ECONOMIC PROSPECTS

KEY POINTS

- Saudi Arabia and Iran are the Gulf region's largest economies, followed by the United Arab Emirates, UAE, which has the highest per capita income and growth.

- In most Gulf economies, economic growth is lower than workforce growth. Other major reform drivers are the desire to diversify out of oil, fiscal pressures and declining oil reserves in Oman, Bahrain, Qatar and Dubai in the UAE.

- Despite modest economic growth over the 1990s, these reform pressures will create new opportunities for foreign firms; fiscal pressures will increase the importance of private finance and privately provided infrastructure, while the drive to diversify will open new opportunities in gas, heavy industry and service sectors. Efforts to boost the employment of Gulf nationals will increase the need for education and skills training.

- Current high oil prices could threaten reform momentum; however, most Gulf Governments recognise the inevitability of volatile oil prices and remain committed to reform.

Since the first oil shock in 1973, oil wealth has funded rapid growth in the Arabian Peninsula and Iranian economies, the region called the Gulf economies throughout this report[1]. In the 1990s, lower and volatile oil prices, and failure to open economies and diversify from oil moderated Gulf economies' growth performance. However, now the young, rapidly growing populations and massive infrastructure needs of the major oil producers, Saudi Arabia, Iran, the United Arab Emirates, UAE, and Kuwait, are generating strong pressures for economic reform.

Throughout the region, political leaders appear willing to respond to these challenges. Hence, in the 2000s, these governments are likely to seek to intensify diversification efforts, open their trade and investment regimes, and reduce their pervasive economic role, including by privatising infrastructure and industry. These reforms should help stimulate more balanced and robust growth, reduce vulnerability to swings in international oil prices, and expand business opportunities for foreign traders and investors.

Young, rapidly growing populations are creating significant pressures to lift economic growth and diversify economic activity. As well as providing a huge workforce, they also create a strong demand for education, health services and infrastructure like roads, water supply and electricity, which the state traditionally provides in Gulf economies. Demand for new services imposes fiscal pressures on Gulf governments, especially as many run significant deficits. This demand creates a major incentive to increase private sector involvement in infrastructure provision.

In 2000 and 2001, high oil prices will boost government and consumer expenditure, and lift import growth. While high oil prices could reduce short term economic reform pressures, most governments recognise oil prices are volatile. Their long term commitment to reform should remain firm because these governments need to deliver rising prosperity.

Australia's longstanding trade relationship with the Gulf economies is built on economic complementarity and Australia's competitiveness as a reliable supplier of high quality bulk agricultural commodities. In the 1990s, this relationship broadened as major new exports, including cars and alumina, emerged. As economic reforms and diversification continue, Australia's opportunities to expand and broaden trade and investment links with the Gulf economies should continue to grow.

HISTORY

Advanced civilisations date back at least 4 500 years in the Gulf, although many states are relatively recent. Modern Saudi Arabia, Kuwait, Qatar, Bahrain, and Yemen all were formed in the eighteenth or nineteenth centuries from Arabian Peninsula cities and nomadic tribes, while Oman and Iran are the remainder of once large empires.

1 In line with standard United Nations' practice, Australia officially uses 'the Persian Gulf'. Readers should note that where the term 'the Gulf' is used, it refers to the Persian Gulf.

The Ottoman Empire exerted considerable influence over the Arabian Peninsula, present day Iraq, and parts of Iran from the sixteenth to the nineteenth centuries. During the second half of the nineteenth century, Ottoman influence in the Arabian Peninsula gradually dissipated under pressure from local tribes in the interior, and as the Gulf and Peninsula coast came under British naval domination. Protectorate arrangements with local Arab rulers continued until the British withdrew in 1968.

The British defined many borders in the nineteenth century. Currently, many of these are contested; no defined borders separate parts of the UAE and Oman, Saudi Arabia and Yemen, and Kuwait and Saudi Arabia. However, progress in delineating these borders is being made. Iran had periods of British, Soviet and US influence during the twentieth century. The Shah's monarchy was overthrown by the 1979 Islamic Revolution.

Before widespread commercial exploitation of oil began in the 1950s, many smaller Arabian Peninsula economies were underdeveloped, with mainly nomadic populations. When world oil prices jumped in 1973, living standards quickly rose to first world levels, and urbanisation was rapid. Post oil-shock prosperity rapidly expanded the population with a baby boom and major inflows of contract labour for skilled and unskilled jobs.

Since the 1970s oil price rises, the 1980-88 Iran-Iraq war, Iraq's 1990-91 invasion of and subsequent ejection from Kuwait, and significant tensions between Iran and neighbouring Arab states have dominated Gulf history. By 2000, relations between Iran and Saudi Arabia had improved gradually, significantly reducing regional tensions. The US Fifth Fleet and British forces are based in Bahrain, and most Arab states in the area recognise that these forces improve regional security. The main exception, Iraq, remains subject to the United Nations' blockade initiated in 1991 in the aftermath of Operation Desert Storm, and is not considered in this report.

REGIONAL ECONOMIC PERFORMANCE

The Gulf economies' size, income levels and growth performance vary considerably depending on their oil production, human resources, economic openness and success in diversification.

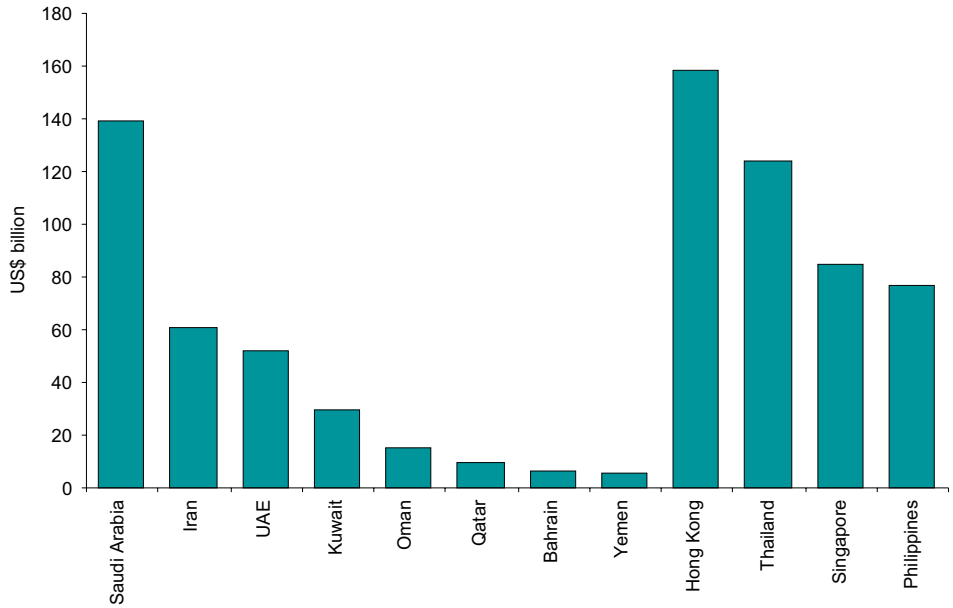
Market Size

Only Iran (with 65 million people) and Saudi Arabia (with 21 million people) have reasonably large populations and gross domestic products, GDPs; other Gulf economies are relatively small (Figure 1.1). Saudi Arabia is the only Gulf economy bigger than Singapore or the Philippines.

Figure 1.1

Saudi Arabia Is Region's Largest Economy

Nominal Gross Domestic Product, 1999



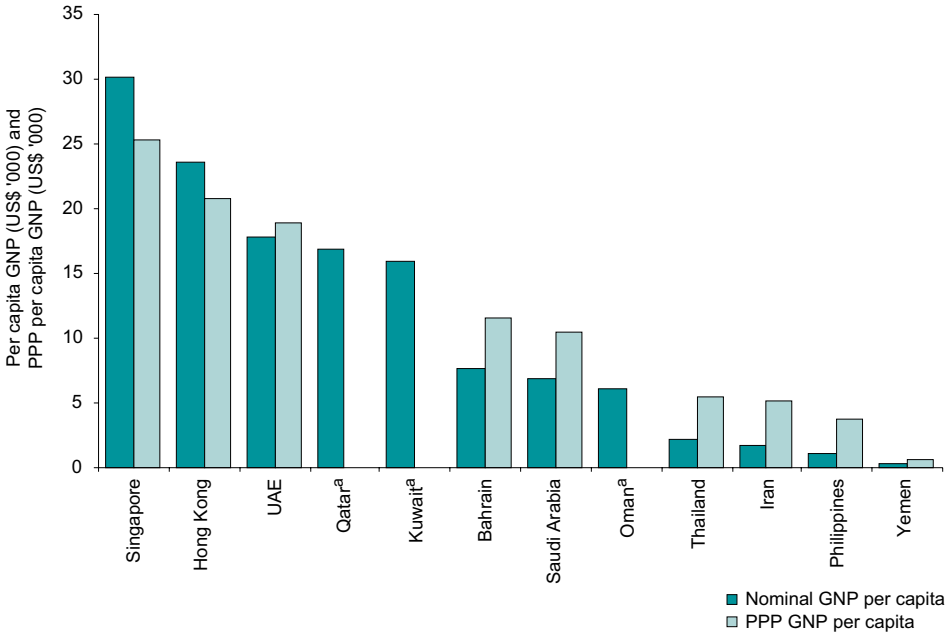
Note: Figures for Saudi Arabia, Iran, Kuwait, Oman, Qatar, Bahrain, Yemen and the UAE are based on estimates by Business Monitor International, 2000a. Figures for Asian economies come from CEIC, 2000.

Source: Business Monitor International, 2000a; and CEIC, 2000.

Figure 1.2

Purchasing Power Highest in the UAE and Qatar

Nominal Gross National Product per Capita and PPP Gross National Product per Capita, 1998



Note: a PPP GNP per capita data are not available for these economies.

b GNP is the value of the final output of goods and services produced by residents of an economy plus net primary income from non-resident sources.

c PPP is estimated by determining the number of units of a country's currency required in country to buy a standard bundle of goods and services that US$1 would buy in the United States, and using this information to adjust the country's US dollar per capita income to better reflect its actual purchasing power.

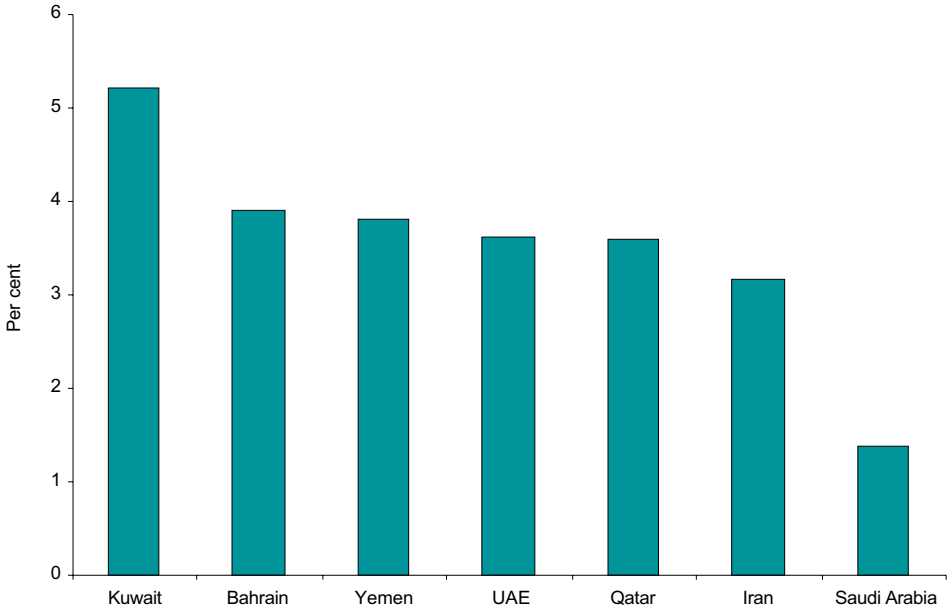
Source: World Bank, 2000a; and Datastream, 2000.

Kuwait, Qatar and the UAE have the highest purchasing power as measured by per capita GDP; Yemen and Iran have very low per capita incomes (Figure 1.2). However, market potential probably is greater than these figures indicate, as low domestic prices for many non-traded goods increase consumers' purchasing power. Purchasing power parity, PPP, estimates of per capita income show the average citizen's capacity to consume goods and services once account is taken of local price differences. In Saudi Arabia, Iran, Yemen and Bahrain, the difference between PPP per capita gross national product and US dollar per capita gross national product ranges is substantial (Figure 1.2). Most notably, in Iran, the PPP figure for GNP per capita is $5 121 compared to a per capita GDP figure of US$1 650.

Figure 1.3

Saudi Growth Slowest

Average Annual Real GDP Growth Rate over Decade, 1990-99



Note: While Saudi Arabia is the region's slowest growing economy, it is by far the largest economy, so a given level of economic growth results in more economic activity in absolute terms.

Source: Datastream, 2000.

Growth Performance

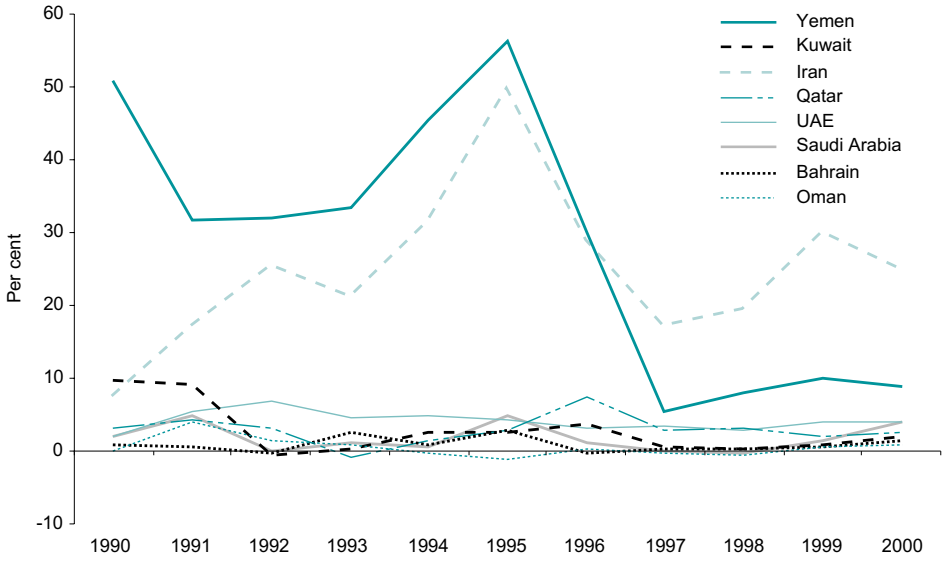
In the 1990s, largely reflecting oil price and production swings, Gulf economies' real GDP growth performance was erratic. Over the decade as a whole, real GDP growth was moderate, averaging 1.4 per cent in Saudi Arabia, 3.1 per cent in Iran, 3.6 per cent in the UAE and up to 5.2 per cent in Kuwait (Figure 1.3).[2]

2 Kuwait's growth figures are distorted by the Gulf War induced contraction in 1990 and the subsequent rebound in 1992 and 1993.

Figure 1.4

Iran Has the Highest Inflation

Annual Consumer Price Rises in Arabian Peninsula and Iran, Per cent



Source: Datastream, 2000.

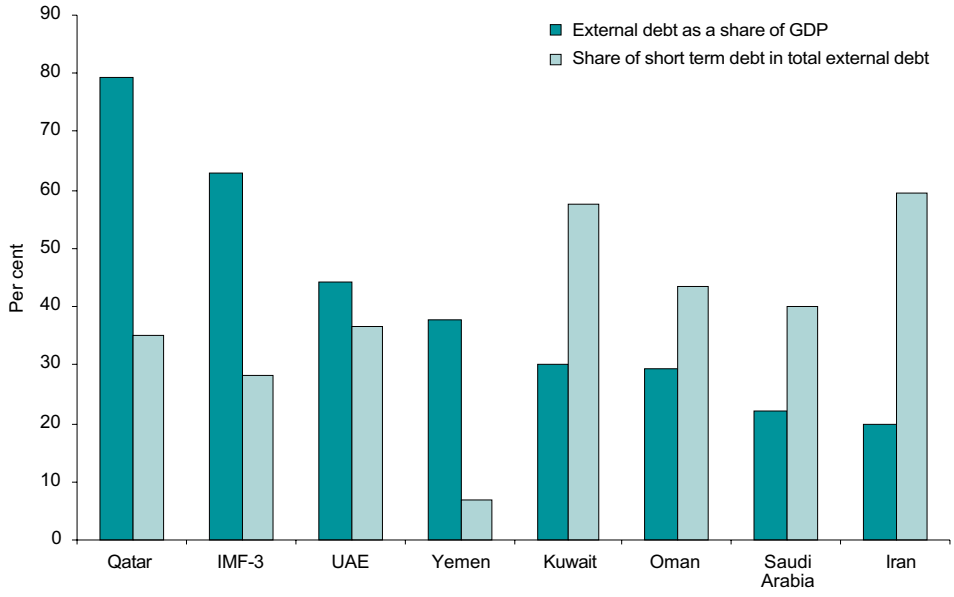
Inflation

By the 1990s, Arabian Peninsula governments had controlled the high inflation of the 1970s oil boom years (Figure 1.4). Gulf Cooperation Council, GCC, economies reduced inflation by controlling money supply and financing budget deficits by issuing bonds, rather than printing money. In the early 1990s, Yemen's severe inflation was due to shortages generated by the civil war and increased government spending associated with unifying North and South Yemen. However, by 1997, Yemen tightened monetary policy and issued bonds to finance budget deficits, quelling inflation. On the other hand, Iran's weak macroeconomic management, especially loose monetary policy, kept annual inflation above 20 per cent throughout the 1990s.

Figure 1.5

Short Term Debt Is High

External Debt as a Share of GDP and the Share of Short Term Debt, 1998



Note: IMF-3 refers to the Republic of Korea, Indonesia and Thailand.

Source: Bank for International Settlements, 2000; and World Bank, 2000b.

Foreign Debt Exposure

Except for Qatar, by international standards, Gulf economies did not have high external debt burdens in 1998. Qatar has a large debt due to its foreign borrowings to develop its huge gas deposits; these loans can be repaid readily from projected gas sales. However, most Gulf economies, and particularly Iran and Kuwait had a high proportion of short term debt, well above that of the Republic of Korea, Indonesia and Thailand (the IMF-3) in 1998 (Figure 1.5).

EXCHANGE RATE ARRANGEMENTS

Fixed and pegged[3] exchange rates predominate in the region making A$:US$ movements significant in driving Australian competitiveness. The UAE, Bahrain, Saudi Arabia, Kuwait, Qatar and Oman maintain longstanding fixed exchange rates against the US dollar (Table 1.1). Fixed exchange rates are backed by significant official and unofficial foreign exchange reserves generated from oil income.

[3] Fixed exchange rates do not change over the long term, while pegged exchange rates are revalued periodically. Saudi Arabia, the UAE, Kuwait, Oman, Qatar, and Bahrain all have maintained fixed exchange rates, pegged to the US dollar, since the early 1970s, while Iran and Yemen maintain pegged rates which have been revised periodically.

In late 1998 and early 1999, in the wake of the Asian financial crisis, Saudi foreign exchange reserves proved more than adequate to counter speculation against the Saudi riyal.

Yemen's exchange rate is a crawling peg against the US dollar and given Yemen's higher inflation rate, the dinar has been devaluing slowly. Iran maintains a complex system of multiple rates, which the central bank eventually wishes to unify. The official rate, available only to Iranian government ministries (R1 750:US$1), was only about 20 per cent of the more market determined rate that other importers pay (R8 200:US$1 in mid August 2000). Consequently, private sector importers often cannot obtain foreign exchange, even for export processing. Scarce foreign exchange is rationed to service foreign debt and pay for essential goods imports.

Table 1.1

Fixed Exchange Rates Predominate

Exchange Rates by Economy, Units per US dollar

Economy/currency	Units per US dollar 1995	Units per US dollar August 2000
Bahrain dinar, BHD	0.37	0.37
Iran rial, IRR	1747.93[a]	1 750 to 8 200
Kuwait dinar, KUD	0.30	0.30
Oman rial, OMR	0.38	0.38
Qatar riyal, QAR	3.64	3.64
Saudi Arabia riyal, SAR	3.75	3.75
United Arab Emirates dirham, AED	3.67	3.67
Yemen dinar, YED	40.83	158.59

Note: a Official rate only.

Source: International Monetary Fund, 2000; and Central Intelligence Agency, 1999.

DRIVERS OF ECONOMIC DYNAMISM

In the 2000s, the need to improve modest economic growth rates and diversify, urgent demographic and fiscal pressures, and in some cases, declining oil reserves, should drive considerable structural change in Gulf economies. This should boost foreign business opportunities.

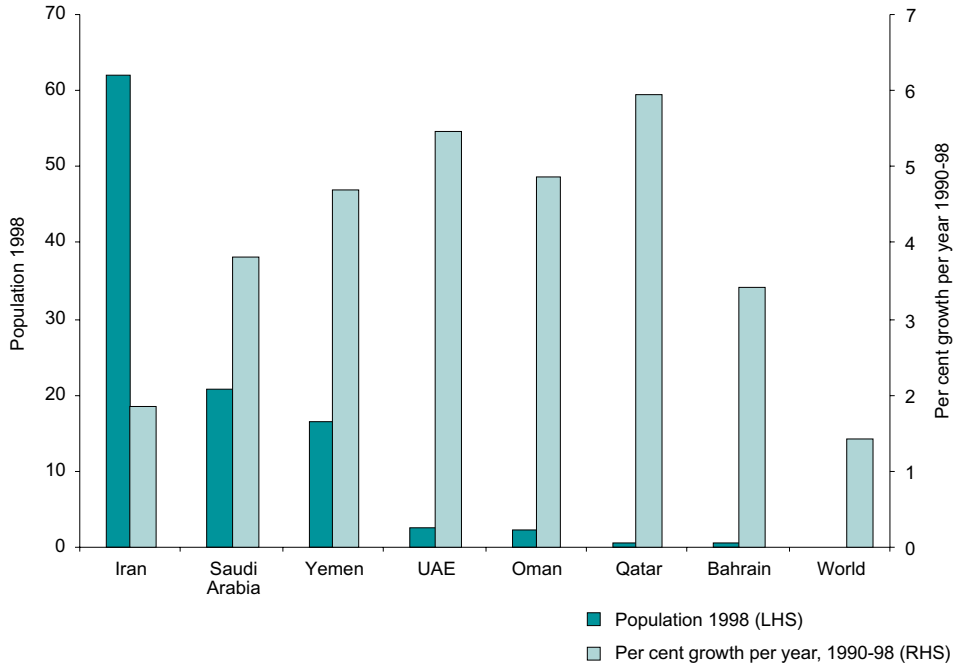
DEMOGRAPHICS

Except for Kuwait, populations in the Gulf economies are growing much faster than the world average, with high natural increases and continuing inflows of migrant workers (Figure 1.6).[4] Rates of natural increase have been high since the oil boom-baby boom in the 1970s. Hence GCC economy populations are very young, with two thirds under 25 years and half under 15 years (Figure 1.7).[5] This creates significant potential for exporters of youth related goods and services, and will drive growing urban infrastructure demand and growing demand for convenience foods as household formation increases. (See Chapter 3 - *Business Environment*.)

Figure 1.6

Population Growth Is High…

Population Level and Growth Rate, 1990-97



Source: World Bank, 1999a; and Asian Development Bank, 1999.

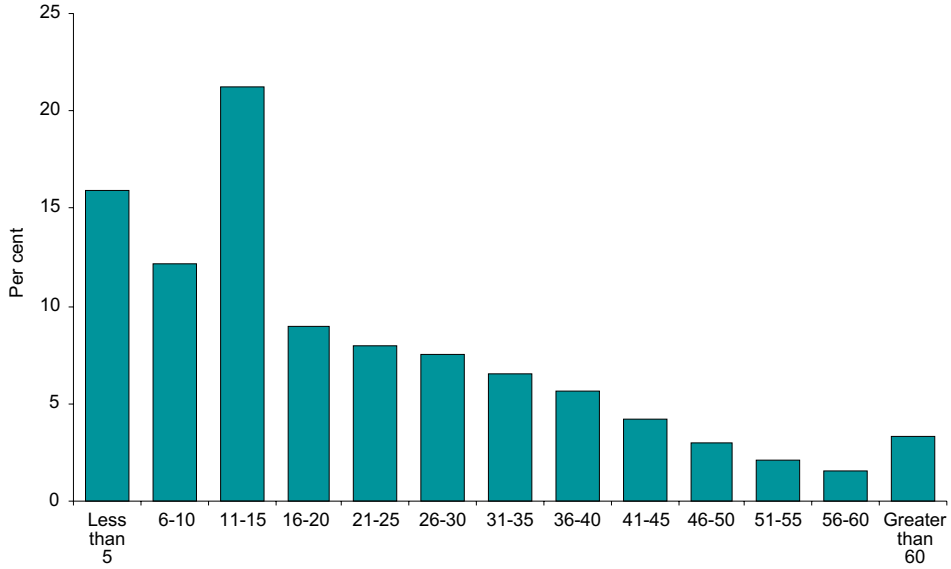
4 This rapid population growth is set to continue, with projected population increases between 1998 and 2050 of 161 per cent in Saudi Arabia, 51 per cent in the UAE, 72 per cent in Iran, 238 per cent in Oman, 43 per cent in Qatar, 64 per cent in Bahrain, 86 per cent in Kuwait and 236 per cent in Yemen, compared to a projected increase in world population of 49 per cent (United Nations, 2000).

5 Iran's population also is very young with 70 per cent of the population aged under 25. Kuwait's low population growth is due to the exodus of locals and expatriates during the Gulf War.

Figure 1.7

...and Populations Young

Population Age Structure in GCC Economies



Source: Gulf Cooperation Council, 1999.

Population Growth and Reform

Moderate real economic growth and rapid population growth together lower per capita living standards. Between 1990 and 1998, average per capita gross national product fell at an annual rate of 1.1 per cent in Saudi Arabia, 1.6 per cent in Iran and 2.4 per cent in Bahrain (World Bank, 2000a). Falling living standards motivate reforms.

Rapid workforce growth, flowing from earlier population growth, also drives major reforms, particularly in Saudi Arabia, Bahrain, Qatar, the UAE and Iran where population growth exceeds economic growth (Figure 1.8).[6] Such a situation increases unemployment pressures, although official unemployment statistics generally are not available in Gulf economies, except for Iran where the official unemployment rate was 13.1 per cent in the year ending 20 March 1998.

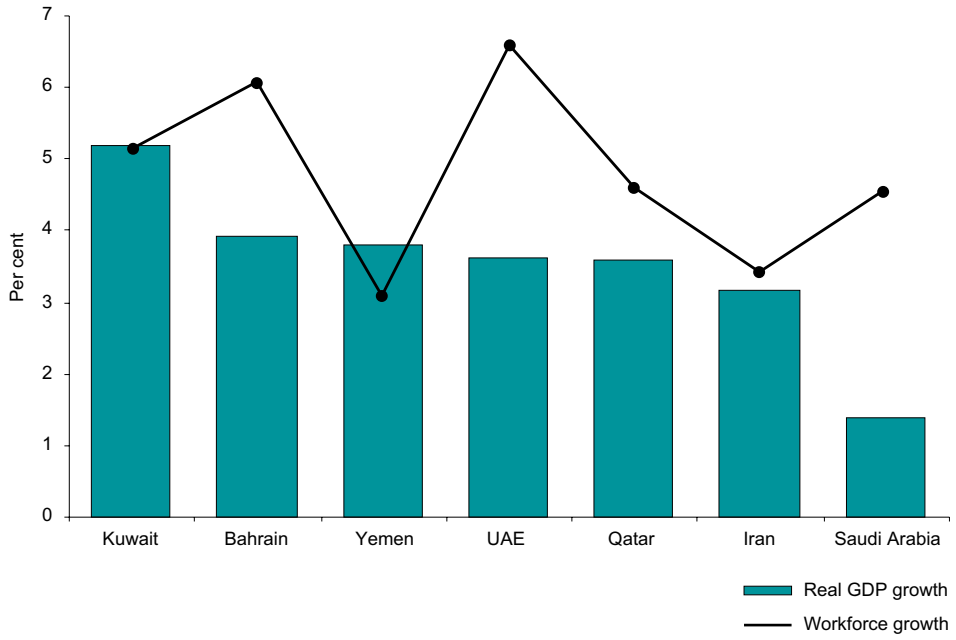
Saudi Arabia illustrates the pressures building from the divergence between workforce growth and economic growth. The government workforce, the mainstay of employment to date, is unlikely to expand. Saudiisation mandates the replacement of skilled expatriates with Saudis, providing a pool of jobs for new Saudi citizens entering the workforce, with the Government expecting private sector

6 The workforce is defined as all people willing and able to work at the current wage rate, whether employed or unemployed.

Figure 1.8

Workforce Growth Outpacing GDP Growth

Workforce Growth and GDP Growth, 1990-99



Source: Datastream, 2000.

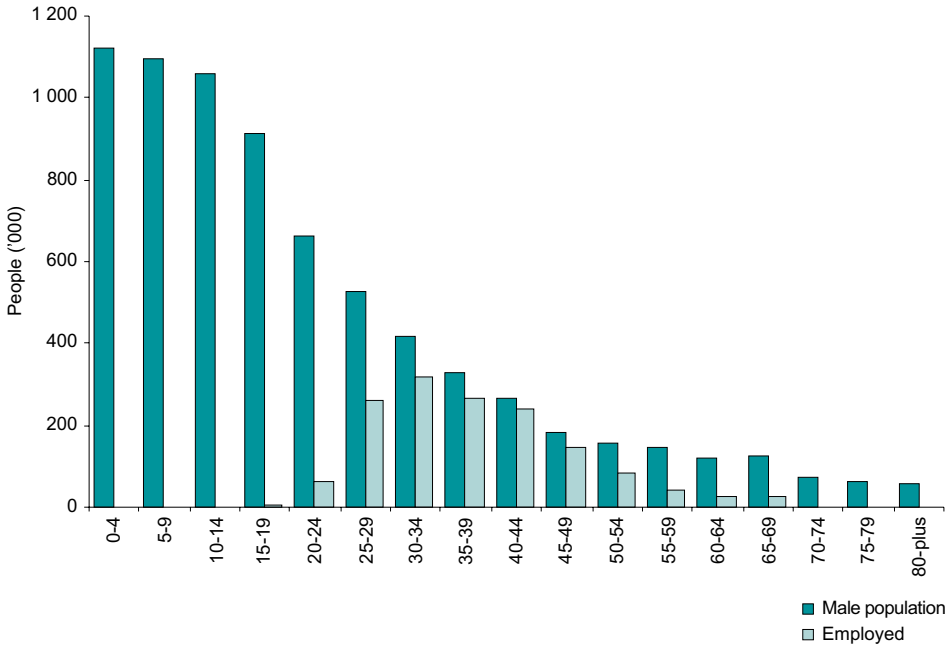
companies to increase the percentage of Saudis employed by 5 per cent per year (Saudi American Bank, 2000). With around two million suitable jobs currently performed by expatriates, economic growth of 2 per cent with constant productivity would add around 40 000 new jobs per year, in addition to the 100 000 likely to flow from Saudiisation.[7] However, with 913 000 males aged between 15 and 19 years, and one million aged between 10 and 14, in coming years, workforce entrants will bulge massively (Figure 1.9). The only long term option to employ these young people is to stimulate rapid private sector job growth through further deregulation and internationalisation.

7 In total, expatriates perform around four million jobs in Saudi Arabia, but Saudi citizens are likely to want to perform around half of these as the remainder are unskilled or unpleasant jobs (Saudi American Bank, 2000).

Figure 1.9

Saudi Arabia Set for Massive Workforce Growth

Age Structure of Saudi Arabia's Male and Employed Populations



Source: Saudi American Bank, 2000.

THE ROLE OF FOREIGN WORKERS

GCC populations feature high proportions of expatriate residents, ranging from around 75 per cent in UAE and Qatar to 27 per cent in Oman and Saudi Arabia. These workers are important economically, performing skilled and unskilled, and unpleasant work. Even in Iran, over three million largely unskilled refugees, mostly from Afghanistan and Iraq, work illegally.

The main source of expatriate workers is the Indian subcontinent, followed by South East Asia and other Middle East countries. In the UAE, Indians account for 29 per cent of the population, Pakistanis and Bangladeshis, 20 per cent, Filipinos, 7 per cent, and Egyptians and Lebanese, 3 per cent each (Jeffreys, 2000, pp. 9-10).

Despite ongoing policies to localise employment, most GCC nationals are unlikely to compete for blue collar construction or manufacturing jobs, such as in heavy industry.

Workforce Growth and Education

To avoid economic disruption as local citizens replace skilled expatriates in the workforce, nationals must have better access to education and skills training. This opens up opportunities to attract additional students to Australia and provide in-country educational services. (See Chapter 2 - *Australian Opportunities*.)

DIVERSIFICATION AWAY FROM OIL

All Gulf economies are highly reliant on oil. The share of oil in GDP ranges from 17 per cent in Iran to 38 per cent in Qatar (Figure 1.10). Oil reliance for exports is higher, ranging from 23 per cent in Bahrain to 90 per cent in Saudi Arabia, while oil reliance for government finances ranges from 41 per cent in Iran to 89 per cent in Kuwait (Figure 1.10). Consequently, oil prices strongly influence economic activity, export income, domestic demand and government expenditure, particularly capital expenditure.

To reduce oil dependence, regional governments employ four main strategies:

- developing gas industries and gas powered heavy industry, including petrochemicals, aluminium and steel
- expanding service sectors including tourism, finance, transport and distribution
- promoting import substitution industrialisation via tariff barriers
- requiring defence offsets, which involve suppliers of military equipment investing in often unrelated areas, as part of their contractual obligations.

Expansion of Gas and Heavy Industries

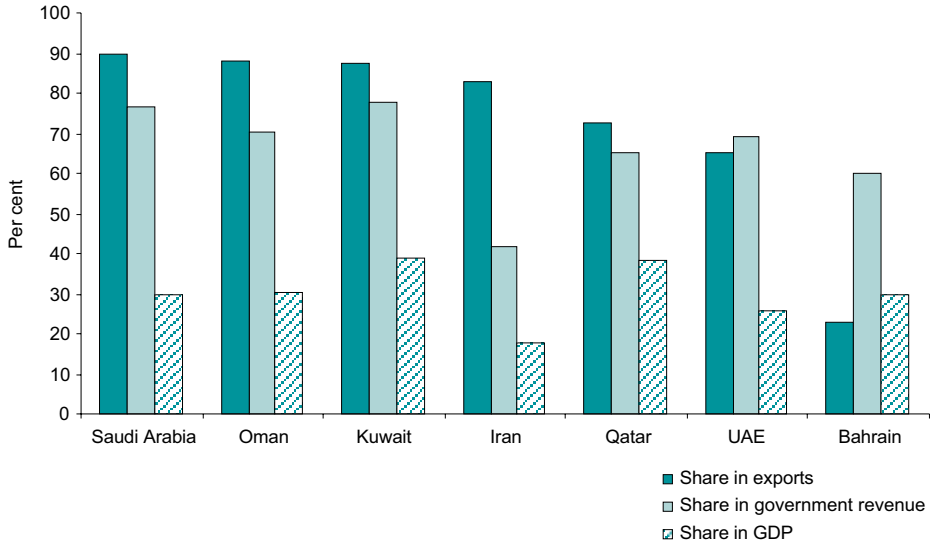
Saudi Arabia, Qatar, Iran, Oman and the UAE are expanding their gas industries; to achieve this, they seek foreign involvement. (See Chapter 4 - *Foreign Investment*.) As Iran, Qatar, the UAE and Saudi Arabia alone contain 30 per cent of the world's proven natural gas reserves, many with relatively low development costs, gas developments have enormous potential (BP Amoco, 1999).

In addition to being exported, gas also will be used as an energy source to generate electricity and fuel energy intensive industry. A prime new development is the proposed Dolphin pipeline from Qatar's giant North gas field through the UAE and into Oman; if it proceeds, it will fuel electricity generation and aluminium, steel and petrochemical industries (Fawzy, 2000). Similarly, in Saudi Arabia, the Crown Prince has invited selected foreign companies to submit proposals for upstream and downstream gas development projects. (See Chapter 4 - *Foreign Investment*.)

Figure 1.10

Oil the Dominant Economic Driver

Share of Oil Revenue in GDP, Exports and Government Revenue



Note: a Gross domestic product, GDP, figures are for fiscal year 1997-98 for Iran, 1997 for Saudi Arabia, 1998 for Oman, and 1999 for the UAE and Qatar.

b Export figures are for 1998 for all economies and refer to crude oil and petroleum.

c Government finance figures are for 1998 for Kuwait, Saudi Arabia and Oman, 1997-98 for Iran and Qatar, and 1997 for the UAE.

d For Saudi Arabia and Oman, GDP figures refer to crude petroleum and natural gas. For all other economies, GDP figures refer to oil.

e Government finance figures relate to oil and gas for all economies, except Kuwait where the figures relate to oil only.

Source: Economist Intelligence Unit, 1999a, 1999b, 1999c, 1999d, 1999e, 1999f, 1999g and 1999h; Gulf Cooperation Council, 1999; and International Economic Data Bank 2000.

Currently, most major regional heavy industry companies, such as Saudi Arabian Basic Industries Corporation, Dubai Aluminium and the Aluminium Company of Bahrain, are majority state owned. However, proposed heavy industry expansions require massive amounts of capital. This should increase opportunities for foreign companies to take equity shares in projects, or at least provide expertise. Heavy industry expansion also should create additional opportunities for Australia to increase alumina, and iron and steel making resources exports. (See Chapter 2 - *Australian Opportunities.)*

Stimulating Services Sectors

Gulf economies are expanding their service sectors to diversify their economies. Dubai and Bahrain are setting the pace, with their service sectors accounting for 70 per cent and 78 per cent of their respective GDPs, compared to only 49 per cent in Saudi Arabia.[8] Dubai is the Arabian Peninsula's premier re-export centre, servicing the Middle East and Africa. (See Chapter 5 - *Trade*.) It also is a substantial tourism, financial, exhibition and conference centre. Bahrain is a major offshore banking centre and like Dubai, targets regional headquarters and tourism investment.

With a growing imperative to strengthen private sector employment, all regional economies need to expand their telecommunications, information technology, tourism, finance and education sectors. As part of this process, increasing opportunities should emerge for foreign service providers. Already Oman has committed to liberalise its electricity and telecommunications markets as part of its World Trade Organization, WTO, accession agreement, while Iran, Oman and Saudi Arabia are attempting to boost tourism. (See Chapter 2 - *Australian Opportunities* and Chapter 5 - *Trade*.)

Import Substitution Policies

In the past, to diversify, many Gulf governments pursued import substitution policies assisted by trade barriers. With no incentive to export, mostly small local markets and limited foreign competition, these policies failed to create viable new industries. However, with all regional economies except Iran and Yemen now WTO members or well advanced in the accession process, these policies will be even less successful in diversifying industry.[9]

One major import substitution industry likely to remain is food processing; Saudi Arabia alone has around 400 plants relying on imports for 75 per cent of their inputs (Austrade, 2000). Further, Saudi Arabia still protects its agricultural sector.

Defence Offsets

Saudi Arabia, the UAE and Kuwait still use defence offset programs. These raise the cost of military acquisitions but can provide a form of assistance to foreign companies looking to establish Gulf businesses. (See Chapter 2 - *Australian Opportunities*.) However, to be a successful diversification tool, incentives to export and establish value-adding businesses must be strong.

---

8 These figures come from Jeffreys, 2000, pp 31-33; Bahrain Monetary Agency, 1998; and World Bank, 2000b. For these calculations, Dubai's service sector includes trade, transport and communications, real estate, government services, finance and insurance, restaurants and hotels, and other services. Bahrain's service sector includes trade, hotels and restaurants, transport and communication, social and personal services, real estate, onshore and offshore financial institutions, insurance, government and household services.

9 The UAE, Kuwait, Qatar and Bahrain already are WTO members. Oman's accession is imminent, while Saudi Arabia's is in process.

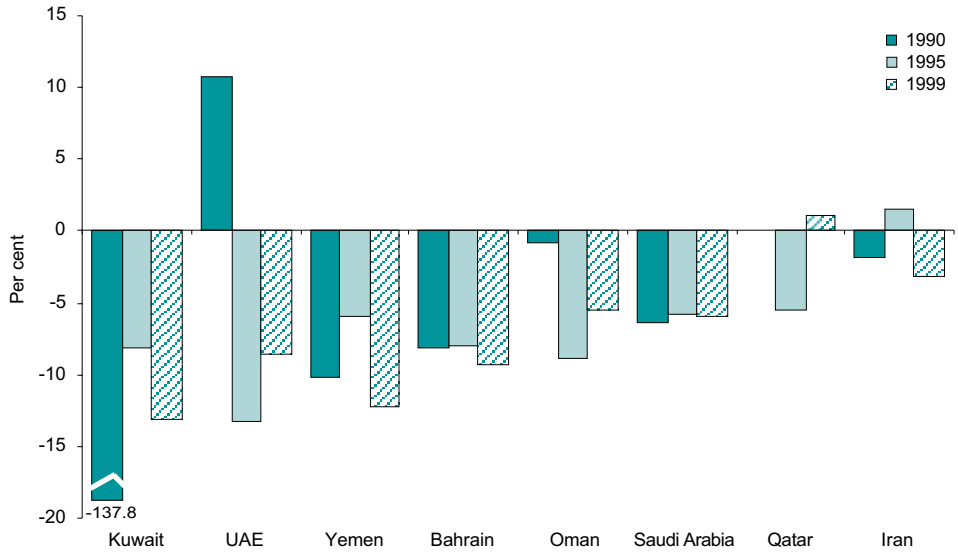
FISCAL PRESSURES

Gulf economies generally run weak fiscal policies, operating deficits in most years, and failing to run these down when oil revenues are high. Apart from Qatar, all Gulf economies have budget deficits; in 1999, these averaged 7 per cent of GDP (Figure 1.11). Persistent deficits generate large official debt stocks. For example, Saudi Arabia's central government debt stock in 1998 was 116 per cent of GDP, with interest payments consuming 25 per cent of expenditure in 1999 (Saudi American Bank, 2000).

Figure 1.11

Budget Deficits the Norm

Government Budget Balances as a Percentage of GDP



Note: a The 1990 figure for Kuwait (-137.8) is massively distorted by disruption during the Gulf War.
b 1990 figures and all Bahrain figures are from Datastream, 2000.

Source: Business Monitor International, 2000a; and Datastream, 2000.

While in 2000, high oil prices will relieve fiscal strains, pressures remain to control expenditure and diversify revenue. All regional governments need to invest more in economic and social infrastructure as populations boom and demand for utilities, education and health burgeons.

Expenditure Restraint

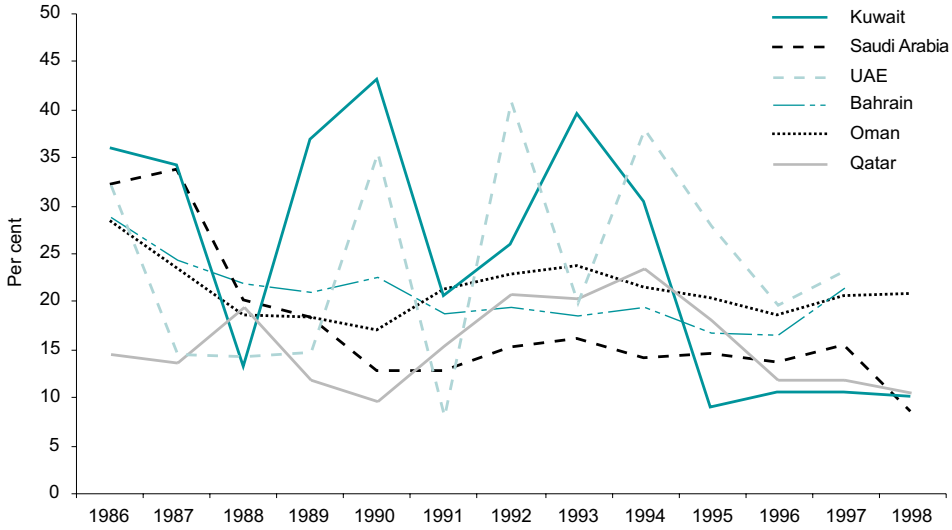
During the 1990s, uncertainty about oil revenue led Gulf governments to more seriously control expenditure. For example, the Saudi Government reduced expenditure by 14 per cent in 1998 and by a further 5 per cent in 1999. Expenditure should rise only 2.2 per cent in 2000, despite higher oil

prices (Saudi American Bank, 2000; and Business Monitor International, 2000b).[10] However, fiscal control mechanisms are crude, largely relying on slowing or postponing capital spending. Consequently, the share of capital expenditure in total expenditure fluctuates dramatically (Figure 1.12). This situation is most serious in Saudi Arabia, where government capital expenditure has declined over the long term (Figure 1.13).

Figure 1.12

Capital Expenditure Fluctuates

Share of Capital Expenditure in Total Government Expenditure for GCC Economies, Per cent



Source: Gulf Cooperation Council, 1999; and Saudi American Bank, 2000.

Revenue Diversification Efforts

Few regional governments impose broad based sales taxes or company or personal income taxes; instead, most rely on oil revenues to finance government spending. As this introduces excessive volatility to government receipts, many regional governments are attempting to increase non-oil revenue. However, rather than structurally reforming the tax system, by introducing personal or company income taxes, or broad based consumption taxes, most measures have been piecemeal. For example, in 1999, Saudi Arabia introduced airport taxes, and raised visa charges, retail fuel prices and electricity tariffs (Saudi American Bank, 2000).

[10] The 2.2 per cent expenditure rise in 2000 represents the difference between actual 1999 expenditure and projected 2000 expenditure (Business Monitor International, 2000b).

Figure 1.13

Saudi Capital Expenditure in Long Term Decline

Capital and Current Expenditure by the Saudi Government, US$ billion

Source: Saudi American Bank, 2000.

Implications of Growing Fiscal Pressures for Foreign Companies

Growing fiscal pressures create opportunities for foreign companies in social services, infrastructure provision and financing.

Trend Towards User Pays

Without major tax reforms, a key method to improve the budget balance is to increase use of the user pays principle for education and health services. This should open up new opportunities for foreign providers to supply services.

Increased Private Infrastructure Provision

Most Gulf economies also now seek to compensate for inadequate government revenue by attracting privately provided infrastructure. Increasingly, Gulf Governments recognise the fiscal burden of publicly funding and subsidising electricity and water infrastructure needs, and the potential efficiency benefits of private provision. (See Chapter 4 - *Foreign Investment*.) Oman is setting the pace by establishing a best practice market and regulatory regime for private electricity provision. However, Gulf economies have massive requirements for additional electricity and water production and distribution, as well as

for enhanced telecommunications, gas and oil pipelines, railways and ports. Between 2000 and 2006, Saudi Arabia, Iran, the UAE, Kuwait, Qatar and Oman will require new electricity infrastructure with an estimated value of US$40 billion (Business Monitor International, 2000d).

Increased Importance of Private Finance

Continuing government efforts to increase private infrastructure provision also will increase the role of private financiers. Foreign financial institutions already are active in infrastructure and project finance, and this role should escalate. Opportunities to sell expertise and services also should increase in other areas, particularly in equity markets if the UAE's stock exchange, established in March 2000, is successful.

THE RELATIVE ROLE OF WESTERN AND ISLAMIC FINANCE

Islamic financing of infrastructure could increase due to the massive funding needs and the new pool of funds Islamic financing can access (Knox, 2000). Conventional and Islamic methods of financing co-exist in GCC economies; most financing currently uses conventional lending arrangements, but Islamic financing is becoming more popular as more products, including managed funds, are developed.

The relative importance of Western and Islamic financing varies throughout Gulf economies. Saudi commercial banks levy service charges for conventional lending rather than charging interest. Other Arabian Peninsula states offer interest on conventional lending, but have specialist Islamic banks, such as Dubai Islamic Bank and Abu Dhabi Islamic Bank, and offer Islamic products within traditional commercial banks. The Iranian banking system is a hybrid of Islamic and western systems. The term 'profit share' is widely used for returns, although the share is calculated as a percentage, like interest. Moreover, the Central Bank of Iran uses term deposits to soak up excess liquidity.

DECLINING OIL RESERVES

At current production rates, oil reserves in Saudi Arabia, Abu Dhabi, Iran and Kuwait should last over 65 years, but in Qatar, Oman, Dubai and Bahrain oil reserves will last only another 10 to 15 years (Figure 1.14) (Jeffreys, 2000, pp. 9-10).

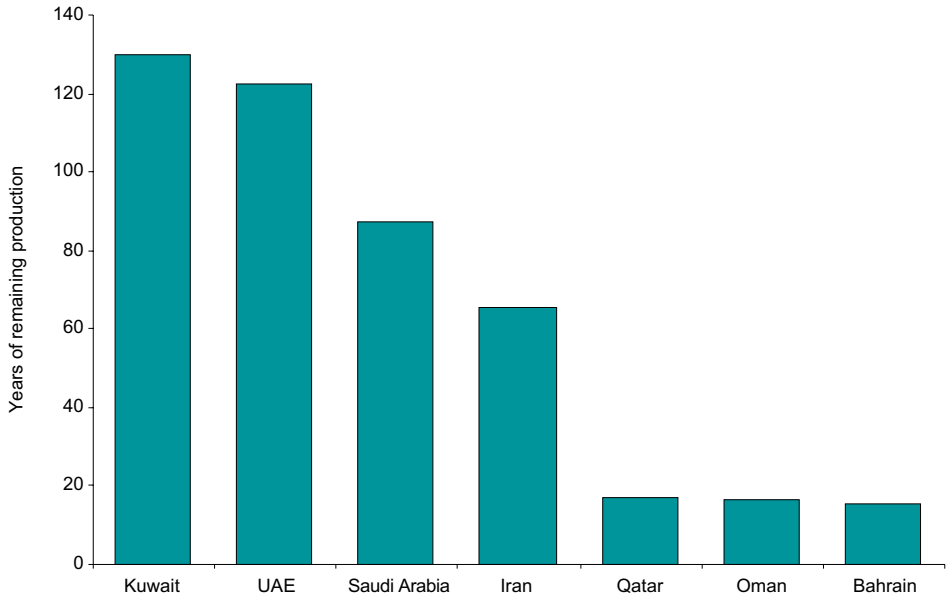
The prospect of oil reserves running out is a powerful incentive to diversify and reform economies. It creates regional examples of successful strategies. For example, Dubai successfully reoriented its economy, so oil now accounts for under 8 per cent of GDP.[11] Dubai now achieves more rapid and less volatile growth than major oil producers; oil rich states may emulate its strategy. Similarly, Oman is adopting a world's best practice approach to attracting private sector infrastructure providers, and encourages foreign participation in its oil and gas sectors.

[11] The share of oil in gross domestic product comes from Jeffreys, 2000, pp. 31-33.

Figure 1.14

Qatar, Oman and Bahrain Face Declining Oil Reserves

Years of Production at Current Extraction Rates, 1997



Note: Iran data are for 1998 from Jeffreys, 2000.

Source: Gulf Cooperation Council, 1999; and Jeffreys, 2000, pp. 47-49.

IMPLICATIONS

Very modest and volatile growth, demographic and fiscal pressures, the need for diversification and declining oil reserves create strong reform pressures. Current high oil prices may reduce the short term imperative for reform, but few governments are likely to change long term strategies.

In 2000, high oil prices will stimulate import growth which should assist new products in penetrating the market. More importantly, ongoing reforms should open more investment opportunities to foreign companies in gas production, infrastructure provision, manufacturing, finance and education. Goods and services trade opportunities are expanding as Gulf economies increasingly source imports from the most competitive suppliers.

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