goods; and the Pan-Arab Free Trade Area (PAFTA), which adds Middle East and North Africa (MENA) countries to the GCC and entered into force on January 1998.

As a GCC member, Saudi Arabia also participates in GCC-related regional arrangements, such as the European Free Trade Area (EFTA)-GCC (signed but not ratified), Australia-GCC (announced), and Japan-GCC blocs (announced). The country is also a beneficiary of a number of Preferential Trade Arrangements in force with Australia, New Zealand, Russia, Switzerland, and Turkey (all under the generalized system of preferences).

While Saudi Arabia's total trade value per capita is the lowest among GCC economies given its relatively larger population, it is comparably higher than in most MENA countries, and also comparable to that of the BRICS (Brazil, Russia, India, China, and South Africa). In terms of merchandise trade, Saudi Arabia's share in total world exports is slightly above 2 percent, which is much higher than for other countries in MENA, larger than most GCC shares (United Arab Emirates has the closest figure of 1.9 percent), and even higher than that for a number of developing and emerging markets (such as South Africa, Brazil, Indonesia and India).

However, manufactured exports as a share of total exports are low, at less than 15 percent compared to a share of up to 70 percent in a number of countries in the MENA region. Oil dominates the export basket (constituting nearly 85 percent of total exports in 2012).



EXPERIENCES WITH ECONOMIC DIVERSIFICATION IN OIL-EXPORTING COUNTRIES

Achieving economic diversification in oil-exporting countries is a difficult task. Historical experience offers few examples of countries that have been able to successfully diversify away from oil, particularly when their oil production horizon is still long. A number of key obstacles that often stand in the way of diversification include the economic volatility induced by the reliance on oil revenues, the corroding effect that oil revenues often have on governance and institutions, and the risks that oil revenues often lead to overvalued real exchange rates (traditional Dutch disease issues).

Malaysia, Indonesia, and Mexico perhaps offer the best examples of countries that have been able to diversify away from oil, while Chile has had some success in diversification away from copper. Malaysia's diversification experience involved active intervention on the part of the state to spur growth in targeted sectors. This was predicated on an international competitive drive underpinned by technological transfers, with a focus on developing national oil companies into global firms. While the economy had an import-substitution strategy in heavy industry, there was an export promotion focus for manufactures, given strong global competition.

Diversification was achieved by means of (i) attracting foreign direct investment in the export sector (which led to a stronger capital base), and (ii) a focus on human and capital development through training and skill-upgrading of workers, which was provided by a fund targeting

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manufacturing firms as well as sponsored state funds for foreign education.

At the same time, Malaysia also targeted small and medium enterprise (SME) development. Taken together, all of these factors led to eventual export diversification and takeoff over the years. Indonesia's experience also highlights the benefits of having strong incentives to successfully diversify the export base. Similar to Malaysia's approach, Indonesia also had an importsubstitution policy in place, as well as policies to attract foreign capital in the manufacturing exports field. In addition, the country enacted a number of incentives to promote exports, such as setting up free zones, providing tax incentives to firms and industries, and reducing barriers to trade (tariff and nontariff).

A fundamental element of its diversification strategy, however, was a large exchange rate devaluation. Indonesia's experience also relied on using oil revenues to tap, enhance, and develop other sectors, such as agriculture and the country's aircraft industry (on both maintenance and manufacturing frontiers).

BUSINESS ENVIRONMENT IN SAUDI ARAB

Saudi Arabia compares relatively well across a number of business indicators, yet challenges remain. For example, the country has been doing well in terms of its business environment and infrastructure, incentives for export promotion, labor market regulation, and education. However, challenges remain in contract enforcement and resolution of company insolvencies, and in trade integration, despite export incentives.

Saudi Arabia has improved its business climate. It was ranked as the 18th most competitive economy worldwide among 144 countries in 2013 according to the Global Competitiveness Index.

Saudi Arabia's ranking on the Ease of Doing Business Index was second to the United Arab Emirates among the GCC countries in 2013, and it outperformed key emerging market and developing countries. It is comparatively much stronger than other countries in the MENA region. The country has facilitated business startups. The number of days to start a business was reduced from over 70 days in 2004 to 25 days by 2013, an improvement that is second only to Indonesia and India over the same period.

In addition, business startup costs (in percent of GNI per capita) were brought down from 60 percent to just 5 percent, and the number of procedures to register a business was reduced to nine from 14 over the past 10 years. In May 2013, a new online company application process was introduced and the number of procedures has been further reduced to seven and the number of days to 23.

The strength of investor protection in Saudi Arabia has helped forge a business friendlyenvironment that is the highest ranked among GCC and selected MENA countries. Despite this progress, more needs to be done to address areas of weakness, including contract enforcement and resolving insolvencies. In these two areas Saudi Arabia ranks low on a global scale (at 127 and 106, respectively). To address these issues, the government is planning to introduce a new insolvency law, and is working to shorten the time taken to enforce judgments by recruiting more judges to work in that area and by establishing commercial courts to oversee resolution of business disputes. Other measures being taken by the authorities to improve competition and strengthen the business environment include improvements to consumer protection, stronger enforcement of competition policy, and revisions to company law.

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