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Non-Oil Industries in the Persian Gulf

For decades the Arab Gulf states and members of the Gulf Cooperation Council (GCC) — Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) — have seen their economic fortunes rise and fall with the demand for their chief export, oil. To shield themselves from the volatility of global oil markets, these states have sought to diversify their economies by investing in a host of non-oil industries, especially services, commerce, and manufacturing. No Gulf community has been seemingly more successful at achieving this balance than Dubai. Starting in the 1970s, Dubai built a thriving economy focused on transportation, tourism, real estate, commerce, and a host of other non-oil industries. Over the last decade, every Arab Gulf state replicated Dubai's model — even as oil prices reached record highs in 2008 and it became clear that the Emirate's model of development had tangible social, economic, and environmental drawbacks.


Sean Foley

The GCC states

The essays presented in this edition of *Viewpoints* capture the challenges which the Arab Gulf states face as they seek to diversify economically and to wean themselves from their dependence on oil exports. Charles Kestenbaum, the president of B&K International and a consultant with over two decades of government and business experience in the Gulf, argues that Dubai and many of its neighbors have had great success in building service and other non-oil sectors. He also notes that these states are using the massive proceeds from recent oil revenues to lay the foundation for a host of future non-oil industries, especially in alternative energies. By contrast, Dr. Matteo Legrenzi, who teaches Middle East politics at the University of Ottawa, argues that the Arab Gulf states are unlikely to escape the boom and bust cycles of the global oil market for decades and that we should be cautious in evaluating the success of non-oil Gulf firms. In his opinion, Dubai's model of development is unsustainable, and the oil-rich Gulf states have no incentive to abandon hydrocarbons as the foundation of their economies.

Dr. Sean Foley, Assistant Professor, Department of History, Middle Tennessee State University, Murfreesboro, TN

Charles Kestenbaum

The six Arab monarchies of the Gulf are wealthy societies which have made remarkable social and economic progress over the last three decades. One only has to look at the pictures of Abu Dhabi, Dubai, and other Gulf communities from the early 1970s to see how far they have come during this period — from isolated desert towns without running water and electricity to bustling cities central to the global economy. In a few decades, these six states achieved a level of social and economic development that it took other states many decades — if not centuries — to reach.

While there is little question that the proceeds from oil sales have been (and will be) central to the development of the Gulf states, they also have built several globally competitive service and manufacturing industries. Even during the increase in oil profits from 1998 to 2008, the Gulf states continued to invest heavily in manufacturing, services, and renewable energy sources, such as solar and wind power.

No state in the Gulf has better taken advantage of these various factors than Dubai. By building on Singapore's example of free trade and openness to foreign investment, the Emirate has successfully promoted itself as a regional service center for global corporations and as a social "escape valve" for the peoples of Saudi Arabia, Iran, and other large, neighboring conservative societies. The city boasts a strong hospitality industry, and alcohol and other vices are available to visitors. Dubai also has taken advantage of capital flight from the former Soviet Union and from nearby civil wars and conflict zones. The Jebel Ali Free Zone has been an impressive engine of growth, drawing industries from North America. A good example is irrigation equipment that formerly had been produced in Nebraska and Texas, but is now produced in Jebel Ali.

Although Dubai's recent economic problems are serious, one should keep a proper perspective of them. Yes, the Emirate experienced a real estate bubble in recent years, and a number of people are suffering because of it. But the economic system is still viable in the long term, and one has to remember how far it and the rest of the UAE have come in recent decades. As recently as 1970, there were no high schools in Abu Dhabi; today, it is a modern city where Western universities hope to establish new campuses. As a

Matteo Legrenzi

The six oil-producing monarchies of the Persian Gulf — Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE — are among the most important but also the most enigmatic societies to study.

On the one hand, they produce strategic commodities — oil and gas — and are integrated into the global economy. Their sovereign wealth funds have substantial investments in Western economies, their currencies are pegged to the US dollar, and their state-owned companies are administered according to US management models. On the other hand, these states are portrayed as extremely vulnerable — to instability in Iraq, Iranian attacks, terrorism, Indian or Chinese influence, and, above all, the boom and bust cycles of world energy markets. For many years, leading financial institutions and analysts have called for the six Gulf states to invest in industries which are not directly tied to hydrocarbons.

Throughout the last 25 years, the Emirate of Dubai appeared to have made great progress in addressing these concerns. Not only did the Jebel Ali Free Trade Zone and similar large projects attract international investors, but Dubai also seemingly made great strides forward in establishing the rule of law, including World Trade Organization (WTO) compliant courts. This did not mean Western-style democratic government, but aspiring to a model similar to that of Singapore, where institutional investors could feel safe. The results were impressive: Dubai's leaders took out enormous loans to finance ever more ambitious projects, such as the Palm Islands and a stock market to rival London, Tokyo, and New York. They also developed close links to US and European financial institutions.

The success of Dubai compelled other states in the Gulf to replicate its approach. Most of the other emirates and the Gulf states integrated themselves into the global economy. They reached bilateral and multilateral free-trade agreements with the US and other major global actors, and they became members of the WTO. Gulf governments also implemented common legal and tariff regimes and announced future plans to further integrate their economies through the establishment of a common currency and central bank, along with regional railway, water, and electrical grids.

During the last five years, the Gulf states have invested in environmentally friendly development projects and green

Kestenbaum . . .

friend recently told me, when you fall off a ladder, the severity of your injuries depends on which rung you were on. Dubai and the UAE generally appear to have fallen hard because of how much they have achieved in recent years.

The future viability of Dubai's economic model is borne out by the success that other states in the Gulf have had in implementing its economic model. Saudi Arabia Basic Industry Corporation (SABIC) has been a global leader in the production of petrochemicals and plastics for more than two decades. Aluminum Bahrain (ALBA) operates the largest aluminum smelter in the world. Qatar's gas industry is among the most profitable in the world, and its Education City houses satellite campuses of several leading American research universities. Indeed, Qatar has replaced Jordan as the state with the most progressive social climate in the region and the best place to earn a Western-style university degree.

Nor are these industries the only vehicle with which the Arab Gulf states can prosper in the 21st century. While a number of sovereign wealth funds in the Gulf may have lost as much as a third of their value in the past year, they are still immensely rich. Abu Dhabi's investment authority alone has approximately $500 million. These resources have allowed Gulf states to invest in promising new companies around the globe. If only two out of every ten of these new companies prove to be viable, the Arab Gulf states will be well positioned to have valuable equity in the future British Petroleum or Shell of renewable energy or the future Google of information technology.

Nonetheless, a model of development in the Gulf that emphasizes services and manufacturing is hardly problem free. While the UAE's domestic population is sufficiently small that it will have to depend on expatriate laborers for years to come, other Gulf states face serious labor issues. In Saudi Arabia, for instance, there are thousands of unemployed young workers who lack the skills to work in a modern economy. They cannot compete with the thousands of skilled expatriate workers in the Kingdom. Reconciling the interests of business leaders, who prefer cheaper foreign labor, and the need to employ Saudi nationals remains a serious issue for the Saudi government.

Developing more rational labor markets has not been aided by weak regional institutions and an inefficient system

Legrenzi . . .

energy sources, and have signalled their intention to develop nuclear power and sustainable fuels. These types of investments could prove to be valuable, since the Obama Administration has stated that it will reverse its predecessor's practice of stalling the implementation of all new global environmental proposals for as long as possible. Alternative energies already were becoming cost efficient as of 2008, as the price of oil skyrocketed to $145 a barrel. A year later, however, it is clear that Dubai's economic model is not sustainable and that the optimism tied to both regional integration and to non-oil industries in the Gulf was partially misplaced.

To begin with, Dubai failed to maintain the confidence of international investors, who came to the conclusion in 2008 that the Emirate's financial authority was too loose and opaque to meet global business standards. It is unlikely that Dubai will regain the trust of the financial community or win back investments soon. The impact of this loss of confidence was clear in the second half of 2008, when oil prices dropped and the Gulf's economy slowed. Dubai soon found that it could not secure the new loans necessary to meet its obligations. Desperate for capital, Dubai's leaders turned to their oil-rich neighbor, Abu Dhabi, whose leaders provided the funds to bail out their fellow royal family.

Dubai's request for assistance showed that the new non-oil industries had done precious little to change the region's economic and political dynamics. Their profits and those of Dubai effectively rested on a sea of oil. Power remained where it has for decades — in the hands of the ruling families who control vast oil revenues and the region's patronage networks. Nor are new non-oil industries likely to change this dynamic, since the percentage of world oil exports coming from the Gulf will actually increase in the next 25 years. While oil prices are down from the highs they reached in summer 2008, they are still high enough (approximately $50/barrel) that Gulf oil exporters can easily meet their basic needs. Indeed, the incentives are not there for Abu Dhabi or any other oil-rich Gulf state to abandon hydrocarbons as their economic base.

At the same time, oil's reduced price means that the other potential sources of power that Gulf leaders had explored are no longer economically viable. While it is true that the UAE has made serious inquiries into nuclear power, this and other projects will not materialize for a long time. Gulf states also must factor in the costs of securing nuclear facilities from attack or sabotage and of safely disposing of nuclear waste.

Kestenbaum . . .

of governance that often substitutes announcements of plans for concrete actions. At times, one wonders whether the GCC should be renamed the Gulf Competition Council, given how many years it has taken the Gulf states to implement plans for even the most basic measures needed for regional economic and political integration. Slow and disorganized official planning has sometimes hampered major projects, such as George Mason University's campus in the UAE Emirate of Ras al-Khaymah.

Even if the Gulf states could address issues of labor and regional integration, they would still have to deal with the byproduct of rapid development, pollution. Desalination plants, which provide the electricity and the water essential to life in the Gulf, can be especially harmful. The chemical process that they use to clean seawater not only pollutes the air, but also discharges harmful chemicals and other pollutants into the Gulf's ecosystems. Over time, this process has changed the salinities of the water in the Gulf and has made it dangerous to swim near some of the region's most exclusive developments.

Despite these changes, the Gulf states are wealthy nations that have come an enormous distance in a few short decades. Regional cooperation in areas such as patents, trademarks, and tariffs will spur innovation and growth in non-oil industries. One sees integration in other economic areas and even in the political arena. A good example is Qatar's linkage of its electrical grid to Saudi Arabia — despite the fact that diplomatic relations between the two countries have been poor for many years because of Qatar's support of the controversial Arabic satellite channel Al Jazeera. While it may take longer than initially thought to implement a common currency and, there is every reason to believe that a common currency and other initiatives will eventually happen. Indeed, the economic future of the six Gulf states — both their oil and non-oil industries — remains bright.

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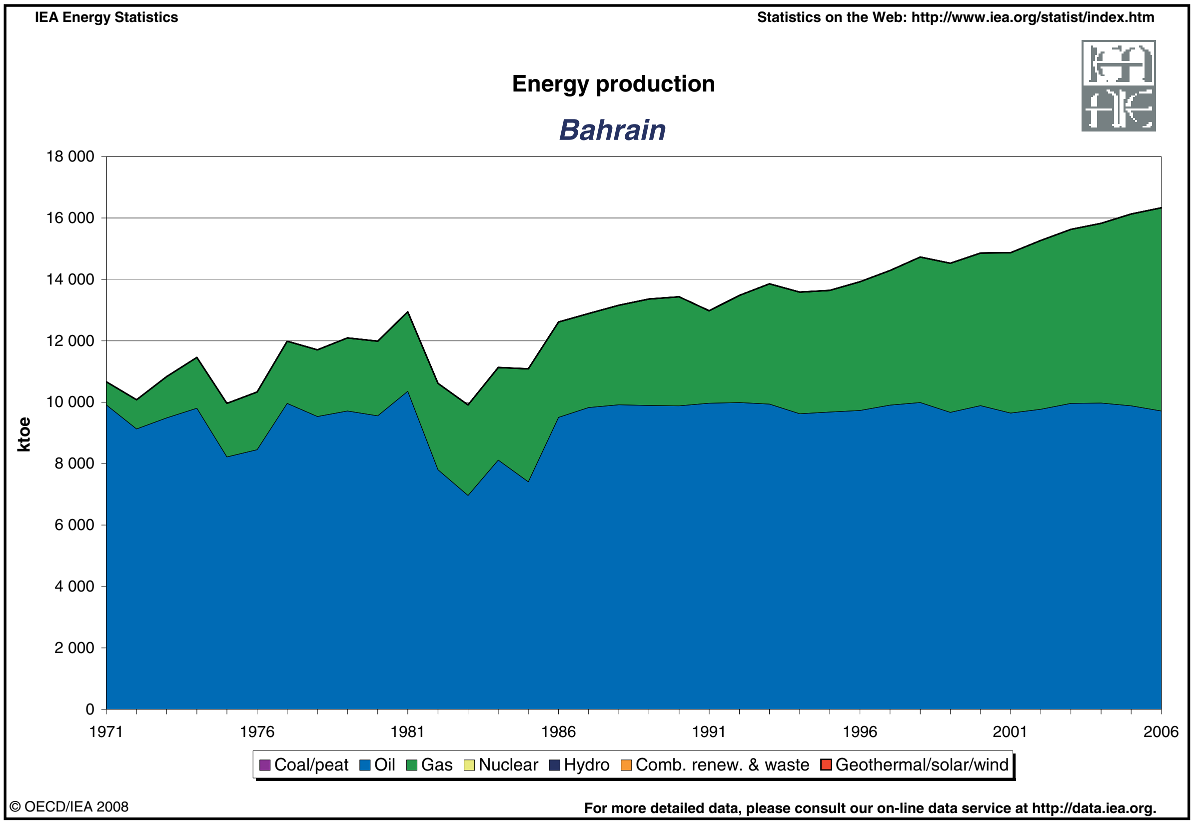
Legrenzi . . .

Equally important, the rise of non-oil industries deepened the region's dependence on foreign workers. Although recent investments in universities may one day produce a well-educated indigenous workforce, it is unlikely that the Gulf states will be able to benefit as quickly from these new schools as South Korea and other developing societies have. Building up human capital takes time, and the incentives are not in place to hire these workers once they enter the labor market. Private businesses, especially in services and industry, continue to employ foreigners and to ignore government demands to hire Gulf nationals. Businesses in GCC countries repeatedly argue that there is no way that they could be competitive internationally unless they take advantage of labor markets beyond the Gulf. In Saudi Arabia this problem is especially acute, since many occupations that are held by women in other parts of the world — i.e., waitressing, basic retail, etc. — are held exclusively by men. Ironically, the more the Gulf states invest in non-oil industries, the more foreign workers will dominate the region's workforce.

That said, the Gulf states are complex and heterogeneous societies which have undergone breathtaking socioeconomic changes in recent years. They are expanding close economic ties with a variety of states around the world, such as China, but it is unlikely that their strategic partnership with the United States (and the peg to the US dollar) will end in the near future. It is equally unlikely that their ongoing dialogue with Iran will bear any fruit, since Tehran's repeated demand in these discussions — the complete withdrawal of foreign (i.e., US) forces from the region — is unacceptable to Gulf governments. Nor are the Gulf governments likely to abandon hydrocarbon exports and foreign labor, since they are the most cost effective mechanisms for their companies to operate in the global economy. It may take decades before we see a regional economy that is not tied to the boom and bust cycles of global energy markets.

But these types of problems are manageable. Though the Gulf states may have become angst-ridden in recent years, they have tremendous resources at their disposal with which to provide for their people and to meet all challenges.

Dr. Matteo Legrenzi is Assistant Professor at the Graduate School of Public and International Affairs, University of Ottawa. His first monograph, The GCC and the International Relations of the Gulf: Diplomacy, Security and Economy Coordination in a Changing Middle East*, is published by I.B. Tauris.*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Energy production
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16 000
14 000
12 000
10 000
8 000
6 000
4 000
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0
ktoe
1971
1976
1981
1986
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1996
2001
2006
Coal/peat
Oil
Gas
Nuclear
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Geothermal/solar/wind
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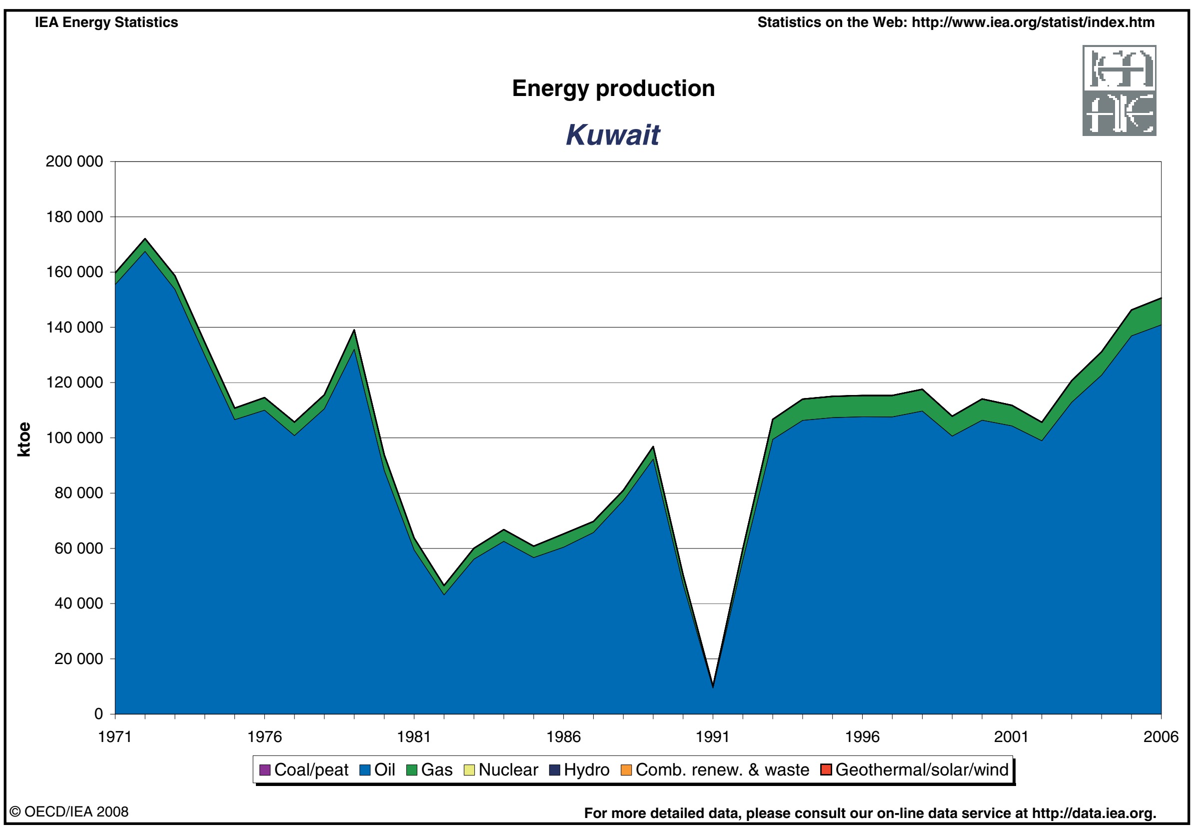
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Statistics on the Web: http://www.iea.org/statist/index.htm
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180 000
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80 000
60 000
40 000
20 000
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1981
1986
1991
1996
2001
2006
Coal/peat
Oil
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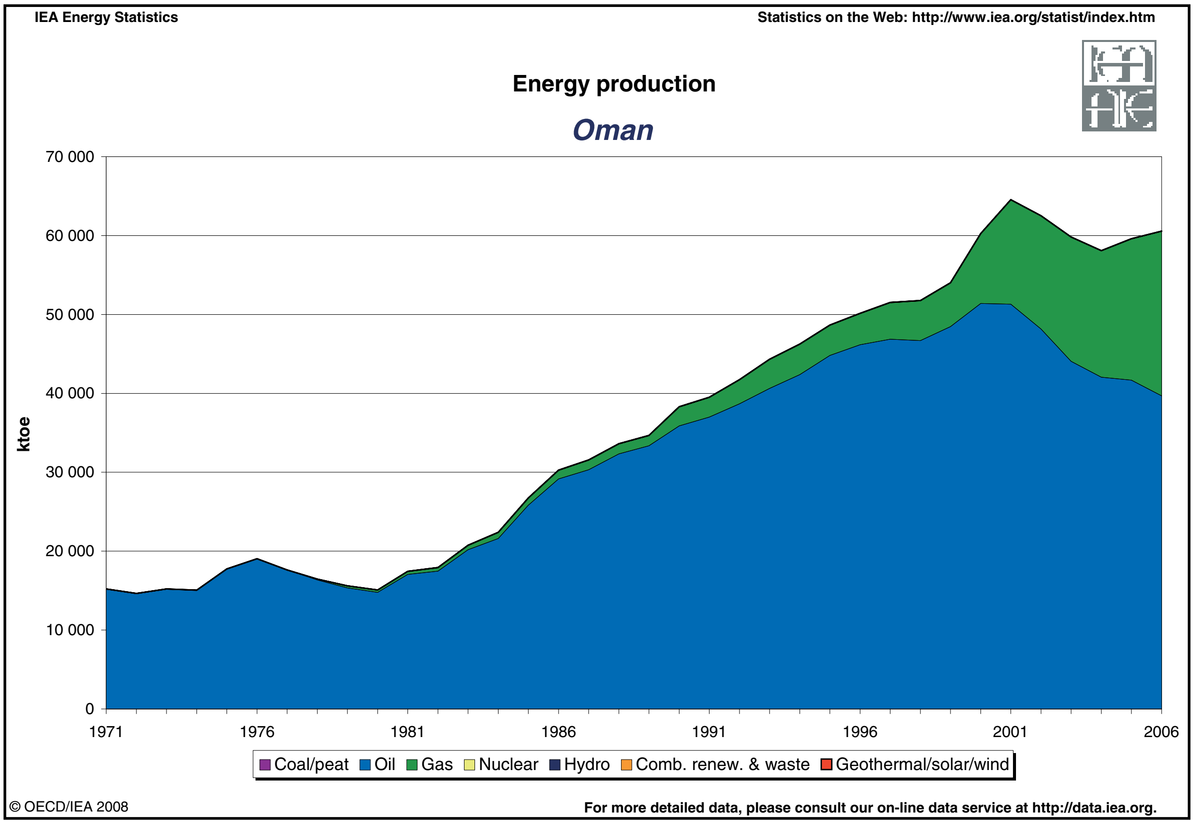
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Energy production
Oman
ktoe
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60 000
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1971
1976
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Coal/peat
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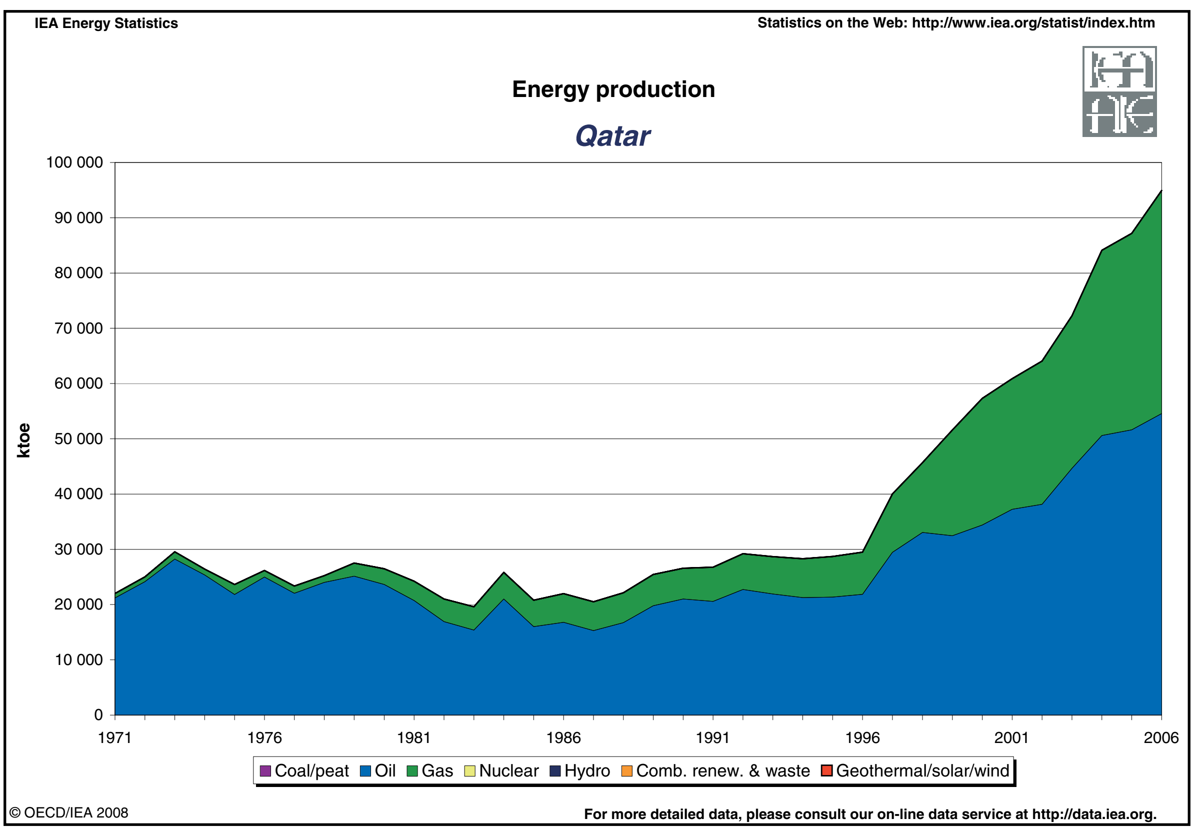
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Coal/peat
Oil
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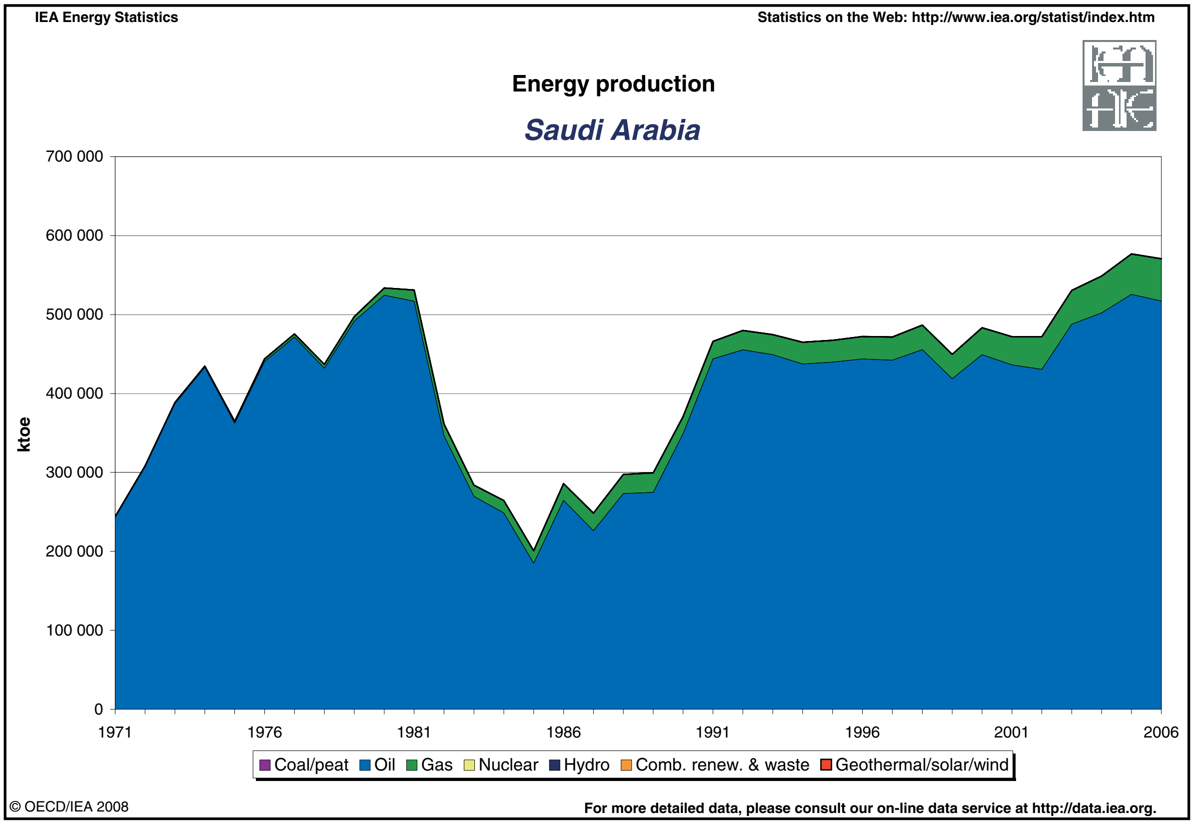
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Energy production
Saudi Arabia
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600 000
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1971
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Coal/peat
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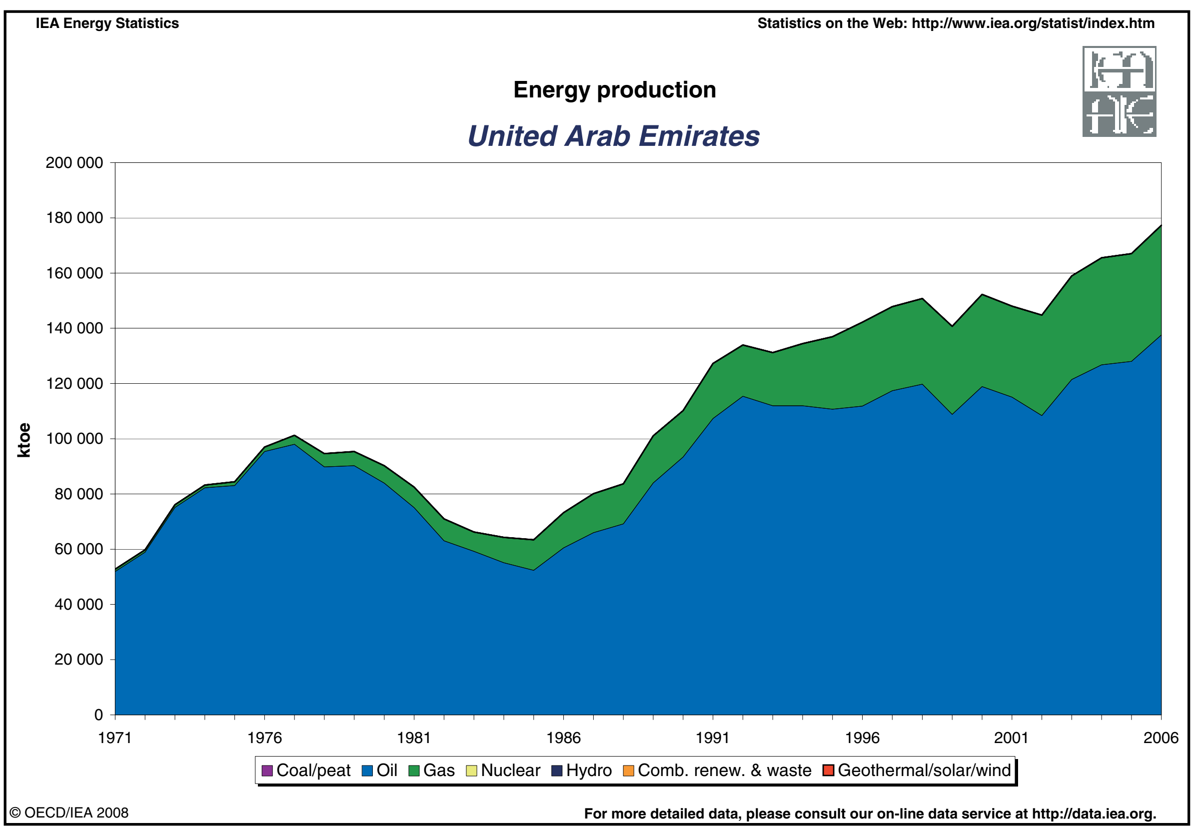
IEA Energy Statistics
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Energy production
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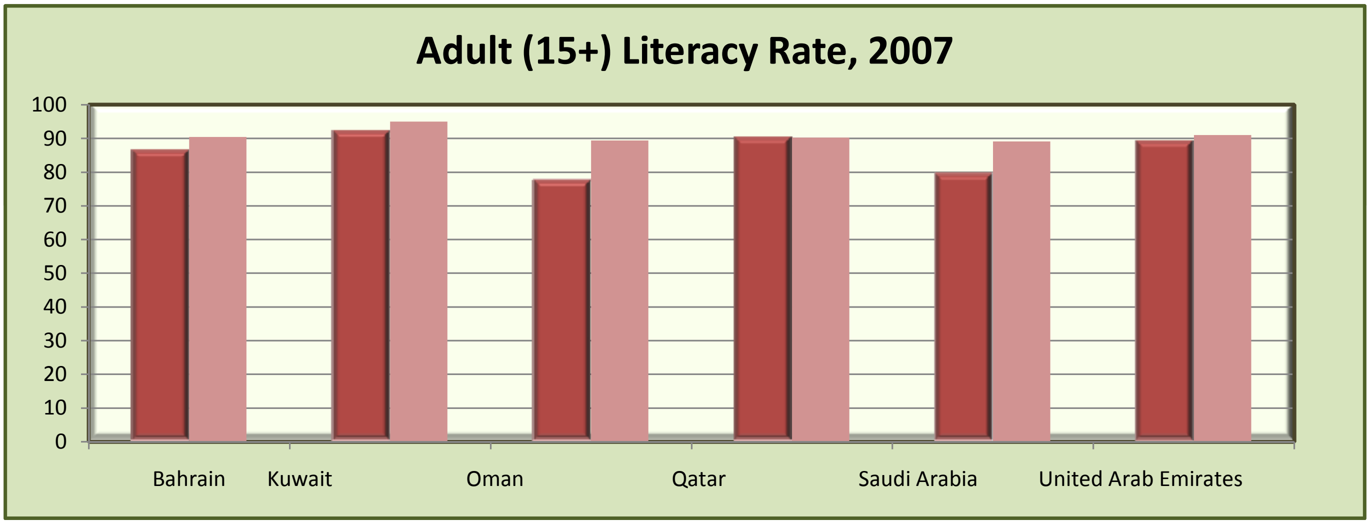

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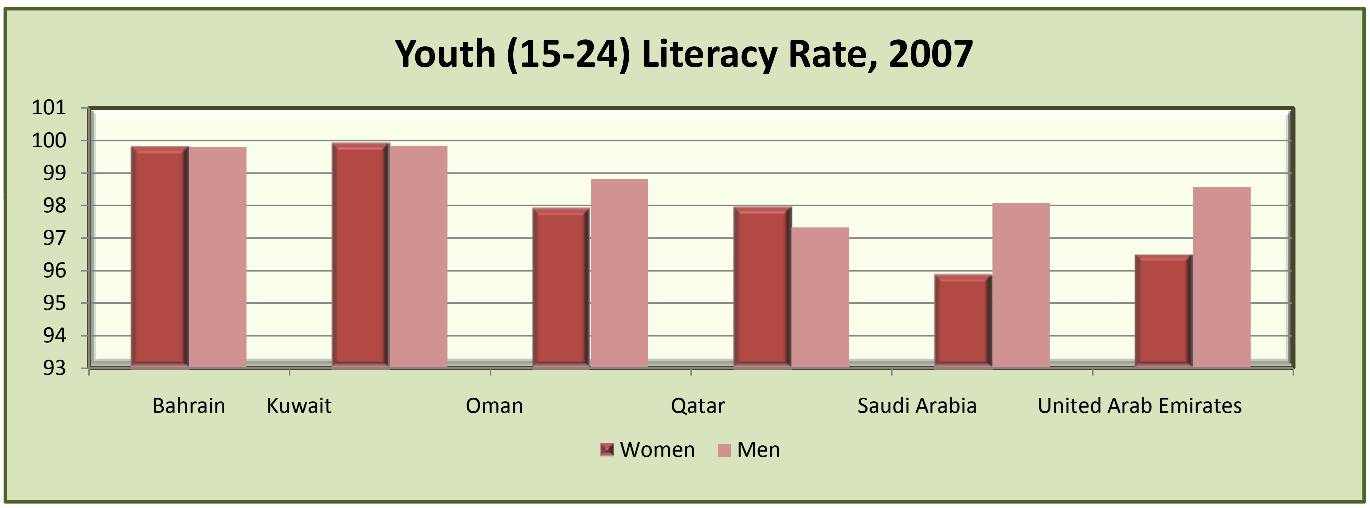

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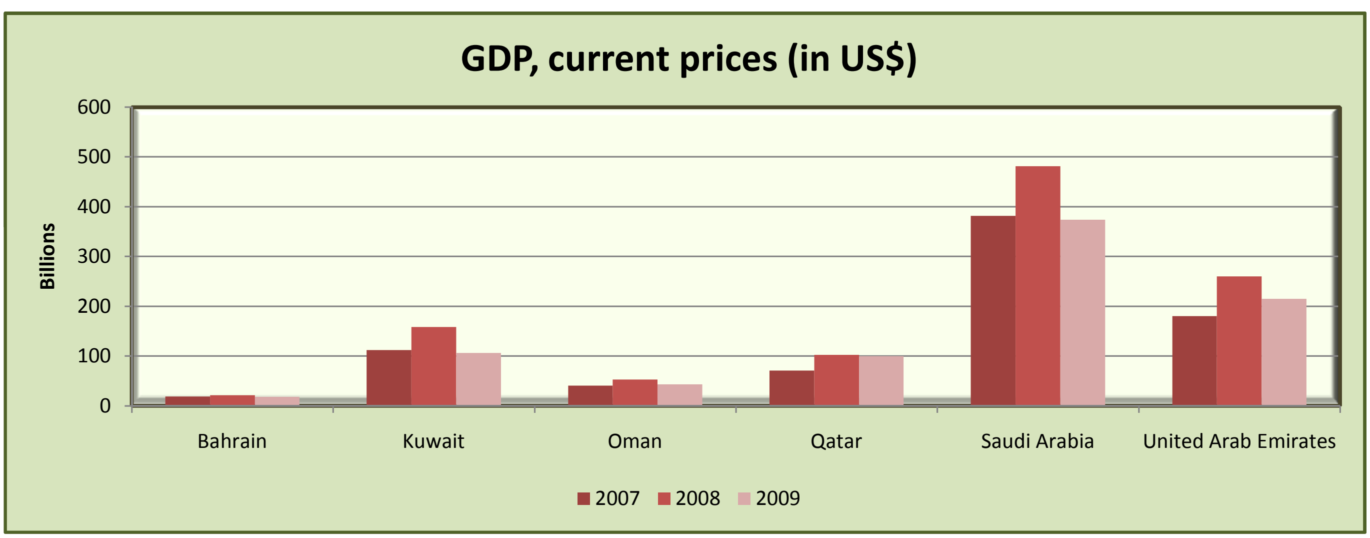
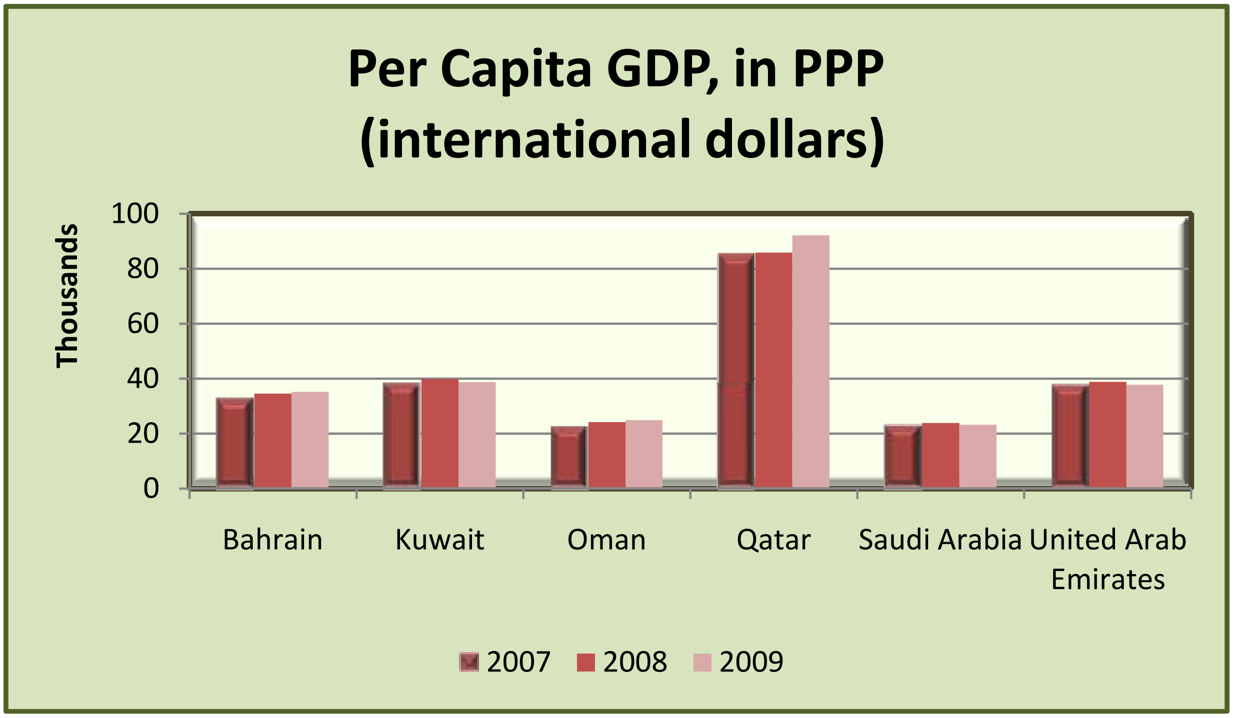


Source: International Monetary Fund, World Economic Outlook Database, April 2009



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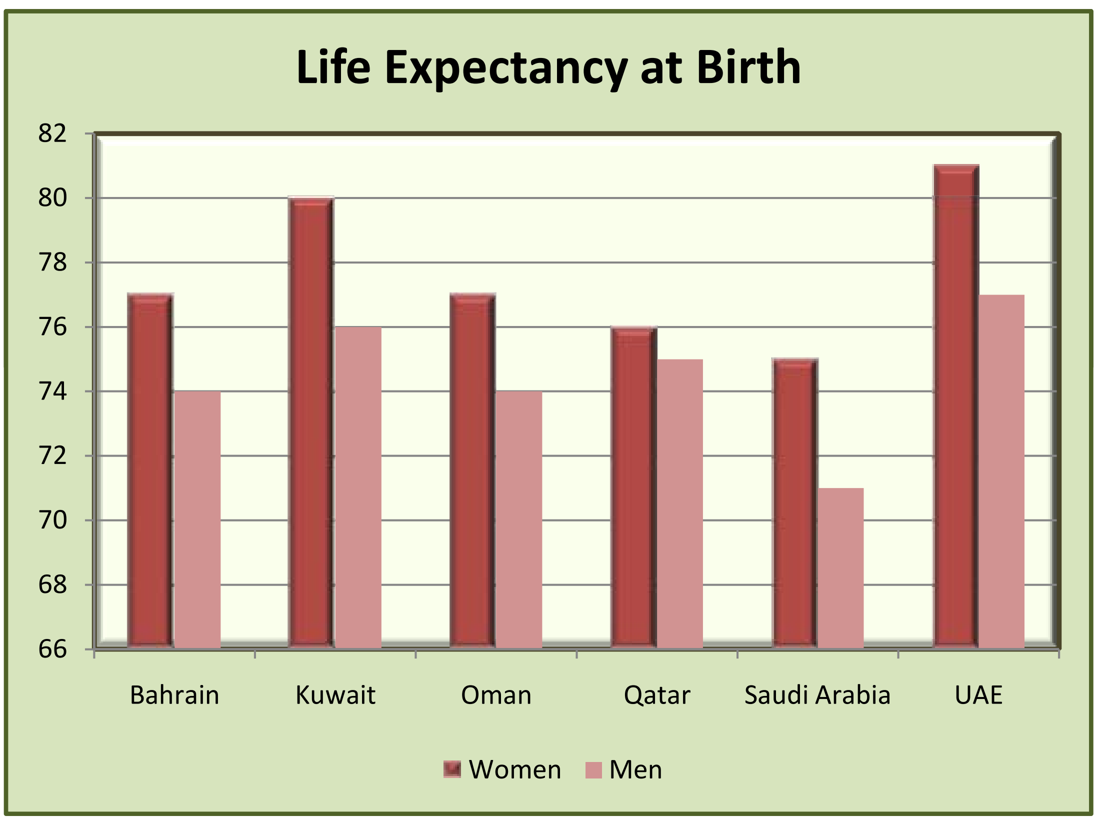

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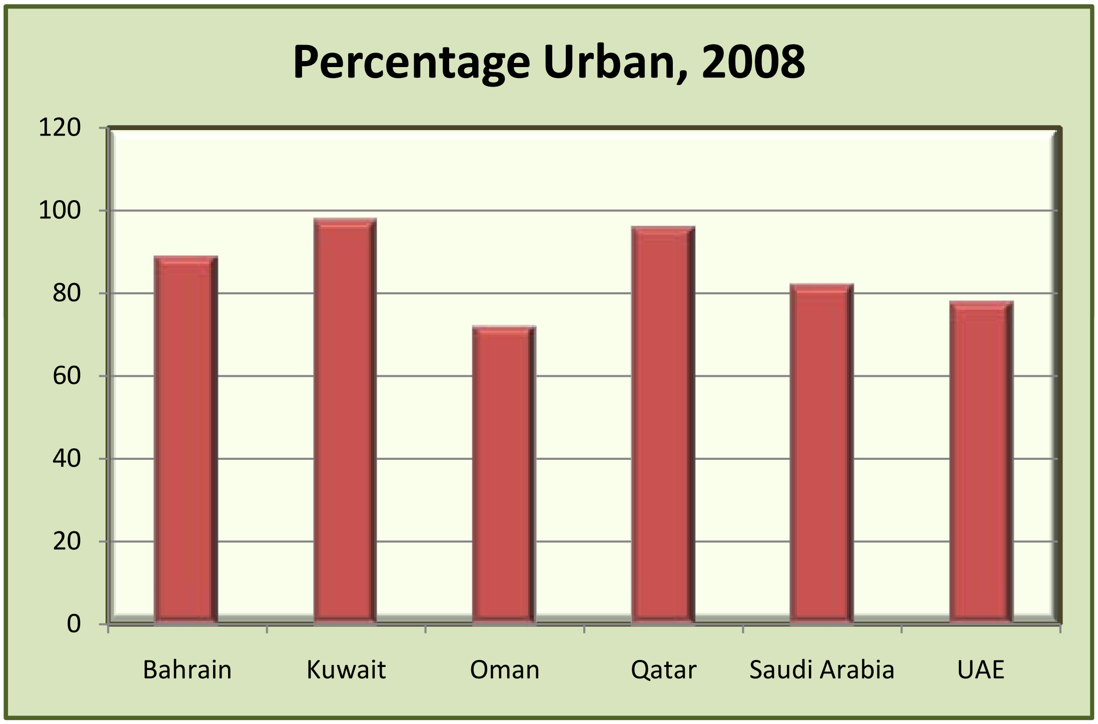

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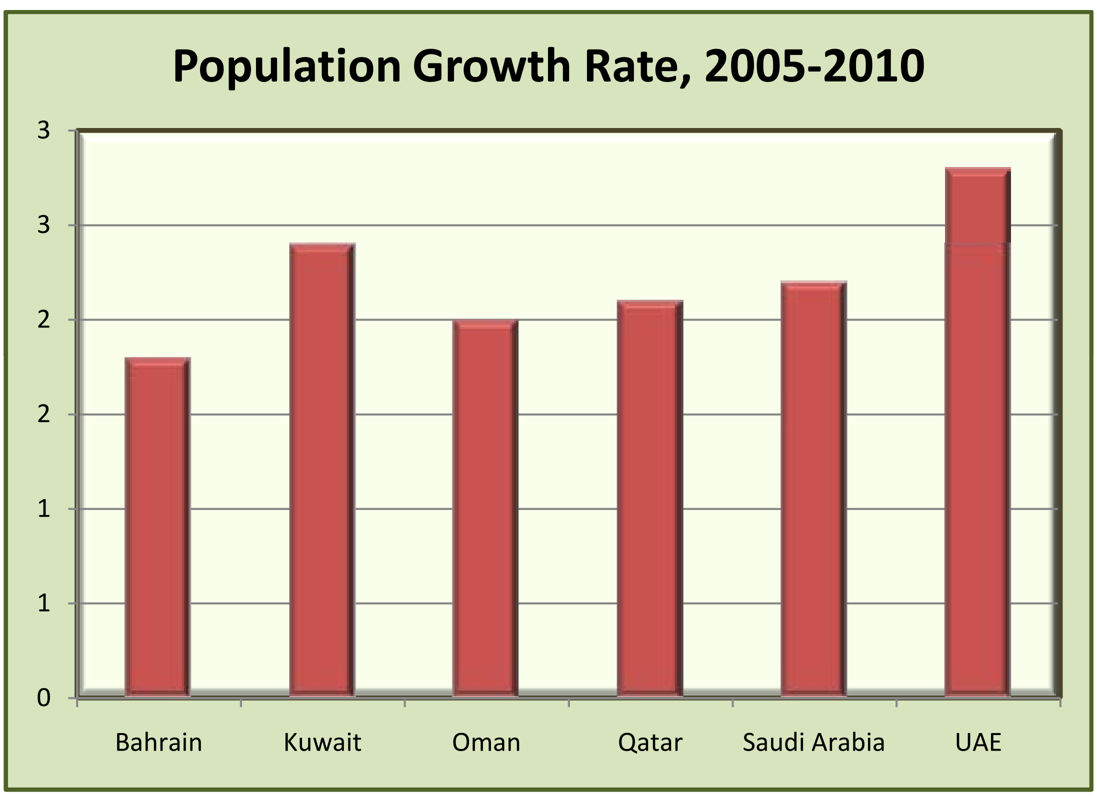

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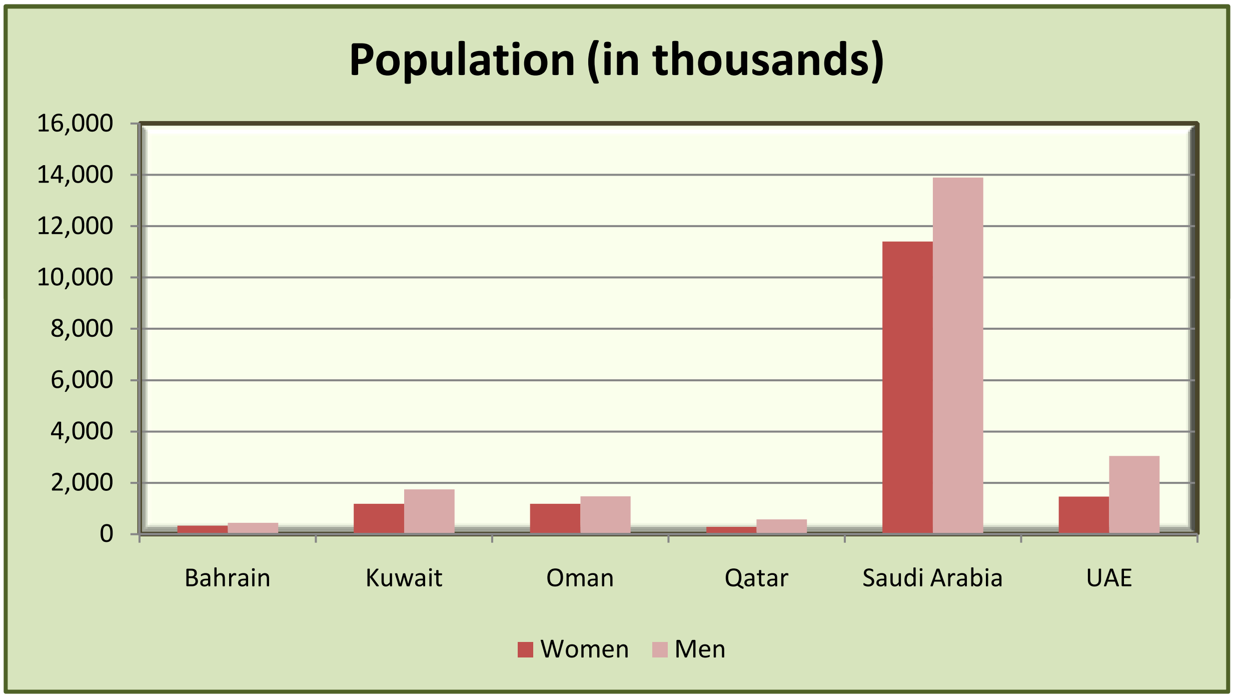

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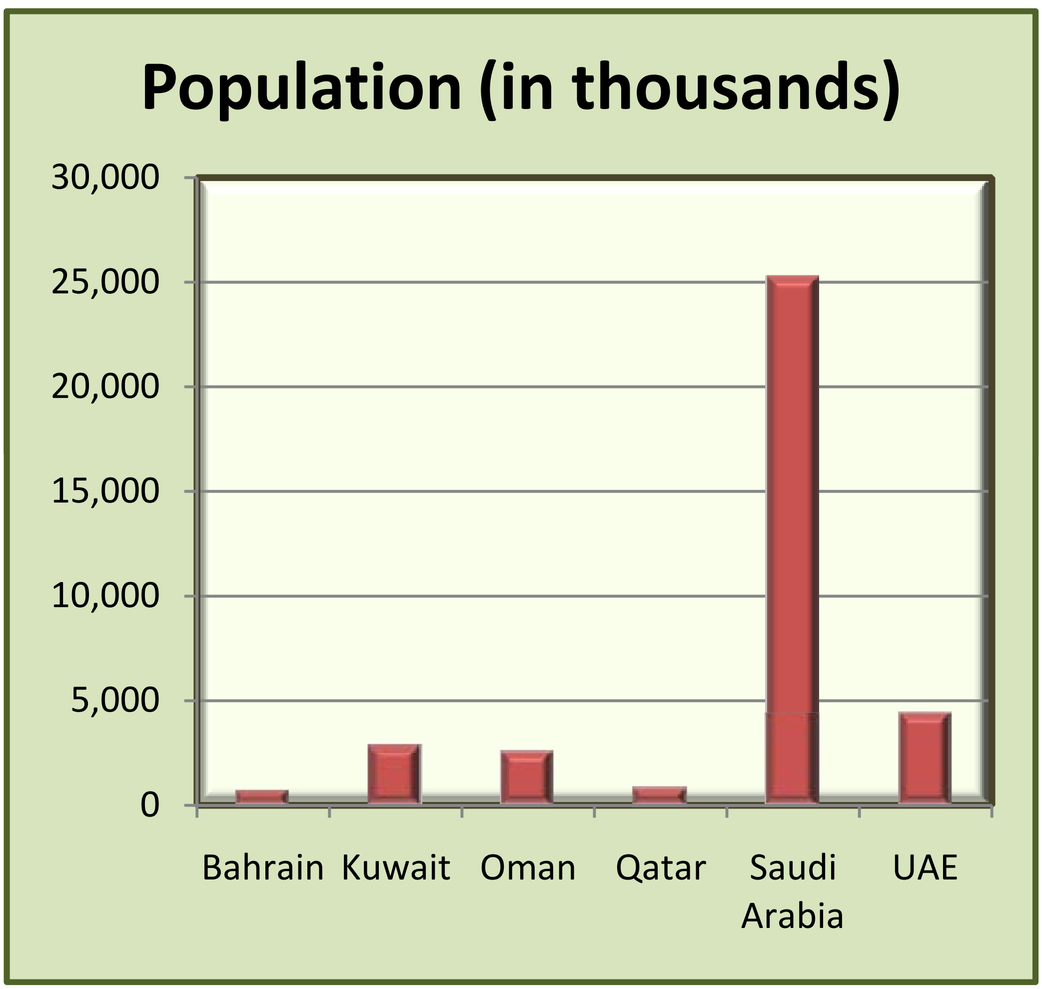

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