Accessing Middle East Growth

BUSINESS OPPORTUNITIES IN THE ARABIAN PENINSULA AND IRAN

EAAU
East Asia Analytical Unit

DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

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The East Asia Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia.

Located within the Department of Foreign Affairs and Trade, the East Asia Analytical Unit has undertaken 24 studies on a major issues related to Australia's trade policy interests in the region. This report is the first in a series covering important emerging markets outside East Asia.

Staffed with nine professionals, the East Asia Analytical Unit also contracts a range of consultants with specific areas of expertise. It draws on a wide range of data and information sources, including reports from Australia's diplomatic and trade missions around the world.

Reports and briefing papers produced by the unit are intended to assist analysts and decision makers in business, the Australian Government and the academic community,

Full copies of previous reports and executive summaries now can be downloaded from the Internet. See website details below.

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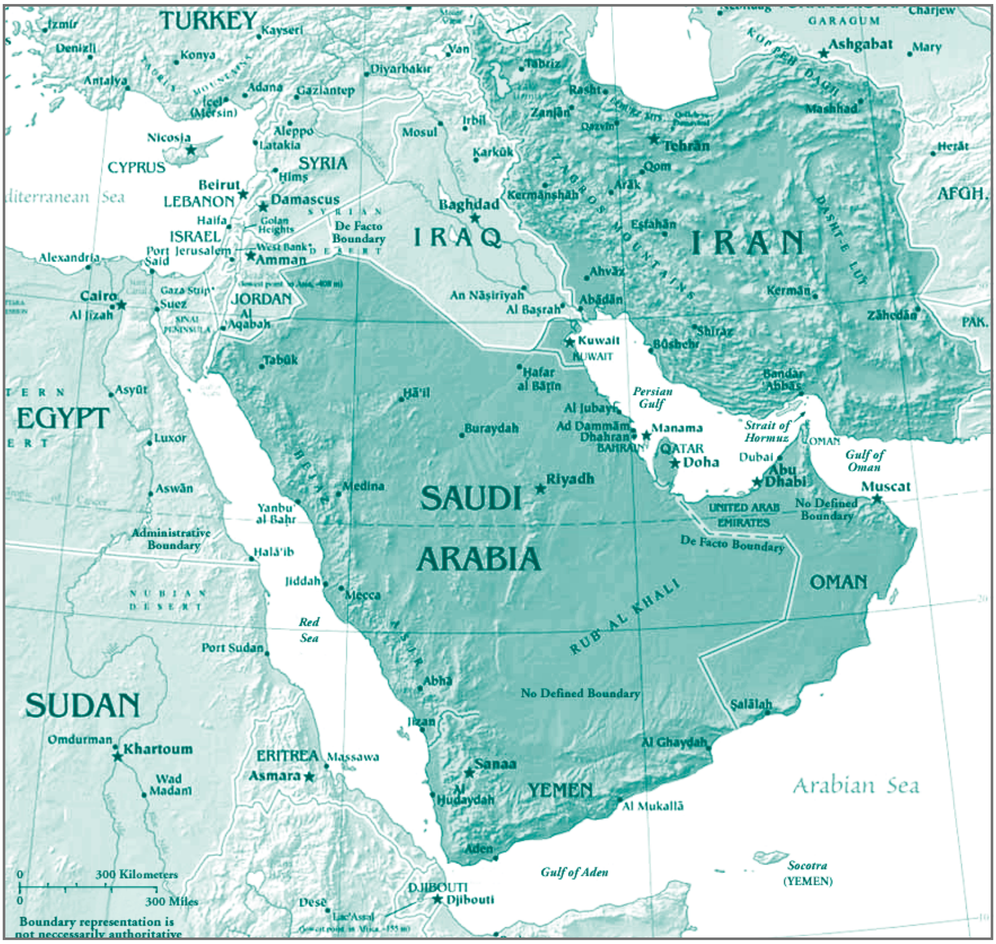
GLOSSARY

AACCI	Australia Arab Chamber of Commerce and Industry Incorporated
ADIA	Abu Dhabi Investment Authority
ADNOC	Abu Dhabi National Oil Company
ALBA	Aluminium Company of Bahrain
APEC	Asia Pacific Economic Cooperation
ARAMCO	The Saudi state owned oil company
BMA	Bahrain Monetary Agency
BOO	Build, own, operate
BOOT	Build, own, operate, transfer
BOT	Build, operate, transfer
Buy-backs	A mechanism facilitating investment in Iran's oil and gas industries, whereby the 'investor' contracts to perform work, and is paid in project output, usually crude oil or condensate. Buy-backs circumvent the Iranian constitutional prohibition on foreign ownership of Iranian natural resources
Defence Offsets	Provisions incorporated by some GCC countries into defence contracts requiring the primary contractor to undertake a set value of investment in a non-defence sector
Dhow	Small, usually wooden cargo vessel used extensively in the Gulf for small scale, traditional, and often unofficial trading
Dolphin Project	The Dolphin project proposal involves building a pipeline from Qatar's giant North field to Abu Dhabi, Dubai and Oman, to supply gas to meet projected shortages in these countries to generate electricity and fuel industries such as aluminium, steel and petrochemicals in new industrial zones. The project is expected to cost between US$8 billion and $10 billion
Downstream	Oil and gas industry term for the refining and processing of oil and gas, such as petrochemicals manufacturing
Dubal	Dubai Aluminium Company
ETM	Elaborately transformed manufacture
EU	European Union
EFIC	Export Finance and Insurance Corporation, of Australia
Farsi	The national language of Iran, also referred to as Persian

FDI	Foreign direct investment, investment in overseas branches, subsidiaries or associated companies in which the investor owns 10 per cent or more equity
GCC	Gulf Cooperation Council: an organisation comprising Saudi Arabia, Kuwait, Bahrain, the United Arab Emirates, Qatar, and Oman, dedicated to promoting closer economic links and integration
GDP	Gross domestic product: the value of all goods and services produced in an economy in a specified time
GTC	Government Trading Company, an Iranian monopoly importer of many bulk agricultural commodities and inputs
Hydrocarbons	Oil and gas
IDEX	International Defence Exhibition and Conference, the world's largest, held annually in Dubai
IPO	Initial public offer
IRI	Islamic Republic of Iran
KSA	Kingdom of Saudi Arabia
LNG	Liquefied natural gas
mbd	Million barrels per day, a measure of oil production or export volume
MW	Megawatt, a unit of 1 000 watts of electricity, commonly used to designate the size of power stations
National interest provisions	Australian Government agreement to act as insurer of last resort for payment for exports, usually bulk agricultural commodities, to nations with poor credit ratings
OPEC	Organisation of Petroleum Exporting Countries
PPP	Purchasing power parity: 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. This information is then used to adjust the country's US dollar per capita income to better reflect its actual purchasing power
SABIC	Saudi Basic Industries Company, Saudi Arabia's largest industrial group
STM	Simply transformed manufacture
TEU	Twenty foot equivalent unit, used to measure the volume of container traffic handled by a port
UAE	United Arab Emirates
Upstream	Industry term for the primary extraction of oil and gas
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

THE PERSIAN GULF REGION



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Source: University of Texas website, www.lib.utexas.edu/Libs/PCL/Map_collection/middle_east_and_asia/MiddleEast_ref802640_1999.jpg, accessed on 23 August 2000.

EXECUTIVE SUMMARY

Over the next decade, growing economic and population pressures should drive considerable reform and structural change in the economies of the Arabian Peninsula and Iran, called the Gulf economies in this report.[1] Recent and anticipated investment and trade reforms should boost opportunities for Australian business. However, the region's economic and business environment remains diverse and fluid.

This report should assist traders and investors accessing markets in Saudi Arabia, the United Arab Emirates, UAE, Iran, Bahrain, Qatar, Kuwait, Oman and Yemen by thoroughly analysing the region's current economic, trade and investment policies, recent and projected economic performance and the unfamiliar business environment, and by highlighting prospective sectoral opportunities for Australian business.

After oil was exploited commercially in the 1950s and oil prices rose in the 1970s, most Gulf economies developed rapidly. However, in the 1990s, slower growth, a desire to reduce exposure to volatile oil prices and increasing demographic pressures forced governments to reassess growth based only on oil revenue and state investment. Even the prosperous Gulf Cooperation Council, GCC, economies of Saudi Arabia, the UAE, Bahrain, Qatar, Kuwait and Oman, seek to diversify and develop other prospective sectors like gas, mining and services. Their strategies include liberalising trade and investment policies to encourage foreign participation.

Lacklustre growth typified Gulf economies during the 1990s. Regional real gross domestic product, GDP, growth rates ranged only from an annual average of 5.2 per cent in post-war Kuwait to 1.4 per cent in Saudi Arabia. Since Iran's 1979 revolution, the population has doubled, but real GDP has expanded at only 1.6 per cent per year due to inward looking economic policies, an eight year war with Iraq and political turmoil. Relatively oil-poor Yemen recently commenced economic reforms and reversed economic contraction after years of civil war, political upheaval and negative growth.

Throughout the Gulf economies, the need to create employment opportunities for rapidly growing populations is intensifying pressure to lift economic growth. The 1970s oil boom produced a baby boom, and oil wealth encourages strong inward migration. Two thirds of GCC economies' populations are under 25 years; 21 per cent are aged between 11 and 15 years. As oil sectors provide relatively few jobs for nationals, governments are encouraging new investment in service sectors able to provide appropriately paid jobs. To achieve this, young nationals require appropriate education and training; this expands opportunities for foreign educational service suppliers.

Pressure to diversify from oil is particularly intense in Dubai in the UAE, Qatar, Oman and Bahrain where oil reserves will last only another 10 to 15 years. Dubai already benefits from diversifying into transport, distribution, tourism, finance and other services; oil production now accounts for less than

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.

8 per cent of its GDP. Even in the 1980s, Bahrain achieved similar success by developing into an offshore banking centre, producing aluminium and refining Saudi and Bahraini oil. Qatar is developing its extensive gas resources, while Oman is undertaking radical infrastructure reforms and expanding distribution and tourism sectors.

To diversify into non-oil sectors, Gulf economies increasingly are liberalising their trade and investment policies. The UAE, Kuwait, Qatar and Bahrain are World Trade Organization, WTO, members while Saudi Arabia, Oman and Yemen are undertaking reforms under their proposed accession programs. Saudi Arabia will liberalise its foreign investment regime so 100 per cent foreign owned companies can participate in many sectors, although international investor interest in this reform is constrained by continued lack of clarity about excluded sectors and lack of implementing regulations. Iran tentatively is opening oil, gas and petrochemical sectors to foreign participation through output 'buy-back' schemes, although most other sectors remain effectively closed to foreign direct investment, FDI. Several Gulf economies are opening education sectors to foreign providers and privatising infrastructure to overcome budgetary constraints.

Because the Gulf economies insufficiently expanded government revenue beyond oil proceeds, they ran budget deficits throughout the 1990s, averaging 7 per cent of GDP in 1999. With ready access to oil revenues, few GCC governments levy income or sales taxes, or plan to introduce them in the near future. However, even major oil producers like Saudi Arabia, the UAE, Iran and Kuwait, feel the pressure to diversify government revenue sources, because of the cap on oil revenues enforced by OPEC quotas and growing demand for government services. New revenue raising initiatives include higher user charges for power and water, and user contributions towards health and education services.

With populations, incomes and demand for new government services rapidly expanding, many regional governments also are encouraging private infrastructure provision. Between 2000 and 2006, meeting new Saudi, UAE, Iranian, Qatari, Omani and Kuwaiti electricity demand alone will cost US$40 billion. Oman has developed a coherent framework for private infrastructure supply, but Kuwait, the UAE, Saudi Arabia and Yemen seek private infrastructure providers.

AUSTRALIA-GULF TRADE AND INVESTMENT TRENDS

Australia's trade relationship with the Gulf economies is well developed and growing rapidly. Australian investment is small but expanding rapidly with the burgeoning range of opportunities.

AUSTRALIAN EXPORTS TO GULF ECONOMIES

Between 1995 and 1999, Australia's exports to the Gulf economies grew strongly at 19 per cent per year, 50 per cent higher than overall Australian export growth. Car exports boomed from nearly zero in 1995 to A$800 million in 1999. As a result, elaborately transformed manufactures, ETMs, now represent 34 per cent of Australian exports to the Gulf. Australia's bulk commodity trade in wheat, sugar, frozen meat and alumina continues to flourish. However, in 1999, primary product exports represented 64 per cent of Australian exports to the Gulf, down from 94 per cent in 1990.

While cars account for 85 per cent of ETM exports, high oil prices in 2000 and 2001 will offer excellent opportunities to diversify ETM exports, particularly for telecommunication products, pharmaceutical and medicinal products now patent protection is improving, and fast ferries. Other key export opportunities include increasing:

- bulk and high value agricultural exports, as governments reduce costly subsidies and water supplies to inefficient local agriculture
- education exports, by attracting Gulf students to Australian institutions and providing in-country courses
- Gulf residents' tourism to Australia and services to Gulf tourism markets
- construction equipment, materials and service exports.

Australian Imports from Gulf Economies

Australia is a net hydrocarbons exporter, so its imports from Gulf economies are limited. Nevertheless, in 1999, Australia's imports from Gulf economies totalled A$1.3 billion, including A$894 million in petroleum products. Non-petroleum related manufactured imports grew from A$32 million in 1990 to A$177 million in 1999. However, the Gulf economies' manufacturing base is narrow, while the markets for niche products such as Persian carpets, musical instruments and dates are limited and suffer from inadequate trade promotion efforts.

Australia's Investment Opportunities

Australia's new investment in the Gulf economies is directed at the relatively open and business friendly UAE; in 1997, it had attracted 30 Australian companies but in 2000, this had increased to 70. This extra growth implies at least A$20 million in new investment. The largest Australian UAE operations include assembly and light manufacturing facilities (Clipsal and Lionweld Kennedy), a regional distribution centre (Boral Plasterboard), construction operations (Multiplex) and leisure sector investment (Greater Union).

Outside the UAE, most Australian investment interest is in oil and gas, with BHP Petroleum, Woodside Petroleum and smaller companies like Novus Petroleum all active. In addition, ANZ Investment Bank has a Bahrain based regional operation and three Australian companies have significant joint ventures in Saudi metal processing, health and construction sectors.

Gulf Investment in Australia

Data on the Gulf economies' investment in Australia are limited, but clearly Australia's share of their massive offshore investment is well below Australia's share of world GDP. Frequent and direct air links between Australia and the Gulf, with Emirates flights to Dubai and Gulf Air flights to Abu Dhabi and Bahrain, should increase investment in real estate, tourism, services and Australian financial products. The UAE's direct investment in Australian agriculture, horse breeding and real estate is considerable, but Australia's agricultural and resource sectors could attract more Gulf investment; in turn, this could generate new Australian export opportunities to the Gulf.

THE BUSINESS ENVIRONMENT

Understanding the Gulf region's religion, culture and business environment remains critical to doing business there. Important issues include appropriately using local agents, choosing local investment partners, understanding the role of chambers of commerce and managing the region's bureaucratic culture. Two important future business issues are the changing role of agents and influence of changing demographics on market demand.

Religion and Culture

Islam permeates Middle Eastern policy making and daily life far more than religion does in most western economies. For example, the Leader of the Revolution in Iran and conservative Islamic theologians in Saudi Arabia considerably influence law making and economic policy. Islam also guides patterns of food and drink consumption, clothing demand, financial sector products, attitudes to advertising, and other consumption and investment behaviour.

The distinction between Arab and Persian cultures, histories and languages also is important. Failing to recognise these differences, and particularly misidentifying Arabs and Persians, can cause offence. Similarly, using the incorrect term for 'the Gulf' can cause serious problems with partners, exports and contracts. Iranians refer to the 'Persian Gulf', while Arabs refer to the 'Arabian Gulf'. Officially, Australia, like most western countries, refers to the 'Persian Gulf'.

The Legal Environment

Governments tend to legislate business law, but even so, legal frameworks are significantly less developed than in western economies. Consequently, avoiding litigation is important to business success. Legal problems include complying with often complex and ambiguous foreign ownership laws, achieving intellectual property protection and terminating agency agreements. Consequently, thorough due diligence on potential partners and use of all available means of dispute resolution, such as negotiation or arbitration, if problems do arise, are essential. Where possible, providing for arbitration in Australia or third countries is desirable.

The Importance and Changing Role of Agents

Most Australian companies selling goods on the Arabian Peninsula initially use an agent for marketing and distribution. In Oman, Qatar, Kuwait and Bahrain, this often is a legal requirement. However, in the period to 2005, WTO requirements will increase the difficulty of reserving agency roles for nationals. In addition, e-commerce, rapid population growth and higher education levels among young nationals should ensure local agents and joint venture partners add more value and more actively contribute to joint businesses.

Demographics

The Gulf economies' young populations should maintain reform pressure and stimulate demand for education, music products, electronics, information technology and communications, snack foods, travel, housing and mortgage financing.

Non-nationals, from the Indian sub-continent, other Middle Eastern states and western economies are important in GCC workforces and market demand. Expatriates account for about 70 per cent of the population in the UAE, Qatar and Kuwait and 60 per cent in Bahrain, and are significant in most other Gulf economies. Non-nationals not only do all menial, dangerous and unskilled work, but fill many private sector skilled and managerial positions.

In recent years, most Gulf economies have introduced programs to localise skilled jobs to create employment for the oil boom-baby boomers entering the workforce. Saudi Arabia, the UAE, Qatar and Oman have formal quotas; however, Bahrain's initiative of establishing an Institution of Banking and Finance at Bahrain University to train Bahrainis (and other GCC nationals) to become very competitive financial sector employees appears more successful. Bahraini banks have 70 per cent local staff.

FOREIGN INVESTMENT

Due to their huge oil export receipts, GCC economies are traditionally capital exporters. Abundant capital and restrictive foreign investment regimes have made FDI a much less significant capital source for the Gulf economies than for East Asia, for example. However, efforts to strengthen growth, diversify economies and create employment are changing rapidly these restrictive policies.

Regional FDI Polices

Remaining constraints on inwards FDI to the Gulf economies include caps on foreign ownership outside the free trade zones, prohibitions on investing in many sectors (particularly oil), restrictions on foreign participation in key infrastructure, energy and manufacturing sectors, and imprecise regulatory frameworks. However, Qatar, Oman and Saudi Arabia lead reform efforts, and further opening of FDI regimes is likely in the short to medium term. Iran also is attracting growing interest in oil and gas buy-backs, and is legislating to provide security for foreign investment.

Investment Opportunities

Gas related projects and infrastructure are generating much private investment interest. Large scale foreign involvement is more prospective in the region's huge emerging gas industry than in oil, as regional expertise and vested interests in the gas sector are less developed. Successful completion of major gas pipelines, such as the proposed Dolphin project from Qatar to the UAE and Oman, will increase the competitiveness of energy intensive petrochemicals, aluminium smelting and steel production. The scale of investment and need for internationally competitive operations should make foreign investment more attractive than majority state ownership, the previous approach. Private infrastructure investment opportunities also should expand due to ongoing liberalisation and massive needs for telecommunications, roads, pipelines construction, railway construction, and electricity and water production and distribution services. Free trade zones also provide light manufacturing and distribution opportunities.

Free Trade Zones

The Gulf's leading free trade zone, Dubai's Jebel Ali, has over 600 international manufacturing, distribution, trading and processing companies, including Colgate Palmolive, Samsung and IBM, and a range of Australian companies. The UAE's other major free trade zone is Sharjah, home to Clipsal's Middle East and South Asian manufacturing operations, and Lufthansa's largest cargo hub after Frankfurt. Dubai also is developing a free trade 'Internet city' for technology, e-commerce and media.

Other important regional zones are at Aden in Yemen and Salahah in Oman; both feature large shipping and distribution investments. Iran's free and special economic zones, particularly Qeshm Island, Al Mahdi near Bandar Abbas and Abadan have considerable latent potential, particularly for heavy industry and petrochemicals, but Iran's failure hitherto to enact appropriate legislation guaranteeing investor security constrains this. Kuwait has established a free trade zone with world class infrastructure at Shuwaikh Port. Ultimately, Kuwait aims to make the entire country a free trade zone.

Foreign Investment Prospects

Significant structural changes underway in the Gulf economies should ensure foreign investors considerable future opportunities. Most governments recognise they cannot allow current high oil prices to reduce reform momentum; for example, unless oil prices remain above US$25 per barrel, only Kuwait could finance its new electricity infrastructure requirements without outside investment.

Service industries require intensive skilled labour, making investment liberalisation in the service sector critical. As Dubai's experience shows, sound economic policies and even a partially liberalised environment offers major growth and employment benefits.

TRADE

Oil dominates regional trade, accounting for up to 70 per cent of Gulf economies' exports. Oil also provides the feedstock for the Gulf region's growing petrochemical exports, which account for around half of non-oil merchandise exports, except in Bahrain and Iran. When oil prices fell below US$10 per barrel in 1998, import volumes declined markedly. In 2000, regional imports are forecast to surge to US$90 billion, and given the significant lag in importing, this strong trend should continue into 2001.

Imports

Because the Arabian Peninsula economies have relatively narrow and underdeveloped industrial bases compared to OECD economies, they import most manufactures, including consumer durables, particularly cars and capital goods. In Iran, with its diverse but relatively inefficient state owned industrial base, bulk foodstuffs and essential machinery dominate imports.

All Gulf economies are significant food importers. Most regional governments subsidise inefficient local agriculture, but fiscal and demographic pressures are likely to weaken these policies in the next decade. This should boost prospects for food exporters like Australia.

While significantly smaller as an import market than East Asia, the Gulf economies still are significant importers. In 1998, the largest regional economy, Saudi Arabia, imported US$28 billion of merchandise, followed by the UAE with US$24 billion, Iran with US$10 billion and Kuwait with US$7 billion. As the UAE is a re-export centre, this significantly inflates its imports. The fastest growing importers are Qatar, the UAE and Oman, while the fastest growing imports include dairy products (Saudi Arabia, the UAE and Bahrain), meat (Saudi Arabia and the UAE) and transport equipment (Saudi Arabia, the UAE, Kuwait and Yemen).

Trading Partners

The Gulf economies dominate world oil trade, but intra-regional trade is relatively limited. Instead, the region's main trading partners are the United States, Japan, the UK, Germany, Italy, Republic of Korea and France. Australia receives only 0.7 per cent of the Gulf economies' exports (mainly crude oil) but supplies over 2 per cent of their imports, well above its 1 per cent share of international trade.

Re-exporting Centres

Dubai is the Gulf region's premier entrepot, with re-exports doubling in value to US$11 billion per year between 1990 and 1998. Dubai's twin ports of Jebel Ali and Port Rashid handle 40 per cent of all Gulf container traffic.

Since 1997, governments and foreign companies have formed joint ventures to build large ports and container terminals at Salalah in Oman and Aden in Yemen. These strategically located ports, close to European and Asian sea lanes, allow ships to bypass the Strait of Hormuz, thereby saving time, fuel and insurance premiums. Nonetheless, for the foreseeable future, Dubai is likely to retain its premier re-export role due in part to its large internal market and its ports' efficiency.

Effect of WTO Accession

WTO accession requirements are driving considerable trade and investment reform in Gulf economies. Oman's WTO accession is imminent; Saudi Arabia wishes to accede in 2000 but this now appears unlikely; and Yemen's application is nascent. Iran's application for WTO membership has not been scheduled for consideration due to US opposition.

When Saudi accession occurs, it should drive regional trade growth and improve access for Australian dairy, car and grain exports. Increased transparency and intellectual property protection, and equal tax treatment for domestic and foreign companies also should result. Oman's accession progressively will open the telecommunications sector and liberalise foreign investment regulations.

Trade Barriers

Tariff barriers, except in Iran, are generally low and not a major constraint on trade. UAE and Kuwaiti tariffs average 3.5 per cent, while Saudi tariffs average 12.5 per cent. About 75 per cent of UAE imports enter duty free, largely due to imports into free trade zones. Iran has tariffs of between 30 and 50 per cent, bans many imports and awards exclusive importing rights to ministries, religious foundations and individuals. Rationing of scarce foreign exchange further constrains Iranian trade.

GCC members recently agreed that by 2005, they would adopt a common range of external tariffs from 5.5 to 7.5 per cent. Implementing this common external tariff is complicated by the need for substantial falls in Saudi tariffs and for rises in UAE and Kuwaiti tariffs. However, the need to have a common external tariff before negotiating a free trade agreement with the European Union should maintain momentum.

Implications

Slower growth, demographic pressures and the benefits of globalisation are convincing many Gulf governments to diversify their economies and open them further to foreign trade and investment.

High oil prices, the competitive Australian dollar and gradually opening Gulf economies generate strong Australian business prospects. Major business opportunities include expanding traditional agricultural and mineral exports, particularly wheat, sugar and alumina, and developing new markets for fresh and processed food, a wide range of ETMs, particularly cars, and tourism, education, infrastructure, construction and business services.

The Australian Government has an important role in raising Australia's trade and investment profile in the Gulf economies, by encouraging high level delegations and adequately resourcing trade and diplomatic posts. It also can further promote Australian educational exports and advertise Australia as a tourist and investment destination.

Prospects

Over the coming decade, Australia's natural complementarity with the Gulf economies and the region's ongoing reforms should deepen trade and investment opportunities for Australian business. However, the Gulf markets are very competitive and cultural differences are marked, so Australian businesses should devote appropriate energy and resources to market research and development to access this highly prospective region.