Macroeconomic Implications of Labor Reforms

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Expatriates' role in the economy

Benefits

- Addressed labor shortages.
- Kept wage levels low –lower Inflation – less pressures on real exchange rate.
- Prevented Dutch Disease.

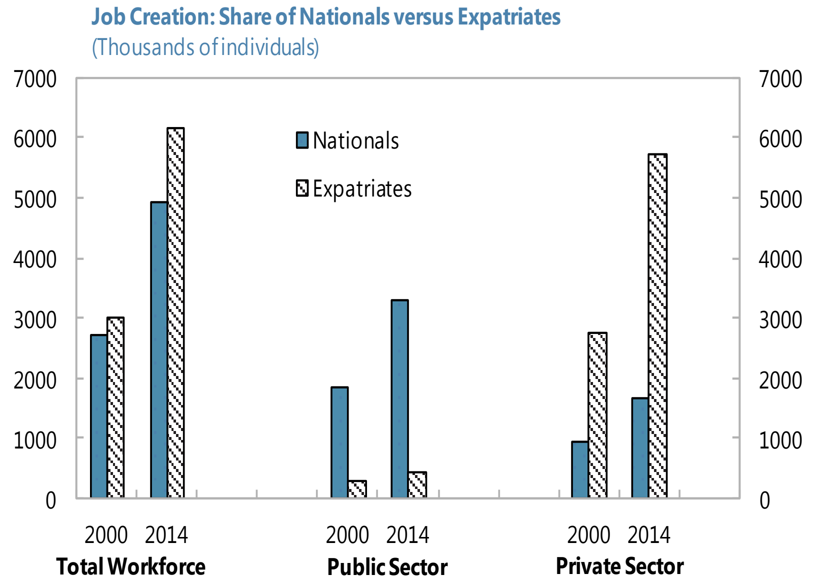
drawbacks:

- Crowded out nationals
- Skill-building of nationals lagged
- Locked economy in low productivity pattern

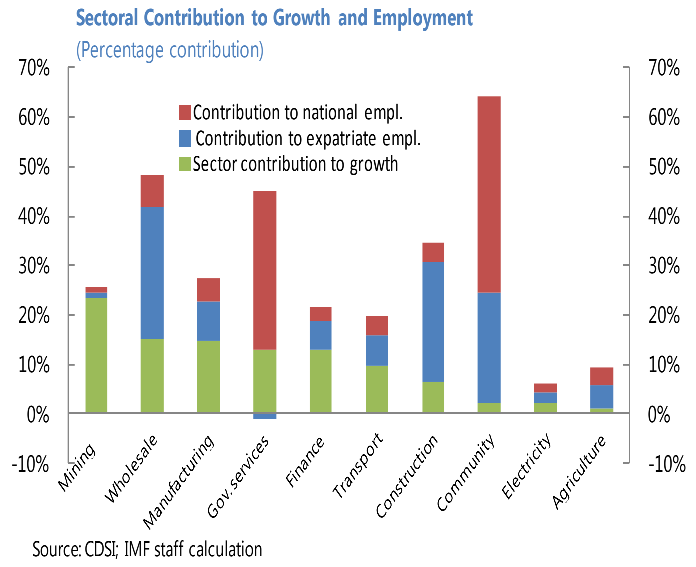
Weak link between growth and employment of nationals

Growth benefits foreigners

its main drivers contribute little to nationals job creation

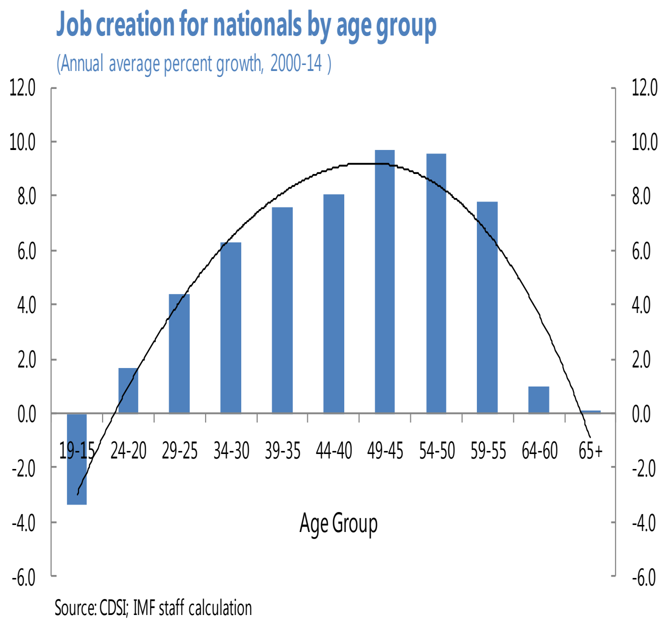


Source: Man power Survey, CDSI

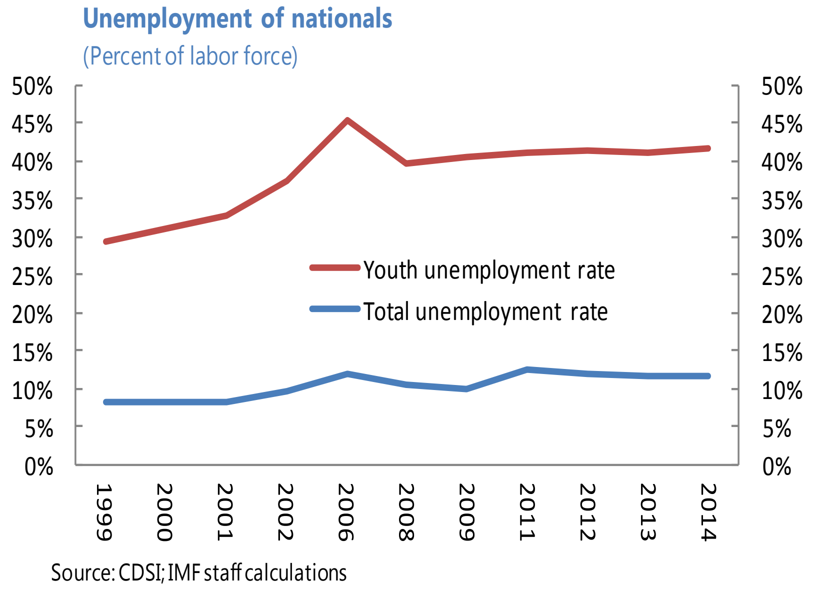


Unemployment high and persistent

Young work-age population is growing fast and benefiting least from growth



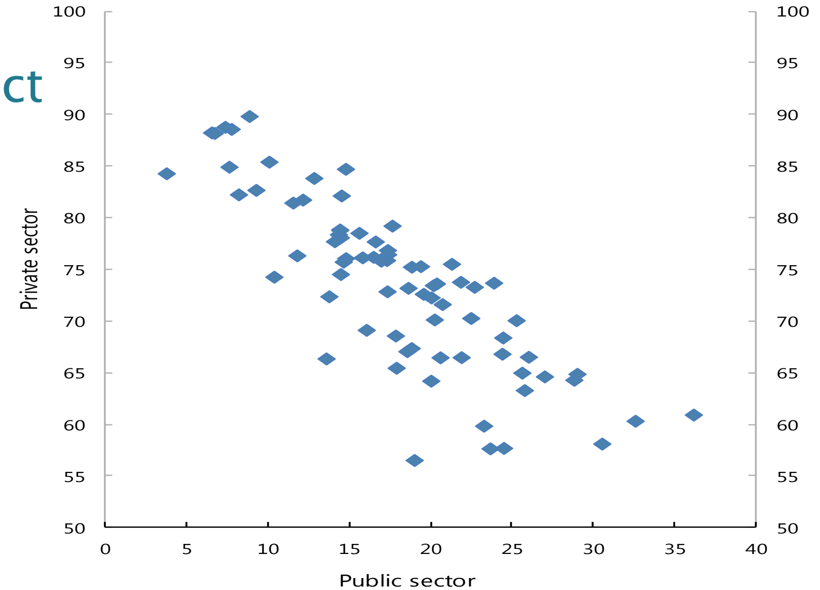
Leading to high and rising youth unemployment



Role of public employment

- Heavy fiscal burden
- Public employment crowding-out effect

Private and Public-Sector Employment Rate
(Percent of labor force)



Sources: Behar, A. and J. Mok (2013), "Does Public-Sector Employment Fully Crowd Out Private-Sector Employment?" *IMF Working Paper WP/13/146*.
Note: Each point marks a country. Data are for 2011 or latest year available.

Recent labor reforms

- Education and training
- Quota system –Nitaqat
- De facto minimum wage
- Other active labor policies: Hafiz, Hardship Incentive Program,
- Unemployment insurance system
- Higher fees on expatriates

Macroeconomic implications

- Immediate impact will result from quota and other active LP
- Education and skill building is a gradual process, impact in the long run

Channels of impact of replacement of expat with nationals

less remittance outflows+ higher wages+ larger propensities to consume from generated incomes

= possible higher inflation and appreciation of real exchange rate

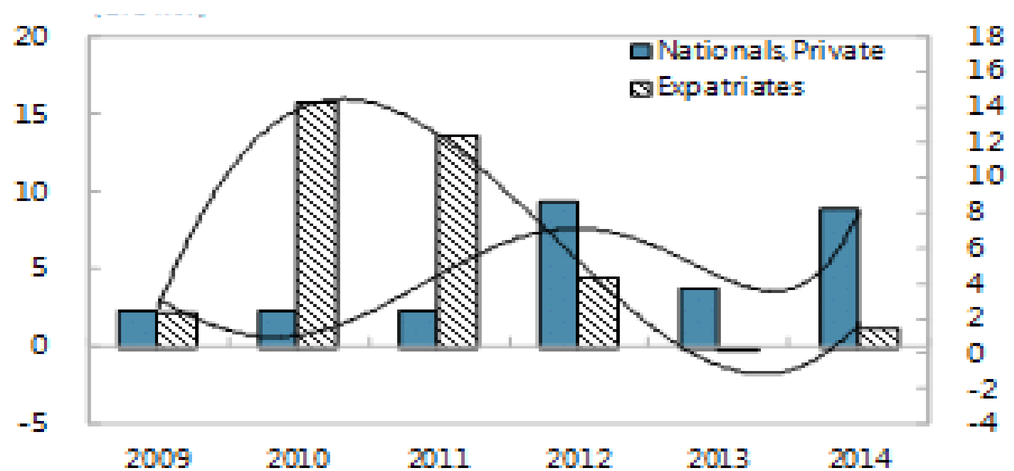
Better composition of skills with more investment in training =Higher productivity and potential growth

Macroeconomic implications

- First impact from Nitaqat: mixed results

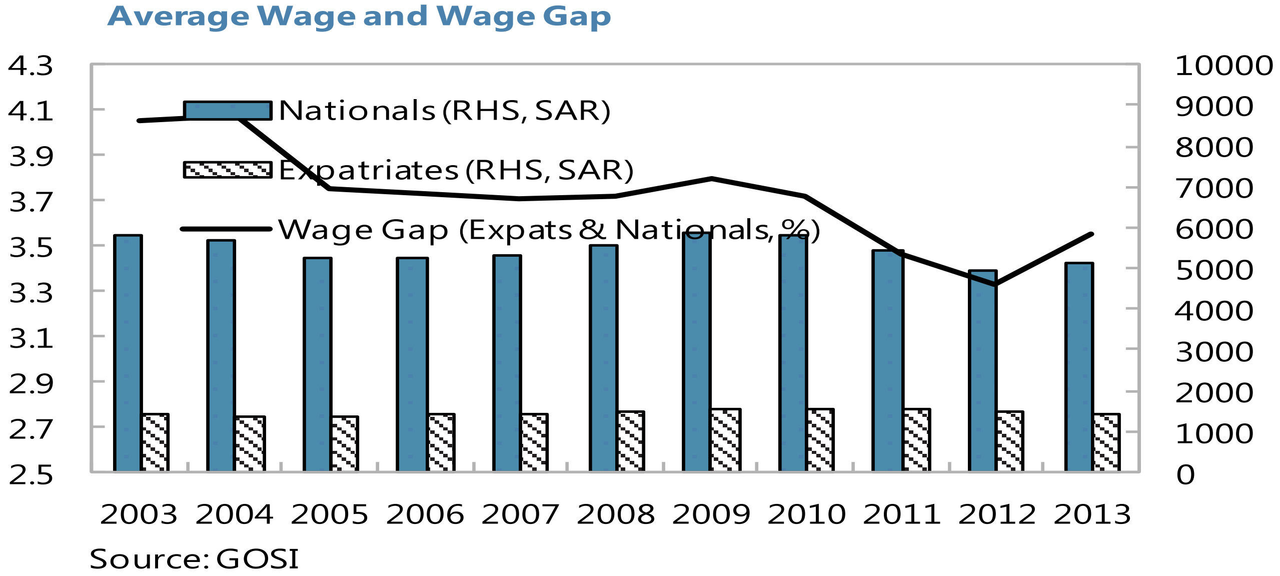
Higher employment of national but lower overall employment growth: other research reached similar finding (Peck 2014), Alshanbri etl (2015). **.. And unemployment remained high**

Saudi and Expatriate Employment in the Private Sector (Growth)



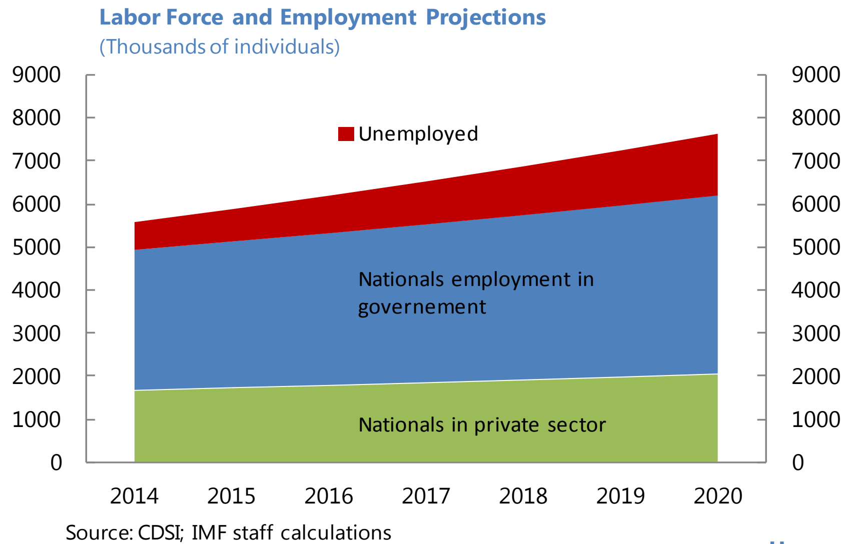
Source: Man power Survey, CDSI

Wage levels and gap increased



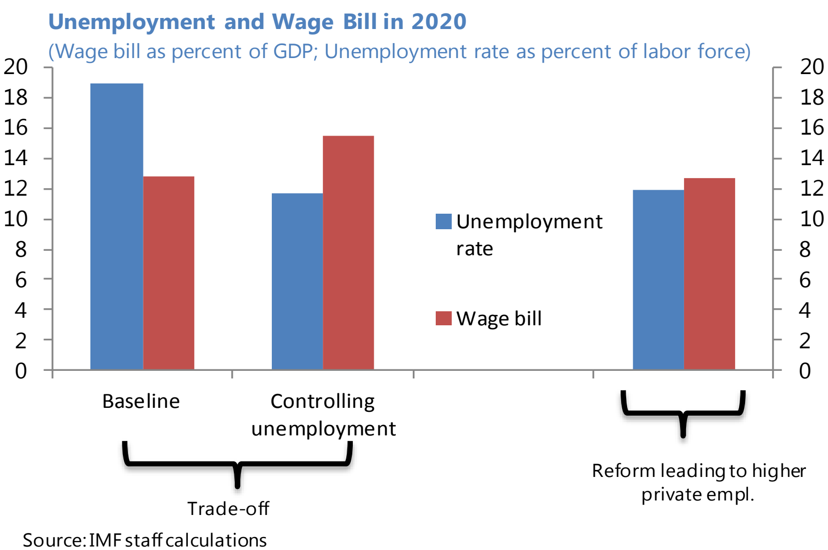
New minimum wage doubled wage of more than 50 percent of nationals in the private Sector

Fiscal implications



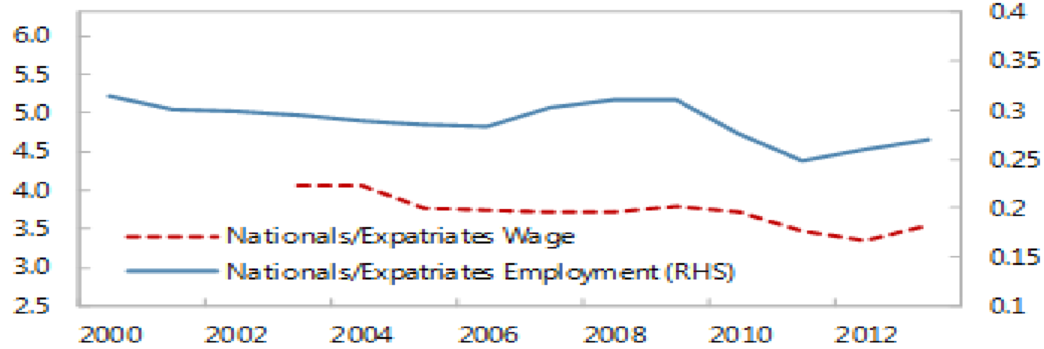
The government will face a trade-off between higher unemployment or higher wage bill

Reforms leading to replacement of expatriates by nationals could address this trade-off



Wage levels will increase further and affect firm cost structure

Employment of nationals in the private sector



Source: Man power Survey, CDSI; GOSI

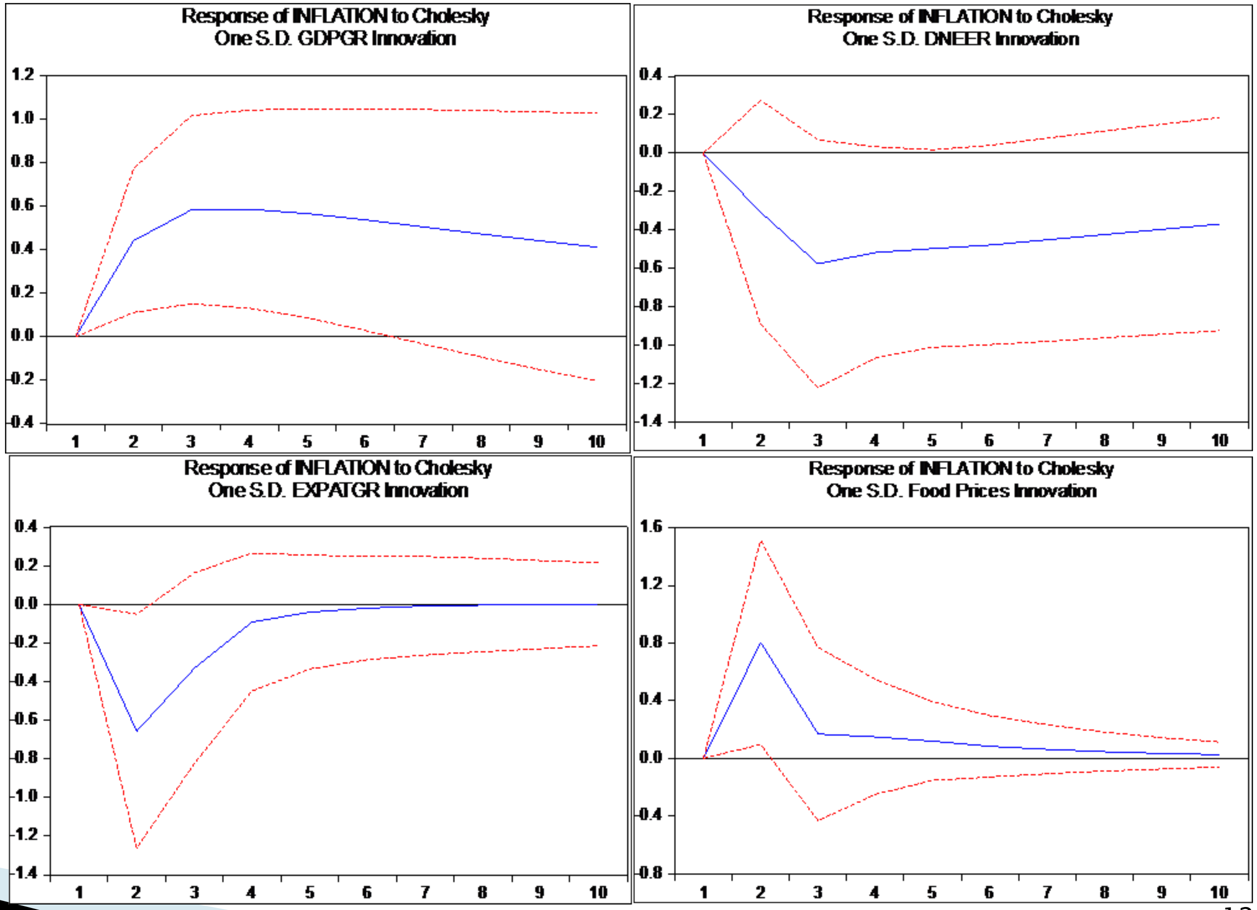
- Higher wage to attract nationals.
- Operational cost of firms could increase by 3 percent for every 10 percentage points increase in share of nationals in the private sector

Expatriates size has a significant impact on inflation: regression results from VAR:

Impulse Response of Inflation

GDPGR: Nonoil GDP growth
DNEER: Change in NEER
EXPATGR: Growth in expat employment
Food Prices

Staff calculations



Gradualism in replacement would reduce and smooth impact on inflation : VAR results

For 10 percentage points replacement:

- Achieved over 2015-2020, lower growth of expatriates by 2 percent annually

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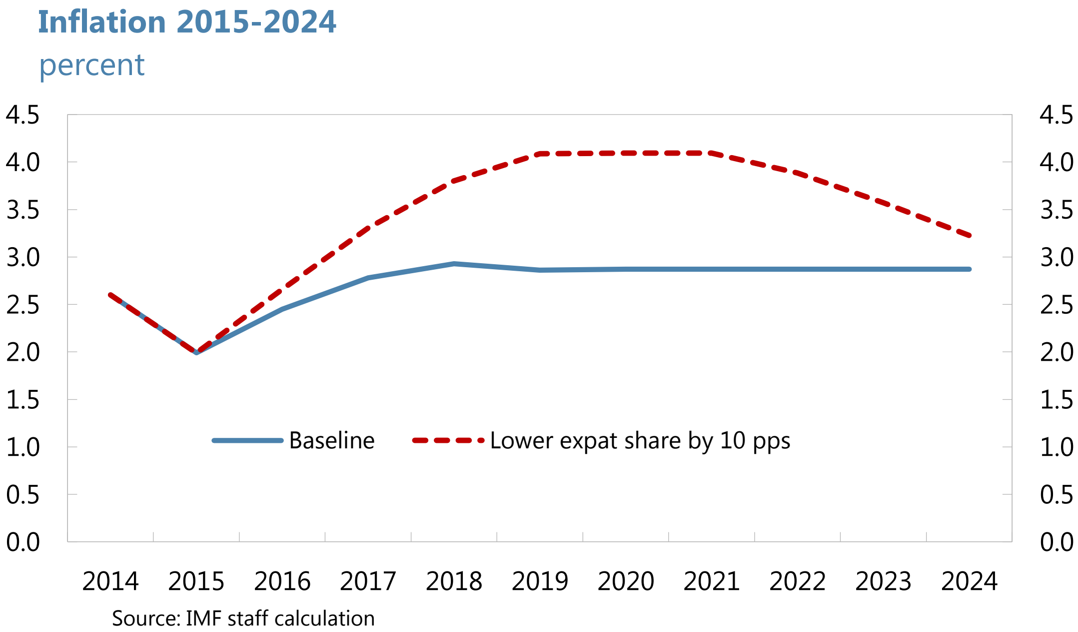
- If the ratio of expatriates were to be lowered at a faster rate, the inflationary impact would initially be greater.



Impact on growth and productivity

Growth accounting exercise: growth driven mainly by factor input, role of TFP small

$$\Delta\ln(Y_t) = \Delta\ln(A_t) + \alpha\Delta\ln(K_t) + (1-\alpha)\Delta\ln(L_t),$$

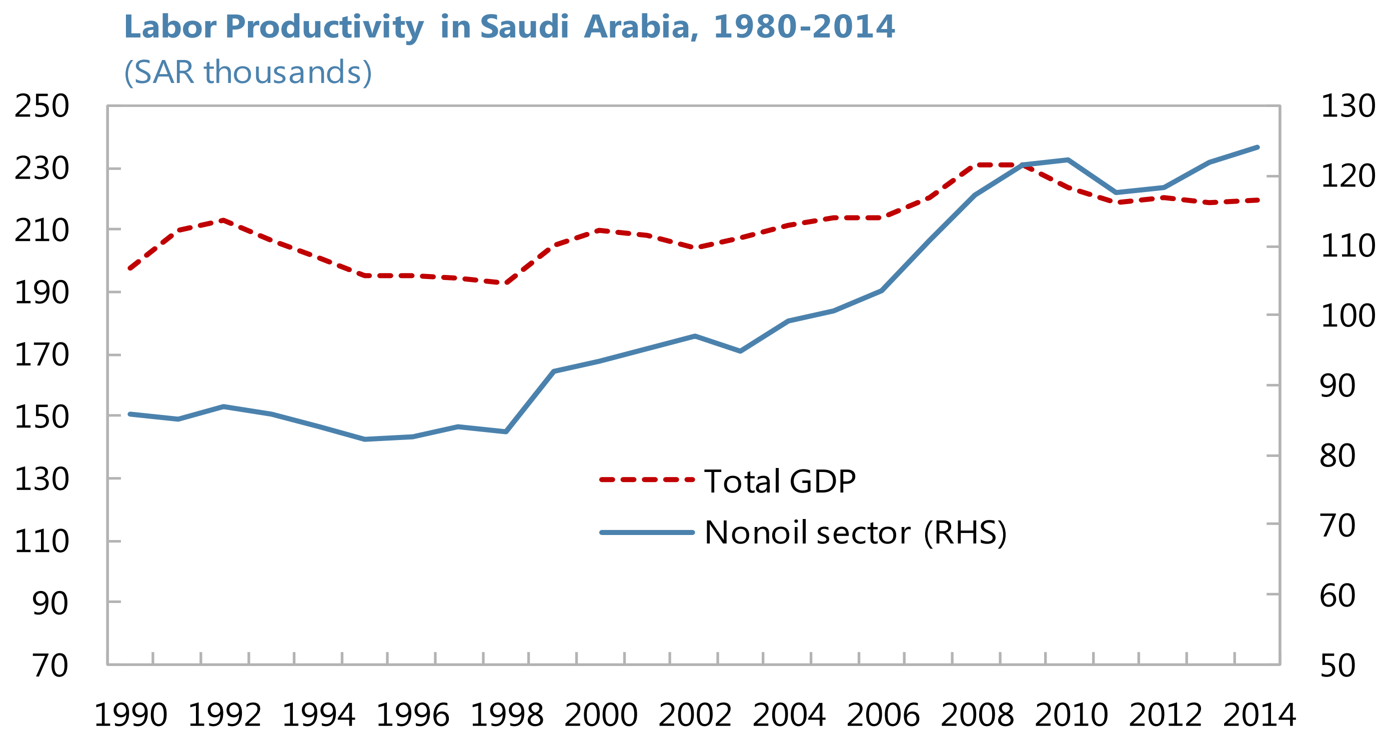
Smaller role of TFP from estimation of α (0.64) from data for SAU.

Average Contribution to Non Oil Sector Growth
(Percent)

	1990-99	2000-2014
	Cost Share of Capital (α) = 0.4	
Growth	2.9	6.8
TFP	-0.4	1.0
Capital	2.0	3.0
Labor	1.3	2.8
	Cost Share of Capital (α) = 0.68	
Growth	2.9	6.8
TFP	-1.2	0.3
Capital	3.4	5.0
Labor	0.7	1.5

Source: IMF staff calculations.

More investment in education and skills could further improve productivity



Sources: Authorities; IMF staff calculation.

Growth accounting with human capital

- Education attainment has contributed little or negatively to growth and productivity but improved since 2000.

$$Y = A * K^{\alpha} * (LH)^{1-\alpha}$$

$$\Delta Ln\,(y_t) = \Delta Ln(A_t) + \alpha\,\Delta ln(k_t) + (1-\alpha)\Delta Ln(H_t)$$

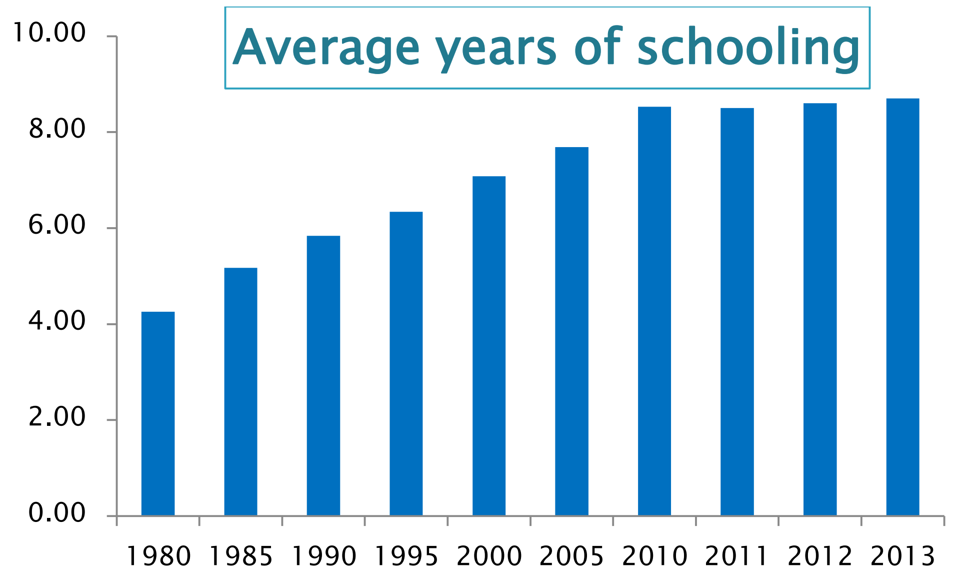
Table 2. Average Contribution to Labor Productivity

	Cost Share of Capital (α) = 0.4	
	1990-99	2000-2014
Productivity Growth	0.9	2.1
TFP	-1.4	0.1
Capital labor ratio	1.1	1.0
Human capital	1.2	1.0
	Cost Share of Capital (α) = 0.64	
	1990-99	2000-2014
Productivity Growth	0.9	2.1
TFP	-1.6	-0.2
Capital labor ratio	1.8	1.7
Human capital	0.7	0.6

Source: IMF staff calculations.

More emphasis on quality of education.. education attainment is reaching limits

- quality improvement in education and skills of nationals in order to improve productivity in line with the expected rise in wage levels



Long term macroeconomic policy response: alternative policy instruments to avoid Dutch Disease if labor market becomes less flexible and less able to play its historic role in containing overheating pressures

- Under the peg, **fiscal policy** is main instrument
  - strengthen fiscal framework and delink expenditure from oil revenue in a medium term framework
  - Reduce rigidities – lower wage and subsidy bills
- Over the longer term, more **exchange rate flexibility** would cushion the economy and allow more independent interest rate policy in controlling inflation

Recommendations

- Gradualism in replacement of expatriates by nationals
- More technical and vocational training
- Control of public employment size and compensation
- Move towards more flexible macroeconomic policy regimes