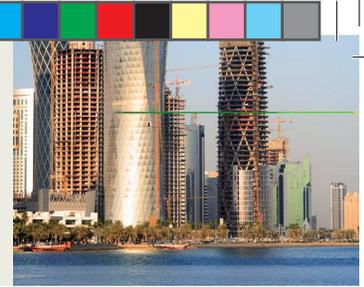




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About the research

This is the fourth report in a two-year programme of research into the long-term trends that will shape the GCC economies over the next decade. It was produced by the Economist Intelligence Unit and sponsored by the Qatar Financial Centre Authority; the Economist Intelligence Unit has had full editorial control over the report. The report is based on in-house analysis by the Economist Intelligence Unit as well as in-depth interviews with businesspeople, economists and academics familiar with the region. Jane Kinninmont was the author and Delia Meth-Cohn and Aviva Freudmann were the editors. The publication date was October 31st 2010.

Our sincere thanks go to all the interviewees for sharing their insight on this topic.

The other reports in the series are:

- The GCC In 2020: The Gulf and the Globe – looking at the changing role of the GCC in the global economy (March 2009)
- The GCC In 2020: The Gulf and its People – assessing the outlook for the region’s demographics, education and skills, and what it all means for the labour market (September 2009)
- The GCC In 2020: Resources for the Future – debating how the GCC states will manage key natural resources (oil and gas, minerals, water and food) over the next decade (March 2010)

All the reports can be downloaded from www.eiu.com/gulfin2020



Executive summary

Oil and gas are the mainstay of the GCC economies. They are the single largest sector in almost all the GCC states, and in most GCC states they also provide some 80% of export earnings and government revenue. The region's oil and gas endowments have proven lucrative, but they are finite resources that have historically been vulnerable to significant price swings. All the GCC states are looking to develop non-oil sectors in order to diversify their economies away from oil and gas.

There are three main reasons for this:

- Previous oil price slumps have made the risks of oil dependence clear.
- Oil and gas provide few jobs, and the region's rapidly growing young population can no longer be absorbed by the public sector.
- Over the longer term, the GCC needs to prepare for the post-oil age. Technological changes could significantly affect demand for oil even before reserves run out.

Policymakers will face five key trade-offs when pursuing diversification:

- Focusing on areas of greatest comparative advantage—generally energy-intensive industries—versus reducing dependence on hydrocarbons.
- Targeting most competitive industries versus a broad range of industries.
- Increasing the tax base versus maintaining low levels of tax to attract investors.
- Maximising growth versus targeting growth to create jobs for nationals.
- Pursuing nationalisation policies versus flexible labour markets.

The report identifies four clear areas of comparative advantage for the GCC, and outlines key trends in each sector over the next ten years: energy-intensive manufacturing, for example petrochemicals, plastics, and aluminium; mining and mineral-based industries; trade and logistics; and tourism, hospitality and aviation.

The key success factor here is the progress of education reforms. The best-case scenario, as hoped for by policymakers, is that the GCC states will manage to convert their current tangible oil wealth into intangible human capital, by investing in the education and skills that are needed for



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a transition from economies based on the primary sector to more diversified economies with more value-added, skilled sectors. Such a transition will be difficult and faces significant risks. It is not likely to be achieved within the ten-year timeframe covered by this report. But this overarching ambition will continue to shape policy over the next decade. It means that education will probably be the single most important economic policy issue for the GCC governments in the years to 2020.¹

¹ See our second report in this series, *The GCC in 2020: The Gulf and its People*, September 2009.

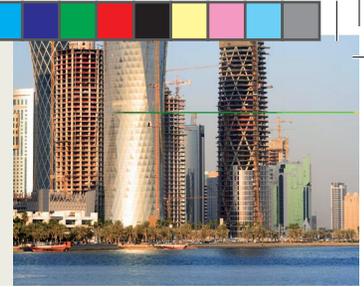


Introduction

This report aims to show how the structure of the six Gulf Co-operation Council (GCC) economies—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates— is likely to change over the next decade. It assesses the motivations for diversifying away from oil and gas and identifies the most promising non-oil sectors out of a range of sectors currently being pursued. As well as looking at the most likely scenario for diversification, the report also highlights the risks to the economy and to business if the region does not diversify away from its dependence on oil and gas, and discusses the risks to the diversification process itself.

From a business or financial investor's point of view, diversification is essentially a way to lower risks by spreading investment across a range of products or assets, thus reducing exposure to any one of them. For the GCC economies, diversification is also about reducing the risks that stem from their economic dependence on the oil and gas sectors, which, although lucrative, are finite resources that have historically been vulnerable to significant price swings. Previous oil price slumps have made these risks clear. Fear of cyclical, oil-price-induced economic downturns is not, however, the only reason that the GCC states are seeking to diversify. They are also looking at the long-term need to prepare for the post-oil age, and are aware that technological changes could have a significant effect on the world's demand for oil even before the GCC's oil and gas reserves run out (which is still more than a lifetime away for some of the states).

Crucially, the GCC governments are also keen to create jobs for their nationals that the oil and gas sector, which is a capital-intensive rather than a labour-intensive sector, is not able to provide. One of the key dilemmas in selecting the right diversification strategy will remain the issue of finding the right balance between sectors where there is a clear comparative advantage, such as energy-intensive industry, and sectors that provide employment for nationals, of which the most successful is the financial services sector. The key success factor here is the progress of education reforms. The best-case scenario, as hoped for by policymakers, is that the GCC states will manage to convert their current tangible oil wealth into intangible human capital, by investing in the education and skills that are needed for a transition from economies based on the primary sector to more diversified economies with more value-added, skilled sectors. Such a transition will be difficult and faces significant risks. It is not likely to be achieved within the ten-year timeframe covered by this report. But this overarching



ambition will continue to shape policy over the next decade. It means that education will probably be the single most important economic policy issue for the GCC governments in the years to 2020².

For investors, these trends mean that there will be a broadening range of investment opportunities in the Gulf region, but also that it is important to take a nuanced and sometimes sceptical view of the potential of specific projects in different sectors. The scale of the GCC's diversification plans means that private capital will be required in conjunction with state funding. Some of this capital will come from within the region; a key trend in the recent oil boom was that Gulf investors kept more of their money in the local economy as more investment opportunities arose. Gulf companies will also be seeking to tap international capital markets through the issue of international bonds (and Islamic securities), while local stock exchanges will gradually be upgraded in an attempt to attract more international investment, although this will again be a long-term process.

² See our second report in this series, The GCC in 2020: The Gulf and its People, September 2009.



The starting point: present-day context

Oil and gas are the mainstay of the GCC economies. They are the single largest sector in almost all the GCC states. Importantly, the hydrocarbons sector is also the main source of export earnings and government revenue. In most states, hydrocarbons – meaning oil and gas – account for at least 80% of both export earnings and government revenue, although the percentage fluctuates depending on the oil price.

It is therefore important to look at both direct dependence on oil and gas, in terms of their direct contribution to GDP, and indirect dependence. By indirect dependence, we mean the economies' dependence on the government sector, which is in turn highly dependent on oil and gas income.

Direct dependence

Direct dependence on oil and gas has been reduced since the 1990s, as a wider range of non-oil sectors has been developed. Over the next ten years, it appears likely that this trend will continue, with growth in the non-hydrocarbons economy forecast to average 5.1% per year, much higher than the 3.3% annual average growth expected in the oil and gas sector.

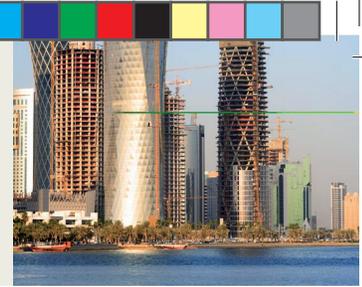
One reason is that growth in the hydrocarbons sector—especially the upstream (crude production) subsector—is likely to be slower than it was during the 2003-08 oil boom. The GCC states are not seeking to ramp up oil production as much as possible: they take world demand for oil into

Oil and non-oil growth

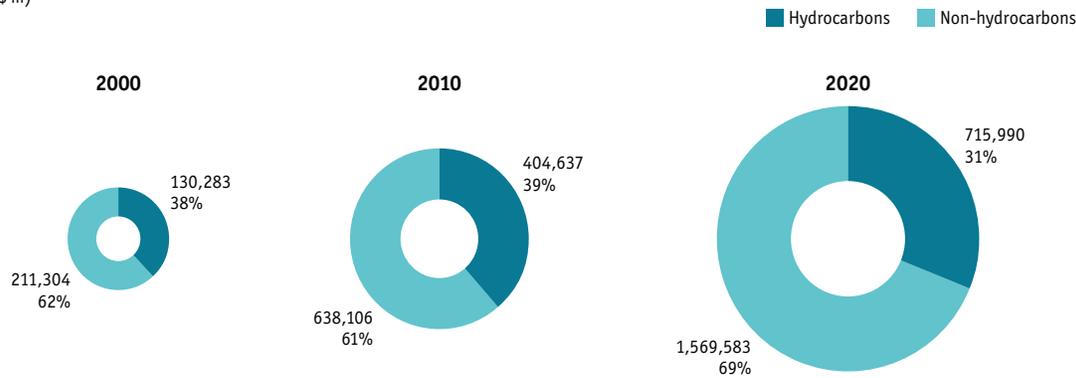
US\$m at 2000 prices unless otherwise stated

	2001-05	2006-10	2011-15	2016-20
GCC real GDP, average	391,428.4	529,387.5	646,937.3	812,916.9
Average annual % change	5.9	4.5	4.5	4.8
Of which, hydrocarbons GDP, average	137,282.7	146,682.5	163,295.1	189,227.2
Average annual % change	3.0	-0.7	3.8	2.8
Of which, non-hydrocarbons GDP, average	254,145.8	382,705.0	483,642.1	623,689.7
Average annual % change	7.6	6.8	4.8	5.4

Sources: Economist Intelligence Unit; country statistical agencies and central banks. Rebasing to year 2000 done by the Economist Intelligence Unit where necessary.



Nominal GDP, GCC aggregate
(US\$ m)



Sources: Economist Intelligence Unit; Country statistical agencies and central banks.

Nominal GDP, GCC aggregate

US\$m

	2000	2002	2004	2006	2008	2010
GDP	341,586	348,889	482,959	746,555	1,061,574	1,042,743
Hydrocarbons	130,283	115,570	186,208	337,582	520,261	404,637
% of total	38	33	39	45	49	39
Non-hydrocarbons	211,304	233,319	296,751	408,973	541,313	638,106
% of total	62	67	61	55	51	61

GCC total	2012	2014	2016	2018	2020
GDP	1,259,858	1,438,201	1,624,263	1,903,136	2,285,573
Hydrocarbons	463,227	465,334	556,644	628,782	715,990
% of total	37	32	34	33	31
Non-hydrocarbons	796,631	972,867	1,067,619	1,274,355	1,569,583
% of total	63	68	66	67	69

Sources: Economist Intelligence Unit; country statistical agencies and central banks.

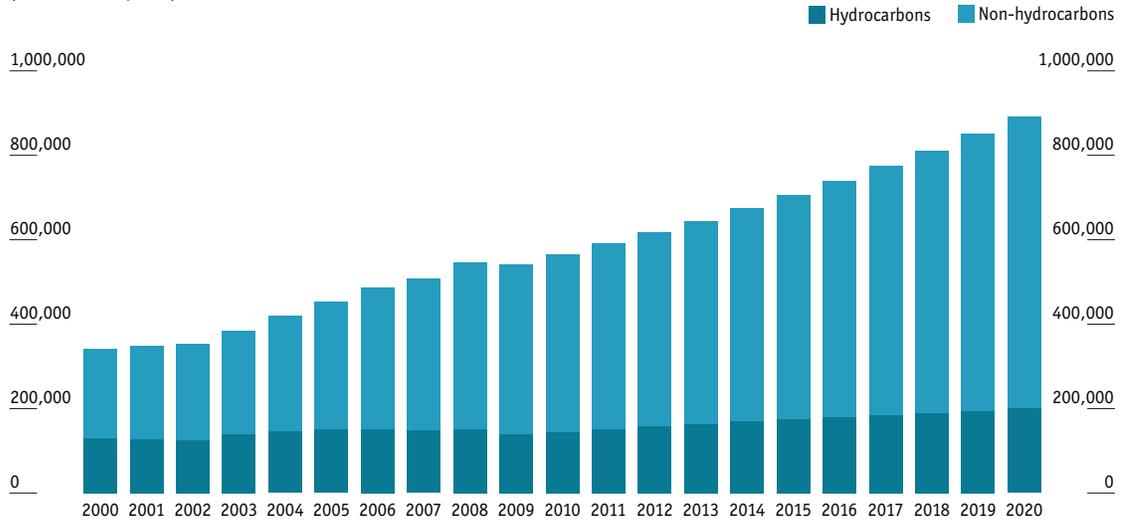
consideration and restrict their output accordingly in order to shore up prices. Since 2008, it has been clear that OPEC policy remains a force in the Gulf, with significant cuts made to production, even if OPEC's stated cuts were not fully implemented.

There is considerable uncertainty about future oil demand growth, but over the next decade demand is generally expected to be slower than it was over the last ten years, as OECD states adopt a broader range of energy sources alongside energy-efficiency technologies. Most of the demand growth is expected to come from emerging markets, but they too are rethinking their energy mix. The progress of international climate change talks designed to impose limits on carbon emissions poses some risk



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Breakdown of real GDP (US\$ m at 2000 prices)



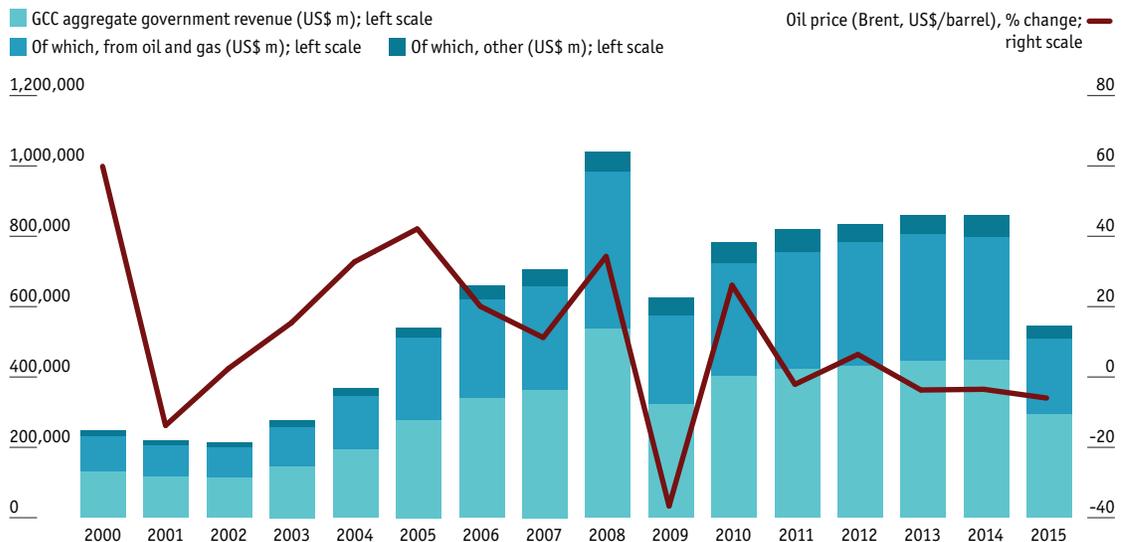
Sources: Economist Intelligence Unit; Country statistical agencies and central banks.

² GCC governments generally increased spending in response to the global recession, but they do not have clearly defined fiscal stimulus packages as is the case in the US and other OECD countries. A strongly expansionary fiscal policy had already been under way throughout the GCC since 2003.

to oil demand, but the most significant threat comes from new and emerging energy technologies, whether these are alternative fuels or ways of making growth more energy-efficient. On the supply side, there will also be new non-OPEC sources of oil (although some of the sources explored during the recent oil boom, such as Canada's tar sands, may be less attractive in the context of a lower oil price and could also be affected by evolving policy on carbon emissions as their production is relatively polluting).

Overall, in this international context, we expect oil production in the GCC states to grow at a restrained rate over the next decade. Gas producers are likely to be willing to increase gas output more rapidly, since demand is very strong (including the demand from within the GCC itself, as some

Government revenue from different sources

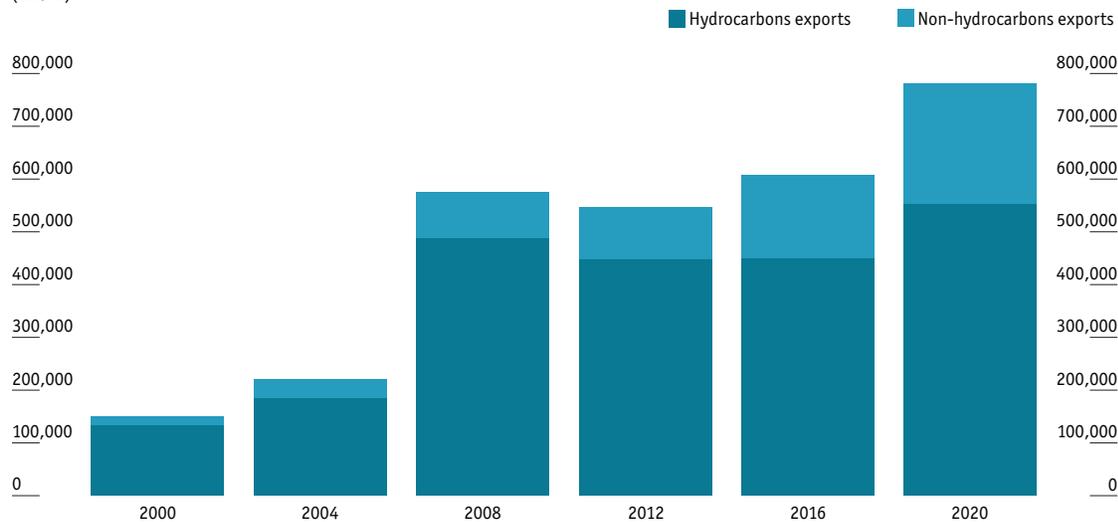


Sources: Economist Intelligence Unit; Country statistical agencies and central banks.

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GCC export earnings
(US\$ m)



Sources: Economist Intelligence Unit; Country statistical agencies and central banks.

GCC countries are now net gas importers). For the GCC as a whole the hydrocarbons sector remains dominated by oil. Overall, we forecast that the hydrocarbons sector will grow by an annual average rate of 3.3% over the next decade, with risks stemming mainly from unexpected oil price movements: in 2009 the GCC’s hydrocarbons sector contracted by an estimated 8.1% as a result of OPEC-mandated production cuts.

In the GCC, growth in the hydrocarbons sector will be increasingly concentrated in the upstream sector, such as refineries, as state-owned energy companies prioritise these more value-added projects (sometimes with investment from international oil companies). Petrochemicals are discussed separately in this report, but they are closely interrelated with the oil sector, although in GCC national accounts they are typically classified as “non-oil”. Non-oil sectors in the GCC are likely to grow more rapidly.

Indirect dependence

As a share of nominal GDP, the oil and gas sector is forecast to decline from an average of 40% of GDP in 2001-10 to 32% of GDP in 2011-20. After peaking at 49% in 2009, it is likely to decline to some 27% of GDP by 2020. However, this understates the sector’s economic importance: much of the growth in the non-oil sector will be driven by government spending, with many private-sector companies depending on government contracts and purchasing agreements. Indeed, the recent boom in the GCC was driven largely by double-digit annual increases in government spending. These levels of spending growth cannot be sustained indefinitely and the IMF has recently advised the GCC states to plan their exit strategies from the recent “fiscal stimulus” policies².

The role of the private sector is expanding (see below), but the government and public-sector enterprises retain overarching importance in determining growth strategies, prioritising projects and financing growth.



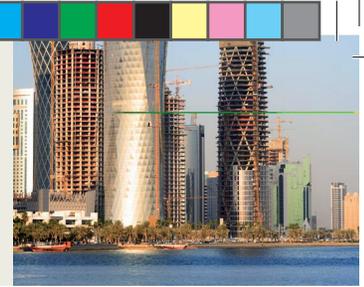
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Eventually, the GCC will need to find a balance between reducing the government's role as a driver of growth and finding new sources of government revenue to finance public-sector spending. These would come from a mix of investment income (on sovereign wealth fund investments) and taxation.

The latter will inevitably be politically difficult. The political model of the region is based on an implicit social contract whereby nationals pay very little tax and the state is a net provider of economic benefits funded by hydrocarbons wealth. The low-tax environment is also one of the key competitive advantages that the GCC has to offer investors.

If it is to maintain its role as a net exporter of capital, the region will eventually also need to find new sources of export revenue from both goods and services. The strong trade surpluses currently experienced are essentially a function of the oil and gas sector.

Moreover, the main "non-oil" goods exports are energy-based manufactures such as petrochemicals. Food is also an important export. Important services exports include tourism, trade and logistics, but in general the GCC states run services deficits as they import more services than they export.



Diversification to 2020

The motivations

There is a broad consensus on the reasons why the GCC economies should diversify. All the government diversification plans take note of the three main issues: the need to reduce risks, create jobs, and prepare for the post-oil age or “future generations”.

- Reducing risk

Dependence on a single export commodity is risky, because changes in the international price of that commodity can have a dramatic effect on the economy. The GCC states are well aware of this, especially since the oil price downturn of the 1990s, a formative experience that helped to shape today’s diversification strategies. “Fifteen years ago, the price of oil was US\$10-15 per barrel, and the GCC states saw their debts climbing, struggled to fund their public services, and were unable to invest in infrastructure,” says Matthew Alabaster, chief commercial officer for the Middle East at Aon, the US-based leading global provider of risk management services, insurance and reinsurance brokerage, and human capital consulting. “Now the boot is on the other foot, and they can move forward, but they remain wholly dependent on demand for oil.”

“It is of utmost importance that GDP is more distributed across various sectors, as a high economic concentration can lead to a very volatile economy,” adds Lukas Mueller, head of Client Management for the Middle East and Turkey at Swiss Re, a global reinsurer.

- Creating jobs

The GCC states have young and rapidly growing populations, the majority of which are under 25 years of age. Creating jobs for the GCC’s youth is a key policy priority for all the GCC governments, in order to make the most of their human resources and to forestall the possible social problems and political risk that can be associated with high rates of unemployment. Traditionally, the civil service has been a major source of employment for Gulf nationals, but this approach to job creation creates overstuffed bureaucracies and is increasingly expensive to maintain.

Oil and gas production is not a labour-intensive business, and therefore another reason to diversify is the imperative to create more jobs in more labour-intensive industries. “The oil and gas sector provides employment for only 1% of the population,” estimates Mr Mueller. “If they don’t find new

³ Available to download from <http://graphics.eiu.com/upload/eb/Gulf2020part2.pdf>.



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sectors, unemployment could be a problem in the very near future.”

Similarly, Hartmut Reinke, director for the Middle East, Turkey and Africa at DuPont, a US-based chemicals company, says, “The governments understand that oil and gas don’t create jobs, and that often the engineers are just coming in from outside, whereas something like packaging production creates a lot of employment locally.”

The choice of sectors that are desirable for job creation will vary from country to country. The most populous countries, notably Saudi Arabia, have a greater need to provide a larger quantity of jobs, for instance through developing manufacturing, whereas those with smaller national populations will prioritise sectors that create desirable, high-quality jobs for their nationals, such as knowledge-based industries.

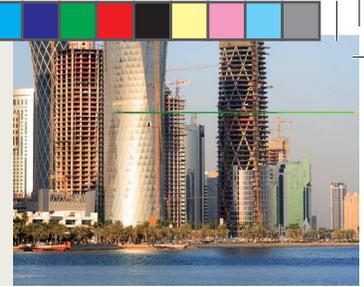
One of the key challenges in private-sector job creation is that average incomes for GCC nationals are relatively high, although they diverge significantly between the different GCC countries. The GCC cannot compete on wage costs unless it offers projects that largely employ expatriate workers (who are, in general, far lower paid than Gulf nationals). Thus, some diversification projects that make sense from a macroeconomic point of view will not generate many jobs for nationals, while diversification projects that are designed to employ the maximum number of GCC nationals will not necessarily be the most globally competitive projects. Again, the GCC states with the highest average incomes are more likely to focus on high-wage, high-status sectors including financial services, medium- and high-tech industries and creative industries.

A greater challenge for the post-oil era is making GCC nationals competitive in terms of skills. At present, nationalisation quotas are widely used to force the private sector to employ locals, but the system encourages abuse on all sides. “Nationalisation is a challenge, to be honest,” says Mr Reinke. “There are always questions about how it will be implemented and what it means for your costs as an investor. They have to strike a fine balance between their own needs for internal social reasons and the speed of economic development that they want to see.” He advises that “investment in education will be the essential factor to enable the local manufacturers to be able to meet global standards.” Significant investments in education are already under way and most GCC countries are pursuing education reforms, ranging from the development of links with world-class higher education institutions to revamping primary and secondary curriculums. These reforms will take time to take effect but some changes should be evident by 2020. (For more detail, please see our second report in the series, *The GCC in 2020: The Gulf and its People*³.)

● Preparing for the post-oil age

The GCC states are planning for the longer term, with most having 20-year diversification strategies. “Oil and gas remains the money-making machine, but the new areas that are developing are those that the societies need to survive the time after oil. Since they know they will run out of oil and gas, the leadership’s key concerns are supplying energy, water and education for the longer term,” says Mr Reinke, adding, “They probably have 100 years or so.”

Some of the GCC states will run out of oil faster than others and therefore have more urgent motivations to diversify than others. But there is also a chance that a post-oil age could come earlier,



if new energy technologies make oil obsolete. This has been an increasing worry for the GCC in recent years, as climate change concerns and the 2003-08 oil price boom combined to stimulate new research and development (R&D) in alternative energy.

● Prestige

Several interviewees suggested that there are additional motivations for diversifying, such as the desire for international prestige and reputation-building. Steffen Hertog of the London School of Economics comments: “The GCC states want to show they’re not just oil and gas economies with a few primitive by-products. It’s partly about a new leadership generation that is far more keen on international visibility.” Ali Borhani, director of Strategy for the Middle East and North Africa at Bosch Siemens, a leading manufacturer of home appliances, agrees. “There is a nostalgia in the region, going back thousands of years, for the time when this part of the world was the hub for scientists, physicians, chemists and philosophers. Unquestionably there is a nostalgia for that; the question is what we are doing to get there.” Building a high-profile international image makes sense for the Gulf states and is part of a wider effort to attract talent to the region—but there is a risk that money will sometimes go into “white elephants”.

How urgent a priority is diversification?

There is a clear consensus on the reasons for diversifying. There is less of a consensus about how motivated the authorities really are to transform their economic systems when oil and gas are still providing ample wealth—and when virtually no one expects the price of oil to return to the days of US\$10/barrel. This is particularly an issue when it comes to diversifying away from dependence on government, and diversifying the government’s sources of revenue. Increases in taxes and fees are never going to be popular and could also be an issue for competitiveness. “Hydrocarbons-rich governments are not under any compulsion to diversify,” says one consultant, who wanted to remain anonymous.

“While they can pump enough oil to pay for everything, I don’t think there is so much motivation to diversify,” adds Mr Alabaster of Aon. “The motivation becomes stronger when things get harder.” However, he believes that GCC governments recognise “they are not in a position where they can keep cranking up oil supplies at the levels seen in the recent boom”. He adds: “There is a genuine effort among the leadership to move away from the dependence and use the wealth to educate the people so that they’re better able to adapt to the demands of the economy.”

Five key trade-offs for policy

- Focusing on areas of greatest comparative advantage—generally energy-intensive industries—versus reducing dependence on hydrocarbons.
- Targeting most competitive industries versus a broad range of industries.
- Increasing the tax base versus maintaining low levels of tax to attract investors.
- Maximising growth versus targeting growth to create jobs for nationals.
- Pursuing nationalisation policies versus flexible labour markets.



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“As long as their reserves are ample and global oil demand is stable, oil and, in the case of Qatar, gas will continue to dominate these countries’ economies on a share of GDP basis,” says Laura El-Katiri of the Oxford Institute for Energy Studies. “But this does not mean that their economies won’t be more diverse; if a job can be found by most residents, then that is already a lot of progress.”

The impact of the global recession

Ironically, during the global financial crisis and the subsequent recession, the most hydrocarbons-dependent GCC states have generally been the best-performing. Meanwhile, the credibility of some of the Western “models” of running an economy has suffered somewhat around the world.

Does this challenge the conventional wisdom on diversification? In general, GCC diversification strategies do not appear to have changed significantly. Policymakers remain rhetorically committed to building a non-oil economy. The diversification process has slowed somewhat as investment in general has slowed, but it is likely to pick up pace over the coming years.

It is, however, likely that diversification will now focus on a broader range of economic sectors, now that the real estate sector has been dented.

Which sectors should be prioritised?

There is some debate about the best sectors for diversification for the GCC countries. The policy choices will depend partly on which of the three main motivations is seen as most pressing. Should they focus on the sectors where they have the greatest comparative advantage? Or should they target as broad a range of sectors as possible in order to spread their risks? If the priority is future generations, should they focus on the most sustainable diversification projects? Or if the focus is on job creation, should they focus on sectors that create the most jobs for nationals rather than projects that would be overwhelmingly staffed by expatriates?

These questions give rise to other policy issues such as how the education system for nationals will be developed and how this will affect the range of jobs that they take. For instance, should the focus be more on prestigious university degrees or vocational training?

There are, of course, considerable differences between the GCC states. But one common theme for many of our interviewees was the sense that diversification so far has involved what one described as a “cookie cutter” approach and others have called “the GCC domino effect”. States follow each other’s strategies closely and often end up competing in the same spaces. In some areas, including financial services and tourism, there is some evidence of differentiation emerging, but there are still some concerns about excess capacity. In industry, there seems to be increasing competition in the same areas, such as petrochemicals and metals.

“I think the most important diversification that has to happen is in the mindset. The cookie-cutter approach of creating another healthcare city, or another golf tournament, because another GCC country already has one, will not succeed,” says Mr Borhani of Bosch Siemens. “To succeed, they need to think out of the box. A big issue is how to create more cohesion and give the expatriates a sense of participation, not just a pay cheque.”

Sector by sector: opportunities and risks

The clearest areas of comparative advantage for the GCC are:



- energy-intensive manufacturing, for example petrochemicals, plastics, aluminium and other energy-intensive industries;
- mining and mineral-based industries;
- trade (wholesale and retail) and logistics (based on location and experience); and
- tourism, hospitality and aviation.

All of these sectors are export-oriented. This report will focus on each of these sectors in more detail below.

Strong growth is also expected in infrastructure and services sectors to supply the growing population of GCC nationals and residents, such as:

- education;
- healthcare;
- financial services;
- transport;
- power;
- water;
- consumer goods;
- sport and leisure; and
- media and film.

These sectors are likely to be successful in attracting foreign direct investment (FDI), given the prospects for population growth and the expectation of continued strong government spending. They will provide significant employment, but will be largely oriented towards the local (and in some cases regional) market rather than for export globally.

The GCC countries have also begun to develop other export-oriented sectors, including:

- agriculture, which largely relies on desalinated water and requires extensive subsidies ;
- agro-processing (such as sweets and sugar refining), which has already seen some success stories;
- renewable energy (particularly solar power), which could also eventually be exported, although this is likely to be a longer-term initiative; and
- medium- to high-tech manufacturing such as biotechnology and pharmaceuticals, which will require significant new investments in R&D.

Government support is helping to develop opportunities in these sectors. However, there are some doubts about how competitive they are internationally, especially if government support is taken out of the picture. Over the next decade, “real estate, hospitality, education, healthcare, trade, transport, tourism and manufacturing will do well. But advanced technology, bio-sciences, and sectors that require heavy research in universities will not,” stresses a Dubai-based consultant, who commented

⁴ Available to download from: http://graphics.eiu.com/upload/eb/GCC_in_2020_Resources_WEB.pdf.



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anonymously for our report. "All the activities that are based on adding more value to oil and gas will see investment. We already see it happening almost every day," says Mr Reinke of DuPont. "Everything else will take longer."

The prospects for agriculture and for renewable energy over the next decade are covered in more depth in the third report in this series, *The GCC in 2020: Resources for the future*⁵. Medium- and high-tech manufacturing was not a focus of the current report, as this area is likely to be a longer-term initiative. Nevertheless, government-backed initiatives to invest in R&D, and to build linkages with international scientific and academic partners, will be valuable for the longer-term development and diversification of both the GCC and the broader Middle East, a region where investment in R&D is currently less than 1% of GDP.

Energy-intensive manufacturing

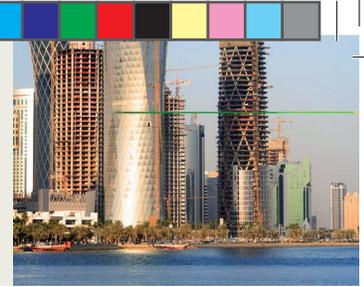
The availability of low-cost feedstock has given the GCC a comparative advantage in energy-intensive industries such as petrochemicals, cement and metallurgical industries including aluminium, steel and copper. Petrochemicals has been one of the GCC's most successful sectors in terms of growth and export competitiveness, with almost 5m tonnes of ethylene capacity added in 2009 and another 6m tonnes due to start up by 2012, significantly more than in China, according to ICIS, a global chemicals magazine. But the value of petrochemicals exports is closely linked to the international oil price. Indeed, investing in petrochemicals is more of a strategy to add value to hydrocarbons than a real case of diversification away from them. Investment plans for the sector slowed during the recession owing to the slump in the oil price, but it is likely to recover in the medium term.

Cement is another traditionally successful area for manufacturing. Again, the sector has suffered a cyclical downturn as its fortunes are closely linked to the state of the local construction sector; after several boom years, cement prices dropped in 2009 and 2010 as numerous construction projects were cancelled or postponed. Gulf cement companies are looking to other regional markets such as Iraq, where significant construction is expected over the next decade, to help shore up demand. The same is true of steel, another industry that has so far been mainly focused on supplying the local market, but has suffered from the construction slowdown.

Aluminium production is currently being dramatically expanded around the Gulf, having been introduced to the region in 1968 by Aluminium Bahrain (Alba). According to the Gulf Organisation for Industrial Consulting, there are already 886 plants producing aluminium and related products in the GCC, employing some 63,000 people. Most of the GCC states are now building or expanding aluminium smelters, mainly to serve growing Asian markets such as Japan and South Korea.

Metallurgical industries have traditionally been dominated by local producers, but some high-profile international investments are under way, typically involving firms that want to take advantage of the GCC's large and expanding ports to export their goods into the rest of the Middle East and North Africa region. For instance, this year, Vale, a major Brazilian mining firm, announced plans to set up its first iron-pelletising plant outside its home country, in Oman, in partnership with the state oil company, Oman Oil Company. India-based Jindal Steel and Power has acquired an Omani metal producer, Shadid Iron and Steel Company, to help it expand into regional markets. Given the need to

⁵ See also our third report in this series, *The GCC in 2020: Resources for the future*, which discusses this in more depth.



diversify the GCC economies, various incentives will be available for investors in manufacturing, often through manufacturing free zones or specialised industrial zones.

One concern is the extent to which growth in this sector will create jobs for Gulf nationals. Another is that, as with oil and gas exports, the value of commodity exports such as aluminium is exposed to risks from shifts in international supply and demand (and hence prices). Some observers have also asked whether the GCC's multiple simultaneous investments in aluminium could lead to oversupply.

Moreover, a key short- to medium-term constraint on the expansion of energy-intensive industries is that some of the GCC countries are running short of gas. "Gas shortages are usually not a result of a lack of reserves but are caused by the lack of development of non-associated gasfields. Crude oil can often be used as a substitute but has a far higher opportunity cost than natural gas," says Ms Katiri of the Oxford Institute for Energy Studies. "There is a lot that speaks in favour of profit-maximising on hydrocarbons wealth—if it is there, why not use it? But this gas issue needs to be resolved before a further expansion of energy-intensive industries can be thought of."

Another issue is that the cost of producing gas in the GCC is likely to rise in the medium to long term⁵, especially as more non-associated gas (gas that is not a by-product of oil production) comes into the supply mix.

Over the next decade, the expansion of energy-intensive industries is likely to continue, although it will be slowed by the need to make more gas available. Here, the development of renewable energy could help, by freeing up more of the GCC's gas for industrial use. Another important trend will be a gradual shift into more challenging, value-added areas such as plastics and rubber, and products based on these materials such as packaging and car tyres. Mr Reinke of DuPont comments: "I can imagine the GCC being successful in producing goods that are needed for local markets and for the local construction sector. A lot of big companies that go into the Gulf want to source locally if they can ensure the goods are up to international standards."

"The next stage for diversification is pushing much further away from the areas of obvious comparative advantage, and moving into areas that are a long way downstream, like plastics, where the price of methane and ethane is less important and technology is more important," adds Mr Hertog of the London School of Economics. "It's a crucial test case for the maturity of Gulf industries, and the jury is still out."

Mining and mineral-based industries

The historically underexploited mining sector has significant growth potential, as our third report in this series, "The GCC in 2020: Resources for the Future" highlighted. This will also provide a basis for some metallurgical industries. For instance, Ma'aden of Saudi Arabia and Alcoa of the US have started construction work on a US\$10bn integrated bauxite mine and aluminium smelting complex in Saudi Arabia's Eastern Province, which is expected to commence production in 2013.

Trade and logistics

Trade has always been one of the GCC's areas of strength. Well before the discovery of oil, the Gulf was a hub for international trade between the Middle East and Asia, and several of its major modern-day cities originally developed as ports. Trade remains an area where the local private sector is particularly



The GCC In 2020: Broadening the economy

Key trends in the GCC tourism sector over the next decade

- Tourist arrivals and tourism infrastructure grow.
- Capacity rates decline.
- Niche tourism develops (healthcare, sports, heritage).
- Budget tourism continues to develop.
- New source markets emerge, particularly India.

strong. The sector benefits from the Gulf's strategic location and from low customs duties, which are a long tradition for the port cities; the common GCC tariff is 5% on most goods and it seems likely that the GCC would avoid significantly increasing customs duties despite the long-term pressure to diversify the sources of government revenue.

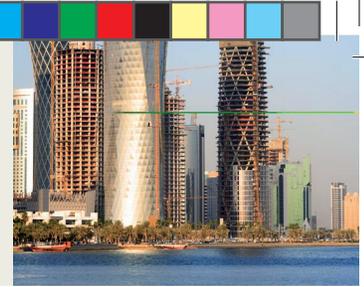
The transshipment subsector will benefit from the expansion of capacity at several key Gulf ports. In several cases, free-trade zones have also been developed alongside the ports to help leverage the infrastructure to develop local manufacturing. For instance, Oman's Salalah Port, serviced by a joint venture between APM Terminals and the Omani government, underwent a major capacity expansion in 2008 and is now attracting investment into its associated free-trade zone. It plans a second phase of expansion in the medium term, with a US\$525m investment in a second terminal, bringing total capacity to 9m twenty-foot equivalent units (TEUs) from 4.5m today. There is some uncertainty over the timeline; port officials have said it could start as early as 2011 depending on conditions in the international shipping market. Bahrain's General Organisation of Seaports opened a new port, Khalifa bin Salman Port, last year, also operated by APM Terminals, with container capacity of 1.1m TEUs, as well as berths for cruise ships. Abu Dhabi Ports Company is developing a new port, Khalifa Port, to be launched in 2012, with capacity of 2m TEUs initially and a longer-term plan to increase this to up to 15m TEUs.

Tourism and hospitality

The GCC has emerged as a tourism and aviation hub in recent years, and this sector is likely to expand further over the next decade by targeting different source markets, especially in Asia.

"It's interesting to see how quickly the hotel industry in the Gulf is developing, when the area was not a destination ten years ago," says Konstanze Auernheimer, director of Marketing and Analysis at STR Global, which analyses the global hotel industry. Investment in the sector has slowed since the global recession spread to the Gulf, owing to tighter credit conditions and uncertainty about future demand, but many new hotels are already in the pipeline. Indeed, there are some concerns about oversupply, which suggests that the pace of new investment in hotels is likely to plateau once the projects already under way are completed.

In the next ten years it is likely that the rate of development in tourism will show robust growth, as the region matures from being an 'emerging' market for tourism into an established market with a high volume of repeat guests-and a diverse range of feeder markets," says Gerald Lawless, executive chairman of Jumeirah Group, based in Dubai. He sees two main trends influencing demand in the coming years: the rise of the "baby boomer" generation in established markets, such as the US and



Europe, and the expansion of the middle classes in India and China. “We have already seen a major increase in the number of Chinese tourists coming to Dubai”, he added. “By 2016 India’s population is expected to be larger than that of the USA, Europe, Russia, Australia, New Zealand, Japan and Canada combined. Add in the fact that India’s middle class continues to expand and you have the makings of a major market shift for tourism in the Gulf,” says Mr Lawless. He identifies Brazil as another emerging source market for tourists, along with Russia, which is already a fairly established source market but which is seeing strong growth in outbound tourism.

Ms Auernheimer agrees. “At the moment tourists are coming out of Europe, the UK and the GCC itself,” she says. “But given the GCC’s strategic location, with millions of people living in short-haul flight distance, there is lots of potential to develop non-traditional markets.” She adds that many global hotel chains are now focusing their new investments in the Middle East, India and China.

GCC governments are supporting bids for global sports events including the Olympic Games and the football World Cup to help develop their tourism sector. There is also likely to be increasing differentiation between the GCC states, with niche tourism offerings developed in areas such as healthcare tourism, heritage and cultural tourism, diving and wildlife-oriented tourism, as well as traditional leisure and retail-focused tourism and the important religious tourism sector.

Aviation

The capacity of Gulf airlines to transport passengers from different countries to the region will be one of the critical components for developing new source markets for tourism, notes Mr Lawless. Major airport expansion projects are planned in all the GCC countries.

- Abu Dhabi Airports Company is expanding Abu Dhabi International Airport to handle 20m passengers per year by 2015.
- Bahrain International Airports Company is working on a development plan that aims to take the airport’s capacity from some 7m passengers at present to 28m passengers by 2030.
- Dubai’s new Al Maktoum International Airport is intended to handle 80m passengers per year by 2025.
- Kuwait International Airport has plans to nearly double capacity from 7m to 14m passengers per year.
- Oman Airports Management Company plans to increase capacity of Muscat International Airport to 12m passengers by 2014 from 4.5m passengers at present. The ambitious longer-term target is 48m passengers by 2050. The much smaller airport at Salalah is to be expanded to handle up to 1m passengers per year by 2013.
- Qatar’s New Doha International Airport aims to handle 24m people per year by 2011, eventually rising to 50m people after 2025.
- Saudi Arabia’s General Authority of Civil Aviation has a plan to expand existing airports—including those at Riyadh, Jeddah and Medina—and add a new one (at Taif), at an estimated cost of US\$10.5bn over several years.



The GCC In 2020: Broadening the economy

Key trends in the GCC financial-services sector over the next decade

- Further development of the non-banking financial sector.
- Further differentiation between rival financial hubs.
- Further development of exchanges.
- The introduction or strengthening of mortgage laws across the GCC; banks, however, remain wary until the legal framework for default compensation is strengthened.

These ambitious plans have been developed with varying degrees of realism. Implementation risk is always an issue to take into account in the GCC; progress will depend both on the evolution of international demand for air travel and on local ability to execute plans. Nevertheless, it appears highly likely that by 2016 the combined capacity of the international airports at Dubai, Abu Dhabi and Qatar will be greater than that of Heathrow, Paris Charles de Gaulle and Frankfurt. As with the broader hospitality sector, Gulf airlines will be aiming to take advantage of the growing middle class in Asia, as well as the smaller but growing African middle class.

Infrastructure

Infrastructure is expected to be a key growth sector over the next decade, as the growing population creates demand for more housing, transport, power, water and other utilities. The government will be a key driver of growth as most such projects will involve financial commitments from the state, but private participation will continue to grow, as has been the trend in the past decade. Significant private capital will come from within the region itself.

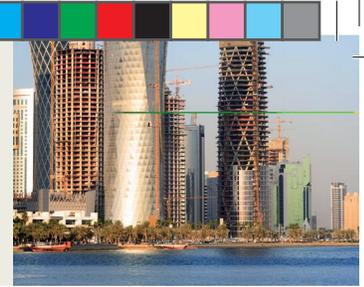
“Middle Eastern investors like to buy land. They’re patient and happy to tie up capital for long periods of time before they expect a return,” says Mr Alabaster of Aon. “I’m sure you’ll also see a lot more investment in infrastructure, power, water, waste treatment and all of those areas, where there’s a huge amount of increase in demand expected over the next 10-20 years.”

The real estate downturn experienced since 2008 will change the focus of construction and property investment in the coming years. “All the GCC governments have become a bit more careful with regard to diversification driven by the real estate and tourism,” confirms Mr Hertog of the London School of Economics. “Ultimately, it’s not really diversification, it’s the first thing you do if you have an undiversified economy with lots of money to invest in assets.” However, there is still scope for further investment in certain areas—particularly in the affordable housing sector, where there are significant shortages in some countries.

Transport infrastructure, especially railways, also has room to develop further. The development of railways in the Gulf has been discussed for a long time without much to show for it. However, a pan-GCC rail network could boost the trade and logistics sector significantly, especially if it is eventually linked to Turkey and Iraq.

Financial services

Before the financial crisis, Bahrain, Dubai, Qatar and, to some extent, Saudi Arabia were competing to become the Middle East’s financial hub. The crisis dampened much of the rhetoric and the authorities are now focusing more on ensuring sustainable development of the sector rather than competing



with each other. For the most part, financial institutions in the region serve clients in the regional market. They have benefited from a clear trend in recent years of Middle Eastern investors choosing to keep more of their capital within the region, and increasingly preferring to work with locally based institutions rather than with bankers or investment advisers in Europe or the US. The region’s liquidity is underpinned by its oil and gas wealth, which is likely to remain an attractive factor for financial services firms well beyond the next decade. In the longer term, however, new sources of wealth will be needed.

Further development of state-of-the-art regulation is essential. There is also a need for greater clarity about existing regulations. “The financial services sector needs to see a greater degree of clarity on the legal system—there’s a lot of uncertainty about liabilities and legal relationship,” says Mr Alabaster of Aon. “The banking sector is still looking for large-scale, wide-ranging mortgage legislation to be put in place. These are all measures that people in the sector are waiting to see and when they take place they will really help that sector to develop.” Better regulation will also be key to the future development of local capital markets, including the region’s various stock exchanges and the nascent bond market. But differentiation is also crucial. “My question is how the different centres will compete and how they will differentiate themselves,” says Mr Mueller of Swiss Re.

The banking sector has been a relative success story in terms of nationalisation, employing a higher proportion of locals than many other sectors, but some of the emerging non-banking sectors are growing so fast that they face skills shortages. Along with many financial services executives, Mr Mueller also highlights the importance of developing talent: “From a pure insurance point of view, there is a fast-moving and attractive market, but there’s a real shortage of talent. The dependence on expatriates could present a risk as the global economic situation changes.”

The role of the private sector

Diversifying away from dependence on government is another major challenge, although there will continue to be legitimate debates about the extent to which this is desirable. Mr Alabaster comments: “Saudi Arabia is beginning to develop other resources in the mining sector, but in the main, diversification is based on a very large and growing public sector, so all the wealth creation is basically still dependent on oil.”

What will determine success in diversifying?

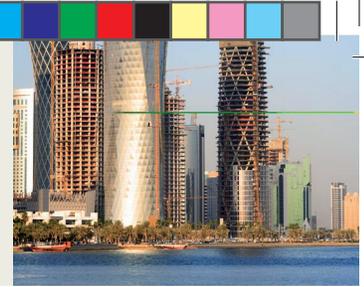
- Education and skills.
- Availability of power and water.
- Levels of R&D.
- Restrictions on foreign investment.
- Bureaucracy and implementation risk.
- Rethinking on government revenue and spending.
- Motivation for change when oil prices are still relatively high.
- Moving away from cookie-cutter diversification.
- Strategies for giving both nationals and expatriates a stake in the future.



The GCC In 2020: Broadening the economy

This is not necessarily a bad thing. Mr Hertog of the London School of Economics says that so far diversification in the GCC has been successful “where large and well-run public enterprises have taken the lead. People often don’t understand that the private sector has been the follower rather than the leader here.” He adds that the “classic state-led industrialisation” in the GCC is not unlike the industrialisation models seen in Japan and South Korea.

However, state spending will not be sustainable in the longer term and the GCC will eventually need to rebalance its economy to give a greater role to an independent and dynamic private sector, if it is to reduce its indirect dependence on oil.



Conclusion

How much progress is likely by 2020? The GCC region will still be reliant on hydrocarbons in ten years' time, but it is likely to have developed a greater range of sectors, and, correspondingly, greater resilience to oil price shocks (as has already happened compared with the 1980s).

Essentially, the GCC's main comparative advantages stem from its oil and gas endowments—it has cheap energy feedstock (although even that is a problem in some countries) and very low tax.

The region's other main strength, independent of oil and gas, is its strategic location—a plus for trade, transport and tourism. Thus before the discovery of oil, the GCC economies were largely based on pearling, trade (maritime and land trade into Iraq, Iran and the Indian subcontinent), and religious tourism to Mecca and Medina. This historical experience may be some guide to the GCC's future after oil.





