

ECONOMIC DIVERSIFICATION IN SAUDI ARABIA: THE PAST, THE PRESENT AND THE WAY AHEAD



**SELECTED ECONOMIC ISSUES IN
SAUDI ARABIA**

**IMF Delegates
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ECONOMIC DIVERSIFICATION IN SAUDI ARABIA: THE PAST, THE PRESENT AND THE WAY AHEAD

2

- Motivation
- Diversification in Saudi Arabia's Economy over the Past Decade
- Experiences with Economic Diversification in Commodity (Oil) Exporting Countries (*Malaysia, Indonesia, Mexico, Chile*)
- Business Environment: How Does Saudi Arabia Compare to other Countries? (*business environment, export promotion, labor market regulation, education*)
- Policies to Support Further Economic Diversification in Saudi Arabia.

Motivation

... so why diversify?

3

- Reliance on oil revenues makes the economy vulnerable to swings in oil prices
- Competitive tradeables sector will help boost productivity and growth
- More jobs need to be created for the young and growing population
- Put in place an economic model that will support the country as oil reserves eventually dwindle.

Diversification in Saudi Arabia's Economy over the Past Decade

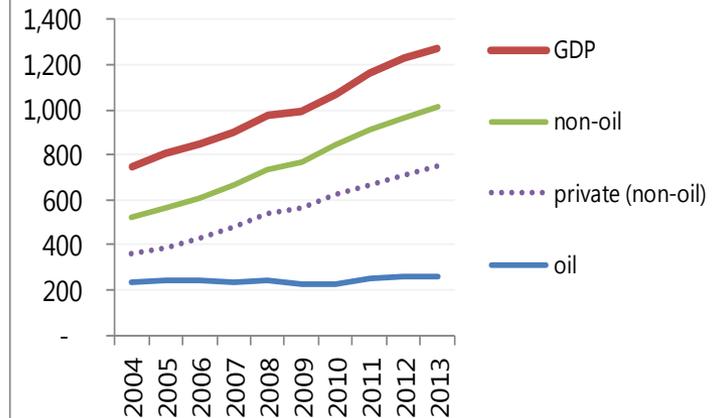
A. Economic production, sources of growth

4

- Historically, and contrary to expectations, non-oil GDP in Saudi Arabia has been dominant
 - a huge pickup—in level—over the past decade
- Real growth in the non-hydrocarbons sector has outpaced growth of oil, yet has decelerated as of late.

Real GDP: 2004-2013

(constant prices, 1999=100, Billion Riyals)



- Deceleration in Non-hydrocarbons growth across the board, several sectors.
- Strong correlation between hydrocarbon and non-hydrocarbon activity in nominal terms, relatively weaker in real terms

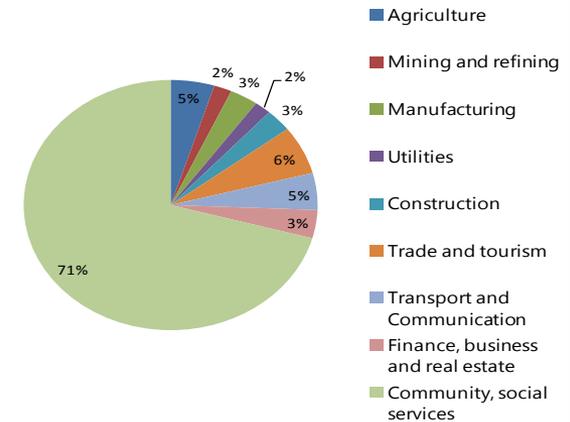
Diversification in Saudi Arabia's Economy over the Past Decade

B. Labor market structure: employment and wages

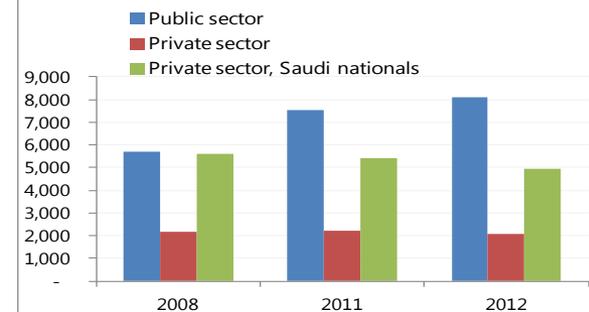
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- Since 2008 through 2013, Saudi Arabia added over 2.7 million new jobs to the economy, of which 1 million for Saudi citizens ... but most in the public sector.
- Cross-sectoral distribution of jobs lacked diversity.
- Differentials in relative wage structures and number of hours worked between the public and private job markets are a cause of potential labor market imbalance.

Employment of Saudi Nationals by Sector (2013)



Average Monthly Wage in the Public and Private Sector (Riyals) ^{1/}



^{1/} Average wage in the public sector is computed as total wages and compensation from the government budget divided by number of civil service employees (includes public administration and defense, education and health employees). Average wage in the private sector is sourced from GOSI.

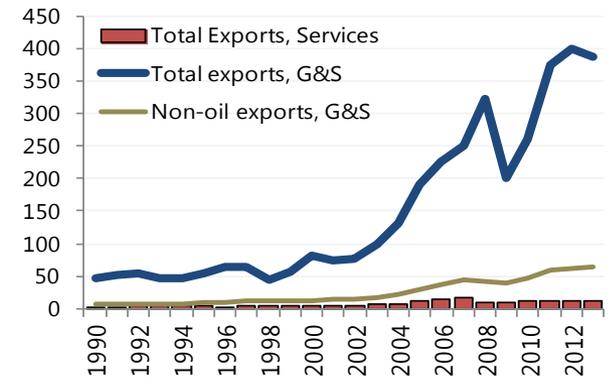
Diversification in Saudi Arabia's Economy over the Past Decade

C. Trade: Exports

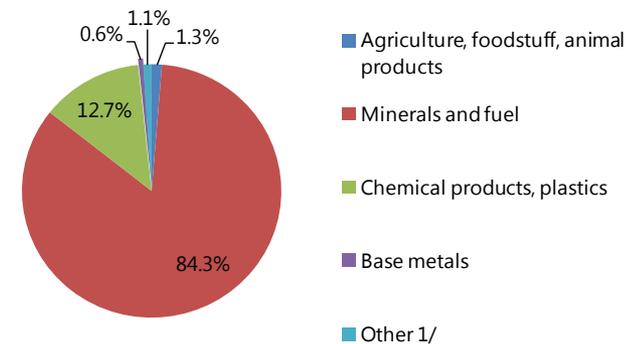
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- Diversification into non-hydrocarbon exports has progressed somewhat; the share of non-hydrocarbon trade to non-oil output has picked up and non-oil commodity exports have been impressively strong, albeit starting from a narrow base.
- Yet, exports are driven primarily by hydrocarbons (hydrocarbon-related products).
- The level and growth in services exports still weak, and restrictions on services trade exist.
- Also, the degree of sophistication in non-oil exports is low (food, base metals, etc).

Exports of Goods and Services
(USD billion)



Saudi Arabia Export Structure (sophistication) ^{1/}
2012



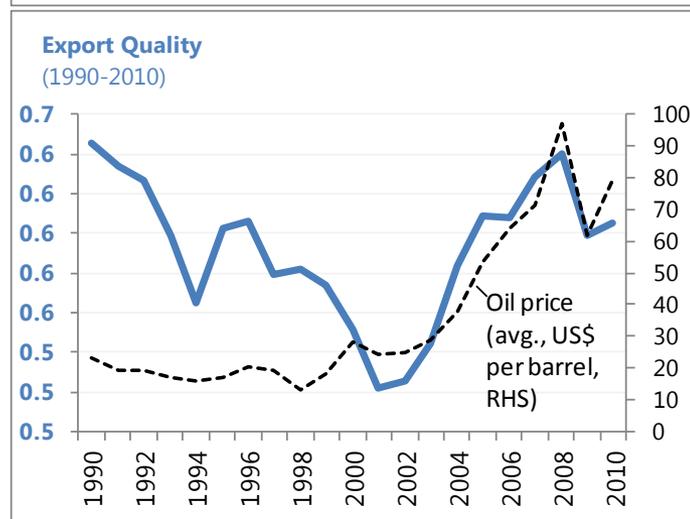
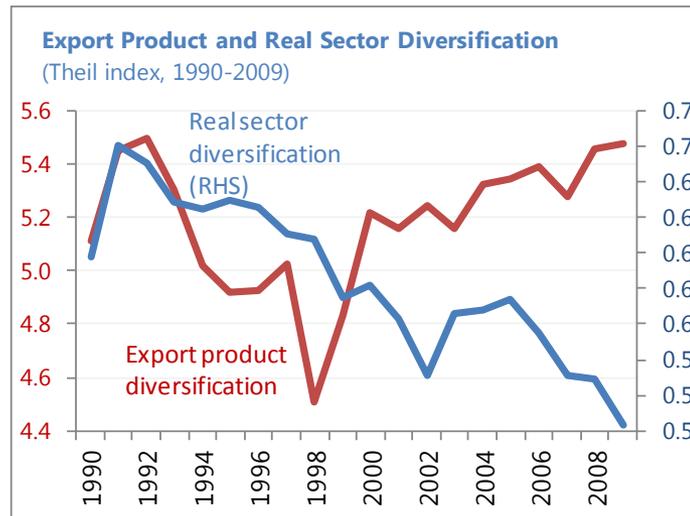
^{1/}Including re-exports.

Diversification in Saudi Arabia's Economy over the Past Decade

C. Trade: Exports (cont'd)

7

- Export concentration has increased since 2000, in opposite direction to improvements in diversity witnessed in real sector activity.
- Export quality remains low, has fallen in recent years, and is highly correlated to oil price developments.
- Trade diversification (regional penetration) remains weak:
 - over half of exported products geared towards Asia.
 - exports to GCC comprise only 7 percent of total exports.



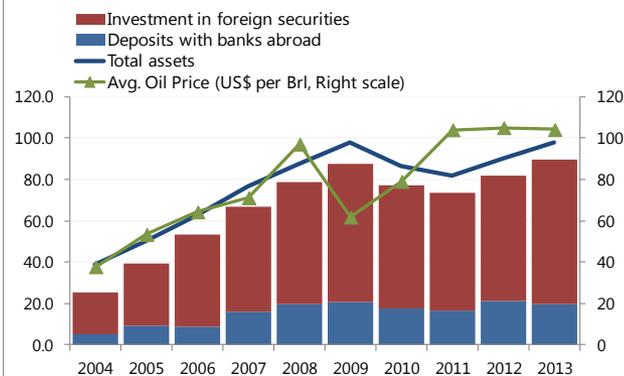
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D. Financial Assets

8

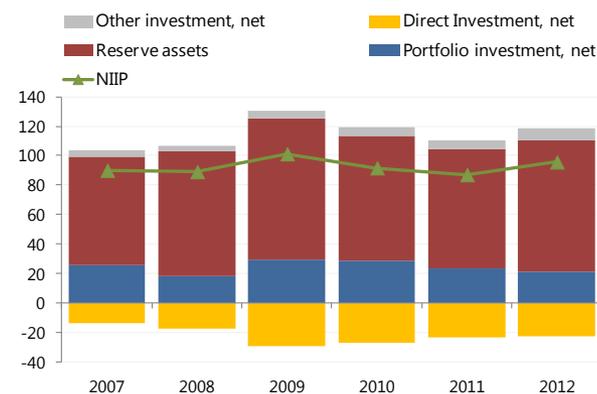
- Financial diversification improved: SAMA has managed to accumulate sizeable reserves over the years—as large as the size of the economy—investing most reserve assets abroad.
- Local banks, however, diversify less of their assets abroad.
- ... reflected positively on the Net International Investment Position (NIIP), which has improved over time, and remains strong, yet still a function of hydrocarbon export performance.

SAMA: Breakdown of Total Assets
(Percent of GDP)



Source: Saudi Arabian Monetary Agency (SAMA).

Net International Investment Position: Breakdown
(Percent of GDP)



Source: Saudi Arabian Monetary Agency (SAMA).

Experiences with Economic Diversification in Commodity (Oil) Exporting Countries

- Only a handful success stories: Experience from 4 commodity exporting countries: Mexico & Chile (Latin America); and Malaysia & Indonesia (Asia).
- In general, diversification attempts have been difficult, and prolonged.
- Historic experiences of these countries sheds some light on a number of key obstacles on the path towards diversification:
 - problem of the state and hydrocarbons sector being (remaining) driving forces in the economy,
 - natural resource-based industries and import substitution were not always sustainable as growth drivers,
 - heavy industrialization policy has not always been successful.
- Successful diversification seems to have come as oil production horizon shortens.

Experiences with Economic Diversification in Commodity (Oil) Exporting Countries

	Malaysia	Indonesia	Mexico	Chile
State intervention to spur growth in targeted sectors	✓		✓	
Technological transfers to improve competition	✓			✓
Import substitution	✓	✓		
Export promotion:	✓	✓	✓	✓
- Attracting FDI / foreign capital	✓	✓		
- Human and capital development / training and skills upgrading / encouraging innovation	✓		✓	✓
- Establish free zones		✓	✓	
- Provide tax incentives		✓	✓	
- Reduce trade barriers		✓		
- Export subsidies				✓
- Exchange rate devaluation		✓		
- Attractive wages (conducive business environment)			✓	
- Join FTAs			✓	
SME development / focus	✓			✓
Tapping non-traditional sectors (utilizing oil windfall to diversify other sectors)		✓	✓	✓
PPPs to develop new firms				✓

Experiences with Economic Diversification in Commodity (Oil) Exporting Countries

- Dutch disease: a common problem in oil exporting countries. Appreciating real exchange rates crowd-out the tradable sector.
- This traditional Dutch-disease doesn't seem a problem in Saudi Arabia. Flexible labor markets have kept wage pressures in the non-tradable sector under control. Real exchange rate not overvalued.
- However, oil revenues may crowd-out tradable production in other ways.
- Specifically, the transfer of oil revenues to the population through public employment and spending on goods and services may skew incentives away from private sector employment (for individuals) and exports (for firms).

Business Environment: How Does Saudi Arabia Compare to other Countries?

12

Business Environment

Pros

- 18th most competitive economy globally out of 144 countries ^{1/}
- Short time span to start a business (25 days, down from 70)
- Low startup costs (55 of GNI per capita, down from 60 %)
- Strength of investor protection
- Trade and transport-related infrastructure (“logistics performance index”) fares better

Cons

- Weak on contract enforcement (ranks 127 globally)
- Weak on resolving insolvencies (ranks 106 globally).
- Relatively high services trade restrictions index (GCC economies highest worldwide)

^{1/} According to the Arab Global Competitiveness Index (2013).

Business Environment: How Does Saudi Arabia Compare to other Countries?

13

Incentives for Export Promotion

Pros

- Export costs have increased in many countries , at slower pace in the Kingdom
- Number of documents required to export is low (5 documents)

Cons

- Trade integration dimension seems to lag behind (integration within GCC minimal)

Labor Market Regulation

Area

Current Stance

Limits on duration of fixed term contracts

No maximum requirement (no limit)

Degree of rigidity in working hours

Workweek can be extended beyond 50 hours, similar to policies adopted in most other emerging market and developing countries or even advanced economies

Redundancy rules

Applies similar legalities like most other countries

Business Environment: How Does Saudi Arabia Compare to other Countries?

14

Education

Pros

- High literacy rates, both for adults and for youth
- A good share of national income and budget spending is directed to the education sector (larger in comparison to other countries)
- The overseas scholarships program has been expanded (185 thousand students, at present)

Cons

- Nevertheless, a large part (half) of unemployed Saudi citizens hold graduate and postgraduate degrees.
- Trends in international mathematics and science study (TIMSS) data:
 - (a) number of years of schooling is low compared to other countries;
 - (b) enrollment rates in early/childhood education compare relatively poorly,
 - (c) education quality suboptimal (lower average math and science score).

Policies to Support Further Economic Diversification in Saudi Arabia

- Continue steps to improve business environment, develop domestic infrastructure, and invest in education and skills:

Business Climate

- Address remaining areas of weaknesses: strengthen ability to
 - enforce contracts
 - resolve insolvencies
 - improve labor regulation, and education

Education

- Greater focus on quality, attainment
 - ensure development of skills needed by private sector
 - ensure systems in place to realize improved outcomes from spending on education (efficiency)

Labor market reform

- Active labor market policies:
 - control public sector wages and jobs
 - increase competitiveness of nationals (ease hiring regulations)
 - greater mobility for foreign workers (narrow the wages differential)

Policies to Support Further Economic Diversification in Saudi Arabia

Infrastructure

- Prioritize, sequencing of mega projects
- Ensure public investment spending efficiency

Develop SMEs

- Continue facilitating access to finance

Other: specific measures for export promotion and trade integration

- Experience of commodity exporters highlights benefits from
 - export insurance guarantees, export credit, other financing
 - role of FDI in non-oil activity (strengthen manufacturing base to act as springboard for export growth)
- Strengthen Arab-Arab integration, accession to FTAs, Customs Union.

Conclusions and Key Takeaways

- Further reduced reliance on hydrocarbons—a prime aim of diversification—will have many benefits for:
 - macro stability: reduce economic volatility and uncertainty associated with global oil market swings,
 - labor market development: create jobs in private sector to absorb a young and growing labor force (especially, to attract nationals),
 - Increased productivity, sustainable, broad-based growth,
 - A strong non-oil economy, to withstand oil revenue downturn.
- Progress has been made in enhancing the business environment, improving infrastructure, and social dimensions of education and health care... Yet how far can further efforts encourage diversity without additional incentives.
- Biggest challenge: creating appropriate incentives to strengthen economic diversification... also, re-align incentives in order to:
 - scale up work opportunities for Saudi nationals in the private sector, and
 - ensure firms continue supplying the domestic economy while putting greater emphasis on international markets: non-hydrocarbons productivity and exports are a key pillar of diversification, to ensure export markets are seen as an attractive business opportunity for firms.