GCC's Fiscal Tipping Point-Has it arrived?

Manaf Alhajeri, CEO, Markaz & KES Member

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The Fiscal Tipping Point

The case of oscillations in oil prices has increased the interest in the subject of "GCC's fiscal tipping point". I.e., is the GCC poised for a change in its economic policy agenda setting? If so, what would such agenda look like? The fiscal pressures brought about by low oil prices marks a tipping point in terms of economic policy planning as well.

Fiscal Revenues Excessively Reliant on Oil Receipts

The impact of oil revenues on Kuwait's economy is visible to everyone. GDP per capita rose from USD 20,966 in 1980 to USD 47,639 in 2013—improving the quality of life greatly in the process. However, the rise of the oil sector in the country's economy has meant that the current expenditure in terms of the national budget has ballooned simultaneously. In 2013, the current expenditure stood at KW 18.5bn; while the capital expenditure was a mere KW 3.0bn. The capital expenditure, in other words, constitutes over 85% of the total expenditure. The oil revenues fueled expenditure spree has meant that Kuwait will find it difficult to maintain fiscal sustainability during times of low oil prices, which the markets are currently undergoing. For e.g., the International Monetary Fund (IMF) expects Kuwaiti government's expenditure to exceed oil revenues by as early as 2017/18. In 2013, oil revenues accounted for about 82% of total government revenues.

The Oil Market is Undergoing Large-scale Supply Side Changes

The oil market appears to be undergoing deep structural changes. While easily available sources of conventional crude are getting exhausted and deeper drilling means more costs, the rise of shale in the U.S. has unleashed a surge of oil inventories into the international markets. The US shale-led boom is continuing to thrust pressure on conventional energy players. Extracting energy reserves from shale rock formations through hydraulic fracturing has transformed the American energy industry, and the U.S. Energy Information Administration sees US shale oil production hitting 9.6 million barrels per day by 2019[1].

For e.g., the Permian Basin of West Texas and New Mexico in the USA holds an estimated 75 billion barrels of recoverable oil. That is an estimate that went up by 50% in just 2013. For context, it is notable that KSA's dominant Ghawar field is estimated at about 70 billion barrels of further recoverable oil. Even as traditional exporters are having to tap more difficult layers and new producers are rising, the demand for oil is forecast to display the slowest growth rate to 2035, at 0.8%, per year.

The Unconventional Sources are Still Not Cheap to Produce

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[1] http://www.cnbc.com/2014/10/28/could-shale-help-us-beat-saudi-arabia-as-top-oil-producer.html

What players in the GCC enjoy are cost advantages. The marginal cost of producing one new barrel of oil in Middle East onshore projects range between USD 10-17 on an average, whereas U.S. shale oil metric on the measure can range from USD 70-77. Projects elsewhere in places like the Arctic can cost an astronomical USD 115-122 per one new barrel of oil. Thus, leveraging the low cost of production in the Mena region may still offer hopes of a distinct competitive advantage in the international oil markets, particularly in Asian countries where the hunger for energy is high (e.g., China).

Though the oil prices are relatively low currently, there are good chances that they could spike over the course of the following decade. Middle East investment shortfall due to low oil prices, especially upstream, may lead to a shortage of two million bpd by 2025, with oil prices jumping by about $15 per barrel due to that. As per the International Energy Agency (IEA), the Middle East region will have to invest $3.2 trillion over the next twenty years in the energy sector.

Meanwhile, there is little doubt that the momentum of demand lies with Asia. For e.g., in August 2014, Kuwait concluded a 10-year agreement with Sinopec Corp of China. This includes an arrangement to export 300,000 bpd of crude oil, which would represent 15% of total Kuwaiti petroleum exports.

The Implications that Emerge from this Research for Kuwait are Clear

There are two schools of thought emerging in the face of the latest oil price crisis. One set of stakeholders are calling for immediate alarm and corrective steps regarding fiscal sustainability; while another set wants to continue on the current path of heavy spending. Kuwait does not have to position itself with either of the two extremes. Structural reforms can be done without dread and kneejerk reactions after chalking up a road map that is able to synthesize every facet of national decision making as part of building a broad based consensus.

Some of the structural reforms needed will be painful and will likely bring opposition from some stakeholders. For e.g., roll back of select subsidies, taking the support of international oil companies, etc., are all extremely sensitive topics. Driving a consensus on them will be difficult. Moreover, the future is hard to predict. Nevertheless, the probabilities that lie ahead suggest that there is still time for constructive reforms, but that time is incredibly precious.

The Policy Tipping Point

A Strategic Policy Roadmap with Tangible End Goals is Needed

Table: Three Pillars of National Capacity Building and their Components

Pillar	2013
Basic Requirements	Institutions
	Infrastructure
	Macroeconomic environment
	Health and primary education
Efficiency Enhancers	Higher education and training
	Goods market efficiency
	Labor market efficiency
	Financial market development
	Technological readiness
	Market size
	Business sophistication

Innovation & Sophistication	R&D Innovation

Source: WEF

It is common knowledge that the GCC lags behind in WEF competitiveness rankings. The GCC is displaying a wide lag behind advanced innovation economies such as Singapore in the areas of higher education and training, innovation, capacity of institutions and infrastructure. Ease of doing business has to increase in several GCC countries. In that quest, it would help if state-owned enterprise (SOEs) serve as vehicles of innovation and competitiveness. Creative public sector reforms are important in that respect. For e.g., the GCC Interconnection Power Scheme can help find solutions to the issue of burning much oil for power generation.

The long-term purpose now is to reduce investments in power-capacity by sharing both the generation reserves and investments in generation infrastructure. The grid integration can also be a source of diversification; for instance, countries could export nuclear power, creating an integrated market by networking the distribution of power.

Economic Diversification

Related to economic diversification is the need to develop knowledge economies. There is a big gap in innovation between advanced economies and GCC despite higher per capita GDP, though there are variations within the bloc. The GCC economy is under transition and require strategic reforms in capital markets too. Capital markets will have to focus on superior corporate governance. A comprehensive policy agenda will have to combine multiple agenda and reform steps. Moving away from an oil based model to a more diversified economic structure involves collaboration with the international community to create opportunities for specialized industries (e.g., high-tech manufacturing). Jobs creation, too, will follow if there is a strategic approach towards reducing public sector employment and increasing rate of private sector employment. For that, it is important to place an emphasis on science and math in education and introduction of innovative vocational training.

Economic diversification in Kuwait requires policies to support infrastructure growth, SMEs, and export promotion activities. Closely connected to this imperative is the need for progress in engineering a competitive 'ease of business environment', along with the social dimensions of education and a skilled workforce.

Close to 25,000 people pass out of Kuwaiti universities and colleges every year. Only about 6,000 of them can be absorbed into the public sector, on a realistic basis, into an already bloated public sector. Thus, the need for job creation on an urgent basis is critical in Kuwait. This is because a mix of heavy urbanization rates and high unemployment could lead to social stressors. However, the private sector can be skeptical in taking in nationals in large numbers due to the perceived or true stereotype that there is not enough critical mass of talent, especially up the higher skill categories.

Private Sector Expansion

With respect to private sector expansion, it is critical to attract foreign investments to bring in technological improvements. Full-fledged support to SMEs (eg: funding, mentoring) and encouragement of PPPs will play a key role as well. Enacting reforms to improve ease of doing business will go a long way in boosting international competitiveness ranking of Kuwait. Using SOEs to guide and strengthen the private sector can create conditions for better accountability and transparency (corporate governance) within the public sector itself.

Fiscal sustainability will improve by following a program of acceleration of capital spending by gradual deceleration of allocation to excessive current spending. Meanwhile, improving spending on R&D as a percentage of GDP will enlarge the potential of the Kuwaiti knowledge economy. Promoting capital markets reforms will interest large groups of investors, both domestic and overseas, adding further impetus to the growth of corporate transparency.

Improving International Competitiveness

Kuwait's consistently poor showing in international competitiveness indexes (like the 'The Global Competitiveness Report' of the World Economic Forum) indicates the need for a comprehensive and cohesive national competitiveness strategy that is aligned with the economic and social objectives for the ultimate well-being and prosperity of the UAE.

Worryingly, Kuwait dropped four spots on the World Economic Forum's Global Competitiveness Ranking for 2014-2015[2]. Declining from 36 to 40 in 2014, Kuwait's position highlighted problems with excessive government bureaucracy, poor labor regulations, lack of access to financing for SMEs, etc. Thus, in order to improve international competitiveness, a calculated program is necessary. First, the extent of gaps in international competitiveness should be ascertained between Kuwait and a select cohort of countries. Then, the component causes of the various productivity challenges and the inter-relationships between them should be examined. This will naturally lead to plans for implementing and monitoring remedial actions.

Public Sector Reforms

One of the critical pillars of public sector reforms in Kuwait will have to revolve around the concept of public sector entities acting as vehicles of innovation and competitiveness. As per the World Economic Forum's Global Competitiveness Report, Kuwait's research capacity indicators lags many other GCC countries by a considerable margin. For e.g., Kuwait ranks sixth among GCC countries in terms of company spending on R&D. Kuwait ranks fifth, ahead of Bahrain, in terms of university-industry collaboration in R&D. Public sector reforms can add to the quest to build national competitiveness, especially in terms of forging a industry-government-academia nexus.

The other critical area of public sector reforms lies in the area of eliminating or minimizing waste. For e.g., how can the government find solutions to the challenge of diverting large amounts of oil produce for generating electricity for domestic consumption in Kuwait, of which much wastage happens as well. Plans such as the 'GCC Interconnection Scheme' could prove useful here. The current GCC power interconnection typology is a hybrid system between the neighbor-to-neighbor principle and a backbone or common link typology.

The long-term purpose now is to reduce investments in power-capacity by sharing both the generation reserves and investments in generation infrastructure. The grid integration can also be a source of diversification; for instance, countries could export nuclear power. An integrated market by networking the distribution of power.

Creating Knowledge Economy

There is a big gap in innovation between advanced economies and GCC despite higher per capita GDP. Within that context, there is much variance in terms of how GCC countries stack up against each other in terms of innovative scores. In the Global Innovation Index (2014), UAE ranks the best among GCC nations (36^{th} out of 143 countries) while Oman ranks the least (75^{th}). Kuwait (69^{th}) ranks ahead of Oman at fifth

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[2] http://news.kuwaittimes.net/kuwait-drops-4-spots-global-competitiveness-state-ranks-lowest-fda-highest-controlling-inflation-hiv/

position. A key aspect of addressing the fiscal tipping point would be add capabilities to grow the knowledge economy.

Capital Markets - Capital Markets Reforms Important to Attract Domestic & Foreign Liquidity

Closely connected with improvements in international competitiveness, there is the need for effective public sector reforms. Public sector reforms should largely revolve around financial reforms, retooling the state's role in the national economy in terms of gradually shifting away from dependence on oil, strengthening private sector participation through PPPs, boosting project ownership by Kuwaiti nationals, and supporting labour market reforms.

Critical to public sector reforms is the underlying need to refine the functioning of the Kuwaiti capital markets further. Ever since the Morgan Stanley Capital International (MSCI) included Qatar and the UAE in 2014, there has been greater need felt in Kuwait to develop its capital markets further. The time for Kuwaiti capital market to align with international standards is at hand.

For integration into international fund markets and obtaining more inflows of FDI, capital market reforms are necessary. This is due to the generic market belief that FDI targets nations with good institutions and strong financial market fundamentals. Capital market reforms can support larger FDI flows, thereby promoting effects of efficient productivity to set in, along with transfer of ideas and technologies.

Lack of effective and transparent capital markets will be largely taken as a sign of financial information friction in a host country, along with notions of weak institutions prevailing. Information frictions cause reduction in the volume of capital inflows significantly for not just FDI, but various other types of capital as well.

Capital Markets - Capital Markets will have to Focus on Superior Corporate Governance

Encouraging good corporate governance facilitates development of deeper and specialized capital markets over time. In contrast, weak governance undercuts the integrity of traded securities and dampens the use of public markets as a way to channel investment. Improving corporate governance through capital market guidelines and regulatory reach can help manage risks while adding value to investments of users of the capital markets.

In weak corporate governance environments, lack of firm standards and feeble enforcement are barriers to making investments. Improving the corporate governance of companies allows investors to invest in high risk/high return environments. Also, it can increase the market valuation of participating companies and can pull further investments, which in turn would heighten exit opportunities on commercially favorable terms.

The GCC Economy is Under Transition and Requires Strategic Reforms

The current oil price volatility may be indicative of more structural shifts rather than simply reflecting periodic market volatility. The age of fossils may indeed be losing dominance, though it is too early to predict anything now. The GCC has to carve a new course to shift away from a rentier paradigm of oil dependence. The GCC has to work towards a broad export, industrial and employment base outside the oil industry, without any illusions of being able to depend on its sovereign wealth funds for long in terms of dealing with protracted downswings in oil prices.

The oil wealth has provided the GCC with years of good economic wellbeing; but has had the side effect of stunting private sector expansion. A new social contract that calls upon and supports the private sector to thrive is now necessary. Reforms will be difficult and may take trials and errors to get the entire package of reforms to click together. However, an era of strategic reforms is critical now.

But Reforms are Mostly Targeting Low Lying Fruits in Relatively Safer Industries

The evidence of some of the reforms across the GCC indicate that they target low hanging fruits in relatively heavily regulated areas. For instance, the financial sector, which is a highly mature industry, faces the bulk of regulations and reform efforts across many GCC countries. Public sector entities or companies are not that easily targeted for reforms.

This suggests inherent contradictions within the current reforms architecture, i.e., most reforms are being targeted at sectors where they are least needed. Public sector reforms and labour reforms are difficult to not only measure, but are strewn with complex linkages and externalities in terms of resistance to efforts to reduce the economic role of the State.

GCC Policy Agenda

In summary, the GCC Policy Agenda should focus on eight key themes or pillars. They are—

1. Economic Diversification – Moving away from an oil based model to a more diversified economic structure while expanding collaboration with the international community to create opportunities for specialized industries (e.g., high-tech manufacturing).
2. Jobs Creation – A strategic approach towards reducing public sector employment and increasing rate of private sector employment. In addition, focusing on imparting skills and training that a globalized private sector seeks.
3. Private Sector Expansion – Regulatory reforms in order to incentivize investments, and reduction of bureaucracy and red tape.
4. Improving International Competitiveness – Enacting reforms to improve ease of doing business and developing better effectiveness in bureaucracy governing business practices (e.g., customs, municipality licenses, etc.).
5. Public Sector Reforms – Looking at SOEs as units that have to churn profits or produce excellent service delivery through increased efficiencies.
6. Fiscal Sustainability – Acceleration of capital spending by gradual deceleration of allocation to excessive current spending.
7. Creating Knowledge Economy – Focusing on developing an ecosystem for science, technology and innovation (STI) to thrive. Moreover, focusing on developing an ecosystem for science, technology and innovation (STI) to thrive.
8. Promoting Capital Markets – Further emphasis in enforcing transparency and corporate governance codes.

The GCC Policy Agenda is required to enhance developmental and strategic plans through a shared vision that leverages historical economic strengths and competitive advantages. The vision should embrace continuous change, keep pace with rapid developments, and enable the GCC to tackle the future with ambition and confidence.