

SAMA Working Paper :

**Challenges to Production Base Diversification
in Saudi Arabia***

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*Translated from Arabic

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Challenges to Production Base Diversification in Saudi Arabia¹

Abstract

Production base diversification is one of the most important economic strategic objectives adopted by the Development Plans in the Kingdom. Countries with an abundance of only a few natural resources are obsessed with diversifying their production base, since they are vulnerable to economic crises due to their heavy reliance on natural resource revenues to fund their public budgets.

For instance, there are major oil-dependent countries that may face difficulties due to low oil prices. In GCC countries in general, and in Saudi Arabia in particular, progress is being made in the area of economic diversification, but it is still below expectations. There is no room for theorization; the current circumstances and the sudden crises that began to appear without warning have pushed economic analysts to constantly call for accelerating the pace of production base diversification and reconsidering government support.

The frequency of such calls has recently increased in view of the great plunge in oil prices that have dropped more than 50 percent in only a few months. This paper reviews the challenges to production base diversification in two major trends: on the demand side, by reforming the general framework for macroeconomic management and, on the supply front, by developing human capital, reforming the public sector, reducing labor market distortions and building an industrial base to boost exports. The paper also suggests that the success achieved in diversifying the

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production base by some countries centers around the government's support for SMEs.

For these reasons, a general commission has been recently established for SMEs in the Kingdom to monitor their performance, enhance their exports and conduct a review process to assess finance schemes and channels available for those enterprises through directing finance for the manufacturing of medium and high-tech export-competitive commodities. This effort should not only focus on the volume of financial aid, but also on its infrastructure and channels, concentrating on the financing of high value-added activities, such as industry and others areas. However, with regard to the Kingdom, SMEs have been focusing on low value-added activities such as trade, building and construction, which has led to the importation of mostly unskilled foreign labor, resulting in a higher level of foreign workers' remittances. This has minimized those enterprises' contribution in growth and employment.

This paper also concluded that those countries that have succeeded in achieving the objective of diversifying their production base are those that are successful in selecting high value-added foreign direct investment (FDI), so that they can diversify their exports, attract and train national labor, utilize leading technology and give their exports a regional competitiveness. The paper also pointed out that FDI in the Kingdom is concentrated in services activity (construction, maintenance and operation), i.e. activities with a high number of foreign labor and high use of subsidized energy resources. Furthermore, FDI in non-oil manufacturing industries remains weak. A large part has gone to investment in chemicals and refined petroleum products, which make the Kingdom's economy even more susceptible to global energy market fluctuations.

The paper also concluded that expediting and streamlining supportive measures for businesses that export high value-added commodities, through strengthening forward linkages (e.g., research, development and manufacturing) between large institutions on one hand and SMEs on the other, represents a real window to production base diversification. Such actions also enhance backward linkages (such as transport, supplies and storage) and establish industrial and commercial relationships between large institutions and multinational companies, on the one hand, and SMEs, on the other. This will eventually result in bringing technology and product development in the environment of a single activity (converting industrial cities into productive conglomerates), benefiting from experiences of other countries, reforming the labor market and raising productivity.

1. Introduction

Every step made towards production base diversification can be considered a real achievement that we should build on continuously, especially in view of global competition. Every achievement in this area, regardless of how modest it is, also represents a direct safeguard for the future of the Saudi economy in general and the economic potentials that are inherent in this economy. Actions speak louder than words since we will end up with the inevitable result; work and action advance our productivity regardless of its level and momentum. Hence, the need to develop sources of income and production persists. This subject deserves more deliberation and attention at all levels of governmental and the private sector. Attaining this vital goal would increase the country's ability to raise levels of public and private investment and consumption, in addition to financing maintenance and replacement requirements in infrastructure, whether physical, social, environmental or industrial.

2. Why Does the Kingdom Need to Diversify Its Production Base?

Saudi Arabia's current economic structure is still heavily dependent on oil. There is no other alternative better than production base diversification that would provide more jobs in the private sector, while also boosting competitiveness and productivity. Such diversification would also achieve sustainable growth and establish an industrial economy in the Kingdom that will be significantly more stable and less volatile, particularly in the future when oil revenues begin to decline. Lack of such diversification would hinder the country's advance to becoming a medium or even a high-income nation.

3. The Growth Model of the Kingdom of Saudi Arabia²

The Kingdom's prevailing growth model depends mainly on oil revenues that are redistributed in the economy via government spending on goods, services and employee salaries. Part of this spending relates to citizens' wages and payroll in the public sector and is classified as a consumption expenditure, while another part of it relates to capital spending on development projects, infrastructure and social services. This kind of spending goes to the payment of private sector contracts and profits. After four decades of oil exports, this sector's activity is still concentrated in three main areas: construction, services, and the importation and marketing of foreign products under Commercial Agency Law. This was achieved through the use of two main factors, (1) huge government spending in times

² Al-Khatir, Khalid, "Challenges to Oil Prices Plunge and Economic Diversification in GCC Countries", (2015).

of oil abundance and (2) cheap and intensive production factors (e.g. capital, cheap energy inputs and low-skilled foreign labor, most of whose income is lost to the domestic economy through workers' remittances abroad).

Saudi Arabia's economic future depends on building human capital, innovation and technological development, while the current model adopted in the Kingdom depends on two factors: generous government spending and intensive production factors. Most of the output of this growth is represented in higher real estate prices, accompanied by an unjustified increase in population due to huge import of foreign labor that does not generate human capital accumulation, lead to technological development and industrial transformation, or contribute to building a knowledge-based economy or diversifying exports. Perhaps this situation may end up in a bubble, followed by a recession for a long time until oil prices rise again.

4. Challenges to Production Base Diversification in the Kingdom

The challenges to production base diversification in the Kingdom are twofold. First, on the demand side, there needs to be reform in the general framework for macroeconomic management, and secondly, on the supply front, developing the accumulation of human capital, reforming the public sector, eliminating labor market distortions and building an industrial base to boost exports.

Reforms in the general framework for macroeconomic management (demand policies) aim at strengthening macroeconomic stability. In essence, this framework is a set of main macroeconomic policies used in aggregate demand management, namely fiscal policy, monetary policy and exchange rate policy.

In the area of supply policies, general framework reforms to strengthen macroeconomic stability should be accompanied by parallel reforms on the supply side, along with diversification of the production base and sources of income away from the hydrocarbon sector and associated industries. Overall, the diversification of production structures represents a long-term challenge that requires the following: developing human capital buildup, reforming the public and private sectors, and building an industrial base that supports the process of diversification.

5. The Role of Production Base Diversification and Increased Export Quality in Economic Growth Sustainability

Empirical studies have shown a strong correlation between production base diversification and sustainable economic growth in low and medium-income countries. Higher and less volatile levels of national income are correlated with the diversification of production and exports. Moreover, the diversification of production is closely associated with a similar diversification of exports; this link is one of the results of the structural transformation of the economy, due to the dynamic reallocation of resources from less productive sectors to more productive ones. High income levels are correlated with sophisticated high quality exports. Exports can be a significant channel to move forward in the use of modern technology and knowledge and scientific sources. Aghion and Howitt (1992)³ stress the importance of innovation and moving up the quality ladder and indicate that achieving human capital buildup, boosting productivity level and moving up the quality ladder requires that the country be exporting on a large scale.

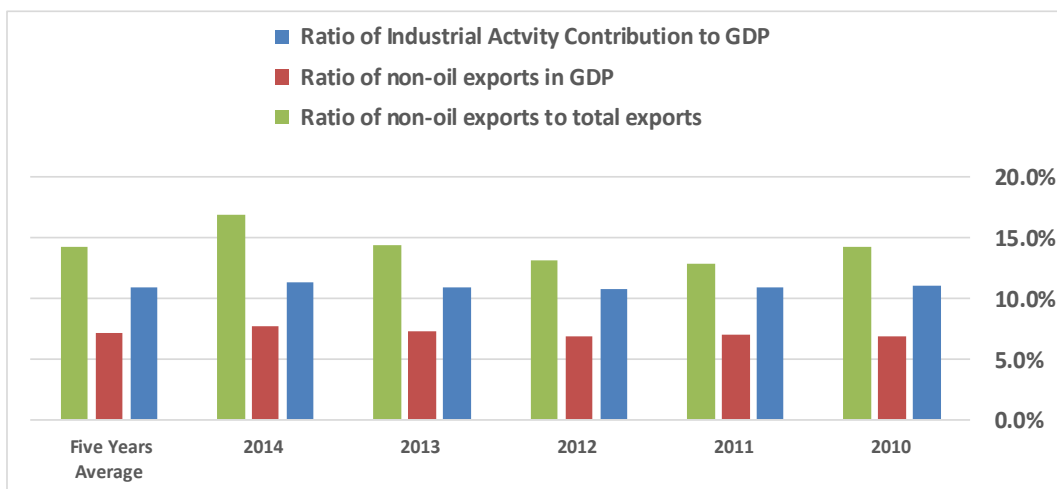
³ Aghion and Howitt (1992), Significance of Innovation.

Facts also show that raising the quality level of exports is strongly associated with high per capita income.

6. Production Base Diversification in the Kingdom’s National Development Plans

Long-term economic and social development strategies in the Kingdom emphasize the importance of economic diversification. These strategies are aimed at enhancing sustainable development, reducing reliance on oil revenues and creating more jobs for citizens in the private sector. Economic diversification is a significant stepping-stone to achieve all three goals mentioned above.

Chart 1: Non-oil Exports Contribution to GDP



Source: Central Department of Statistics & Information.

Chart 1 shows that the average of non-oil exports contribution to GDP for the past five years stood at 7 percent; the average of non-oil exports contribution to total exports amounted to nearly 13 percent, and the average manufacturing activity contribution to GDP stood at 11 percent. These indicators, which can be considered as a benchmark for the performance of

policies aimed at production base diversification, remain somewhat modest when compared with those of countries such as Malaysia, Korea, Japan, Singapore, and China. Thus, the need arises to find urgent solutions that will support production base diversification. Although there are some differences in the diversification strategy formulas among countries, and there is no clear and unified recipe for success, policies whose effectiveness was tested on the global level include the following:

√ intensifying investments in the field of education in general, including science, technology, technical and vocational education areas;

√ developing industry and supporting its activities, along with providing infrastructure (land, tax exemption and energy);

√ investing in infrastructure and strengthening the legal and regulatory environment to reduce the cost of doing business and industrial activities;

√ encouraging entrepreneurship and innovation through improving access to information, communications technology and finance, as well as increasing spending on research, growth and development aspects; and

√ focusing on raising the quality level of exports and their diversification to align them with economic strategies, which represent channels to build human capital and facilitate access to new technologies that are essential for increasing productivity rates.

7. The Role of the Public and Private Sectors in Production Base Diversification

In the public sector, following up the implementation of development plans and ongoing assessment of the effectiveness of economic policies to achieve

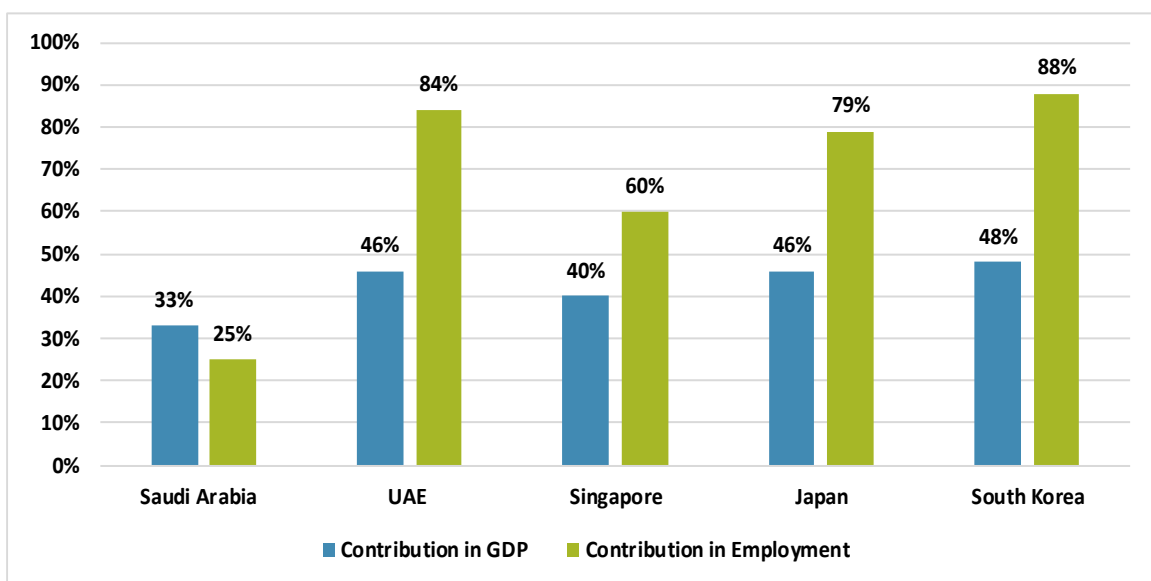
the objective of production base diversification is of strategic significance to the Kingdom. Here, the role of the government is to reform the market through business services, vocational and industrial training programs, in addition to providing incentives for on-the-job training by companies. However, the success of these efforts requires good determination, communication with employers, providing the necessary environment for the market, skills transfer and enticing creative competition. It also requires employing qualified persons with innovative and development inclinations, investing in industrial facilities, using e-learning, achieving a stable, economic environment with low inflation rates, expanding the scope of education sector, removing obstacles to FDI and deepening the financial sector. Government may also help strengthen ties between government-owned companies and multinational enterprises on the one hand and SMEs on the other hand, in order to promote development in export goods to attain its desired objectives.

In the private sector, the increase in its contribution to the national economy is directly related to the requirements of the production base diversification. This, in turn, is linked to the level of the private sector's efficiency and ability to manage various production units in light of market economy conditions and mechanisms. It is widely accepted that increasing the contribution of the private sector and developing its institutions will improve the market economy environment and will further liberalize the economy in terms of ownership, employment, trade and competition. Therefore, the competitiveness of the national economy will improve to accelerate the achievement of the objective of the production base diversification.

8. The Role of SMEs in Diversifying the Production Base

Many studies have stressed the correlation between developing SMEs and economic growth because they are closely interrelated. For example, the dynamics of SMEs contributed to the rapid growth of the economies of China and Taiwan in their early stages through manufacturing activity. Those SMEs provided the bulk of jobs in these two countries.

Chart 2: SMEs' Contribution to GDP and Employment in 2013.



Source: World Bank.

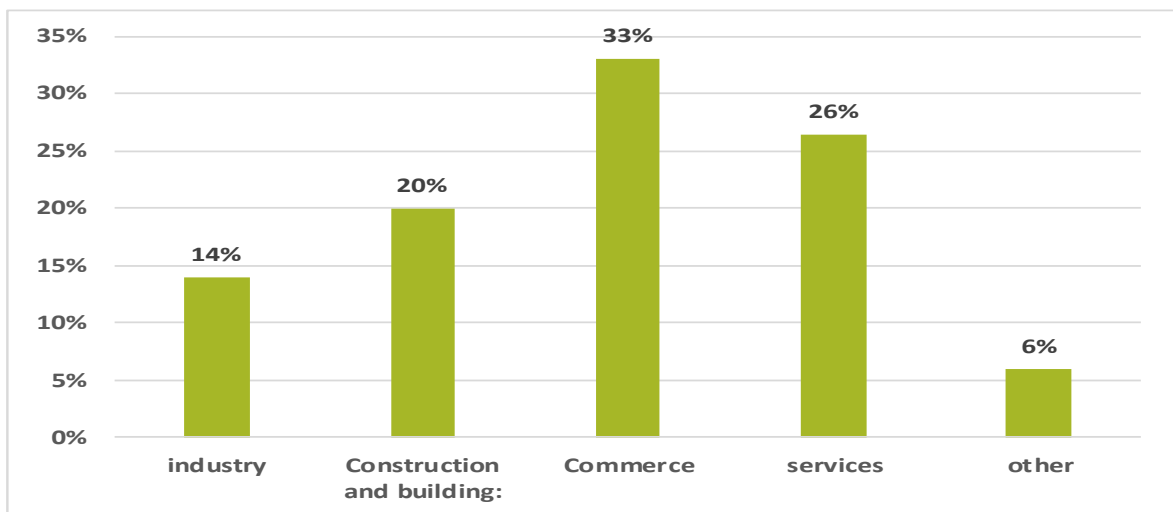
Chart 2 shows that SMEs' contribution to GDP and employment in some countries is significant; note that South Korea's contribution ratio reached 48 percent and 88 percent, respectively, during 2013. This was attributable to the government's support for these SMEs, supervision of their performance, support for their exports and a focus on finance infrastructure rather than its absolute volume. It was also due to the existence of specialized agencies or bodies dedicated to the support of industrial enterprises and their exports (thus creating a suitable environment for competition), facilitating the supply of highly skilled labor, and forming effective industrial facilities as in Japan, Singapore, Malaysia and others.

SMEs' contribution to GDP and employment in Saudi Arabia amounted to 33 percent and 25 percent respectively in 2013. These are considered to be rather low rates when compared to some other countries. This is because of several factors, including:

√ SMEs finance as a ratio to total private sector's finance does not exceed 3 percent. This is low compared to ratios recorded in developed countries, where it amounts to nearly 30 percent (Source: SAMA).

√ SMEs finance concentrates on low value-added activities (trade and construction). Those activities will increase import of low skilled foreign labor and increase transfers that will lead to a decline in its contribution in growth and employment. Chart 3 shows a breakdown of SMEs by economic activity in the Kingdom.

Chart 3: SMEs Loan Portfolio by Economic Activity in the Kingdom June 2015.



*Source: SAMA.

√ Much legislation and many laws are needed to increase the contribution of SMEs in GDP and employment.

√ There is weak cooperation and coordination among concerned authorities in their unification efforts.

√ There is evidence of a weak institutional approach and management in SMEs' feasibility studies.

√ Communication with big companies is another weakness.

√ This is all exacerbated by a labor force with low skills, training and little knowledge of using modern technology.

9- Challenges to Labor Market and Production Base Diversification

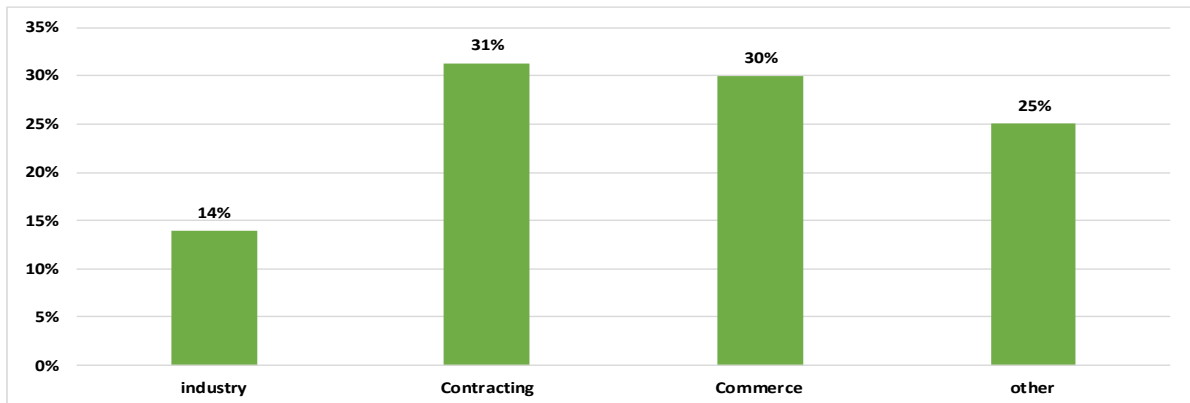
The oversupply of free or subsidized public services or cheap energy to private sector consumers has negative effects. Not only does it lead to wasteful and excessive consumption, but it also results in distortions in the labor market. Government intervention may not be sufficient to achieve the desired objectives (Saudization of the workforce and increased levels of industrial output) and may not address the root of the problems effectively. Such interventions may only deal with some of the minor symptoms. Although these policies may push private companies to hire more Saudis to meet the minimum requirements and avoid sanctions, they do not provide incentives for investing in high-tech manufacturing needed to diversify exports, boost competition and provide more permanent jobs for citizens. This is supported by recent findings showing that the number of new foreign workers entering the labor market has been much more than the number of Saudis; in other words, the gradual and selective reduction of expatriate workers has not yet been achieved. One possible reason for this is that the education and training institutions in the Kingdom may not be satisfactorily responding to the scientific and technological demands of the labor market. As a result, the ratio of Saudis who have education in science and technology stands at 9 percent while the ratio is 70 percent in Singapore.

In summary, negative factors such as 1) low productivity, 2) adopting employment policies to only meet regulatory quotas and requirements to avoid sanctions, 3) the shortage in skilled labor, 4) lack of incentives to enhance skills level, and 4) the excess of subsidized goods and services such as energy and transport will prevent the market from generating a competitive environment to encourage industry and achieve the cherished objective of production base diversification.

10. The Role of FDI in Diversifying the Production Base

The Middle East has attracted a reasonable share of foreign direct investment (FDI), partially due to the improved business environment in many economies. This is also the case in Saudi Arabia when its new laws entered into force in 2000. The economic equilibrium programs and the Foreign Capital Investment Law are considered among the main significant tools of the Kingdom's policy to encourage joint ventures and achieve economic diversification. Recent FDI has been concentrated in the services sectors in the domestic market (business services and contracting) and on sectors that overuse resources and foreign labor, while FDI in non-oil manufacturing industries has remained quite modest.

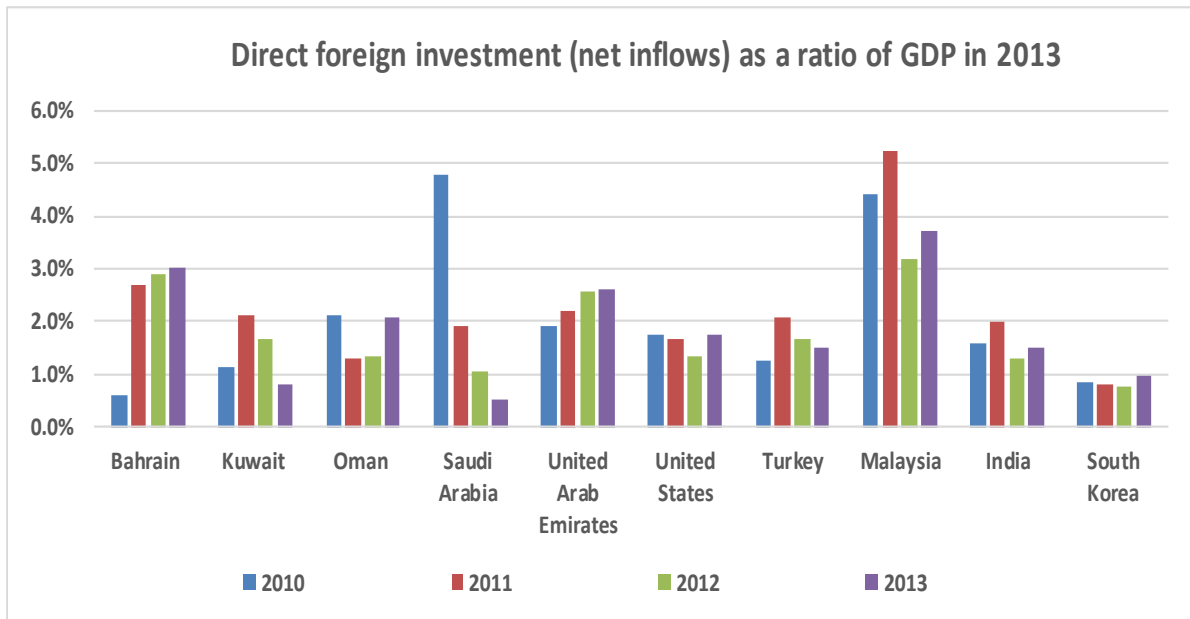
Chart 4: Breakdown of SMEs Financed by FDI by Economic Activity in 2013.



Source: General Investment Authority.

As shown in chart 4, the share of contracting services amounted to 31 percent, followed by trade services with 30 percent and industry (manufacturing) activity with 14 percent. Based on such shares, it is necessary to reconsider those activities and the value they add to GDP and employment. The manufacturing sector indicates a relatively low distribution in terms of FDI. Furthermore, investment in this sector is concentrated in chemicals and refined petroleum products, which makes them vulnerable to the fluctuations in the global energy market. Therefore, FDI should be directed to value-added industrial activities that will lead to export diversification, greater employment of the national labor force, and a higher level of regional export competition, so that the real objectives of FDI, especially production base diversification in the Kingdom, would be achieved.

Chart 5: Net Foreign Investment as a Ratio of GDP in 2013.



Source: World Bank, 2013.

11. Experiences of Some Countries in Production Base Diversification

South Korea

In 1970, exports of textiles, wood, wigs and shoes were salient characteristics of the Korean economy. In 1980, those exports shifted to iron, steel and shipbuilding, and then to the exports of computers, automobiles, electronics and telecommunications.

The factors that helped to achieve diversification in South Korea included the following government actions:

√ Paying attention to the financing of manufacturing activity since 1970. Korea's domestic savings were low at that time, but were strengthened due to external grants, borrowing and financial transfers.

√ Enabling rapid diversification and enhancing the country's capability to increase its international competitiveness by activating the concept of a

"knowledge economy". This was achieved through universal education, improving its quality and implanting a willingness to learn. The ability and willingness to do hard work and abide by industrial discipline were also keys to this success.

√ Pushing companies to make use of incentives offered to them when they show ingenuity in manufacturing and exporting, and addressed those obstacles hindering this, which led to the adopting of new technologies and the attainment of high levels of productivity.

√ Encouraging manufacturing research and reinforcing intellectual property rights.

√ Putting an ongoing assessment system in place that was directed at both existing and newly established SMEs.

√ Making use of performance enhancement programs.

√ Giving educational and training programs for owners of SMEs.

√ Setting up and equipping an advisory unit that performs onsite visits to project to attempt to improve productivity.



Malaysia

Malaysia achieved the best results in diversifying its production base from that of a rural resource-based economy during the 1950 -1960 period, when the share of manufacturing was less than 10 percent of exports. At that time, primary commodities accounted for 80 percent of its total exports. In 1970, the government began to pay more attention to the role of the private sector through supporting SMEs, attracting FDI and encouraging it to develop commercial manufactured goods via assembling, processing, and enhancing exported goods.

How did Malaysia achieve this diversity? The answer to this question can be summed up in the following points:

√ Benefiting from South Korea's strategy and its pattern of a vertically integrated industrial policy, which was adopted in 1980.

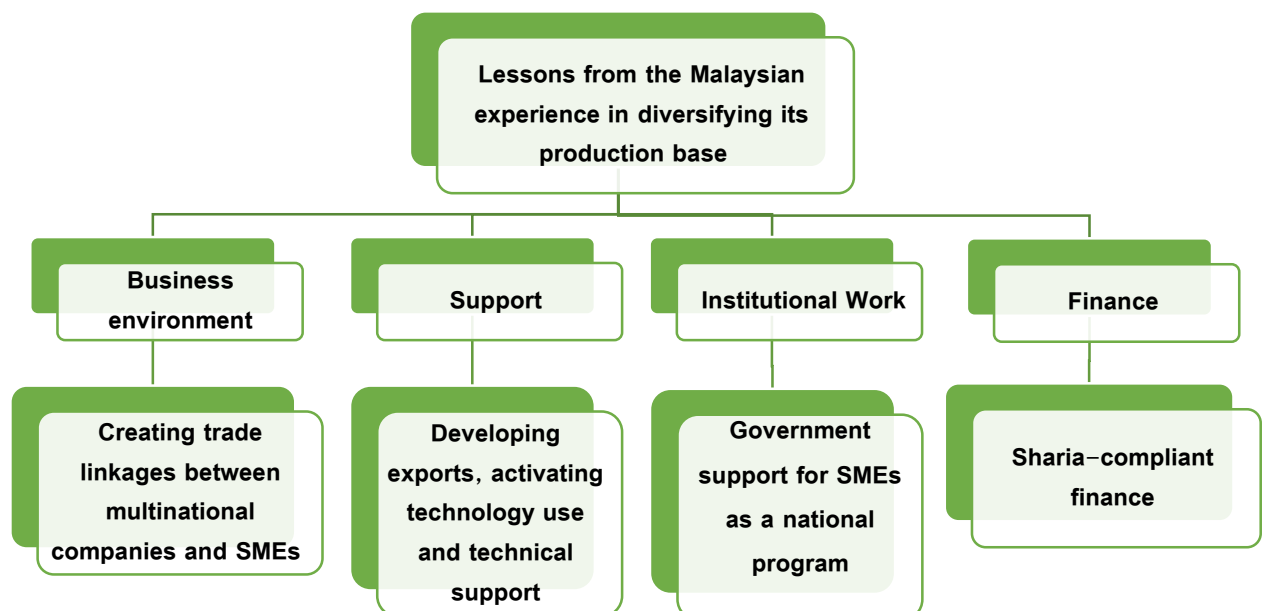
√ Developing manufacturing production related to machineries, automobiles, steel, cement and petrochemicals (again imitating the Korean model).

√ Removing customs barriers and setting controls for the import of machineries and equipment to support the competitiveness of local industries.

√ Developing industrial plans (e.g., the Second Industrial Master Plan, 1996-2005) for further technology enhancement.

√ Providing multiple channels to attract FDIs and direct them to high-tech activities and providing the necessary finance.

√ Supporting programs that gave the labor force high skills, spending on research and development, and promoting the entry of new industries to the country, resulting in an increase in the level of productivity.



12. Results and Recommendations

The Saudi government should take the following steps:

- √ Provide support to restructuring the most suitable sectors to create more jobs for citizens and contribute to diversifying the production base.
- √ Evaluate and review the current finance schemes for SMEs in order to direct them to supporting high-tech export goods industries.
- √ Establish industrial and commercial conglomerates between large institutions and multinational companies, on the one hand, and SMEs, on the other, to enhance technology transfer and product development at the environment of a single activity (converting industrial cities to productive conglomerates).
- √ Streamline forward linkages (research, development and manufacturing) between large institutions and SMEs; and enhancing backward linkages (transport, logistics and storage).
- √ Focus on the industrial sector to introduce linkages in a chain of unified production, distribution and marketing.
- √ Study carefully and benefit from the experiences of other countries (such as Malaysia, South Korea and Singapore) that have managed to diversify their production base away from the oil sector. The experiences of oil-producing countries such as Chile, Venezuela and others can be utilized.
- √ Minimize the private sector's reliance on the public sector, reversing the penchant of the private sector to depend too heavily on public sector activities and spending plans.

√ Develop industrial plans, such as the Malaysian Industrial Master Plan, (1996-2005) for further technology enhancement.

√ Put sophisticated and advanced economic data base and information systems in place to strengthen the management of economic activities and provide production-related information and data.

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