OPEN ACCESS
Saudi Journal of Economics and Finance
Abbreviated Key Title: Saudi J Econ Fin
ISSN 2523-9414 (Print) |ISSN 2523-6563 (Online)
Scholars Middle East Publishers, Dubai, United Arab Emirates
Journal homepage: http://saudijournals.com/sjef/

Review Article

An Analysis of Economic Diversification of Middle Eastern Countries

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DOI: 10.36348/sjef.2020.v04i02.002 | **Received:** 15.02.2020 | **Accepted:** 22.02.2020 | **Published:** 29.02.2020

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Abstract

Economic diversification entails the process of reducing dependence on single source of income or output generation. The basic idea behind economic diversification, therefore, is to develop the kind of diverse sectors that make significant value addition in an economy rather than relying on a single sector. It is in this backdrop that the present study is articulated to shed light on the pattern of economic diversification among the countries of the Middle Eastern region. The present paper employed two measures of diversification such as share of employment and value added of a particular sector in Gross Value Added over the period 1970-2016. The study has found that the region as a whole is witnessing economic diversification in terms of both the criterions at a moderate speed. Dynamic tradeable sectors should be developed in order to enhance the pace of economic diversification to strengthen macro-economy.

Keywords: Economic diversification, employment, value addition, Middle Eastern Countries.

INTRODUCTION

Economic diversification connotes the process of reducing the dependence on a single source of output, income, employment, and government revenues etc. It also entails the idea of reducing the dependence on a homogeneous basket of export goods. Diversification involves developing a more robust range of sectors and provide diverse range of goods and services. In other words, the underlying objective is to enhance the performance of non-agriculture sectors such as manufacturing, services, construction, infrastructure, tourism, information and communication technology, finance etc. Diversification plays significant role in sustaining long term economic growth and development of the countries. Diversified economies are able to perform better over the long periods of time while as those countries that have specialisation in the exports of primary goods perform worst [1]. It helps to maintain and/or create international competitiveness in the world economy. An obvious advantage of economic diversification is that, it help to create resilient economy able to mitigate the likelihood of occurrences of business fluctuations.

Gelb [1], noted that economic diversification reduces fluctuations in various macroeconomic variables and declines the possibility of exhaustion of natural resources. This is particularly relevant to Middle Eastern [2] region given that almost every country is dependent directly or indirectly on natural resources such as oil and natural gas. As a result, Middle Eastern region is more prone to income volatility because of the frequent fluctuations of oil prices. Therefore it is pertinent that the region should diversify the economic base of the countries. Development of non-oil sectors and reducing the dependency on oil revenues should facilitate the sustained growth of output and employment of the region as a whole [3]. High volatility of oil the revenues produces significant fluctuations in the growth rate of output. This uncertainty acts as inimical to improving the living standards of the masses. Economic diversification is believed to be a panacea of the above mentioned problems [4]. While analysing the past trends of diversification, Hvidt M [4], reported that diversification efforts of Gulf Corporation Countries (GCC) aims at creating comparative advantage. This implies that revenues from oil and gas production should be utilised for creating infrastructure, production facilities, education, health, housing and 'soft infrastructure' in terms of efficient administrative and legal institutions that promotes global competitiveness of the countries.

The concept of diversification is closely related to structural change of an economy. In this paper, we discuss two types of diversification as follows. (1) The journey of acquiring economic development requires structural transformation whereby contribution of primary sectors in Gross Domestic Product (GDP) tend to decline. While as, the share of secondary and tertiary sectors increases over time. This process is described as diversification of output or value addition. (2) Resource reallocation is another main aspect of structural change. Basically, the economy shifts the resources from less productive sector particularly agriculture to higher productive sectors especially manufacturing sectors. Agriculture employment decreases and growing manufacturing sector absorbs increasing labour force. This process leads to improvements in production, productivity and employment generation over time. Such process is referred to as diversification of employment. These sectoral shifts in value addition and employment towards higher productivity sectors are a function of policy and institutional environment [5].

Performance of Middle Eastern Countries: Discussion

Middle Eastern region possess abundant crude oil reserves amounting to 55.6% in total proven world reserves. The region also accounts for 27.7% of global proven natural resources [6]. Saudi Arabia, Iran and Iraq accounts for 30%, 18.22% and 16.46% share of the total Arab oil reserves. The region is also endowed with other underground resources such as phosphate, coal, potash, iron ore, zinc, lead, copper and cotton etc. Over 70 per cent of the regional population are settled in six countries: Egypt, Iran, Algeria, Iraq, Morocco and Saudi Arabia. Before investigating the issue of economic diversification, we would like to emphasise that Middle Eastern region consists of more than twenty countries. However, for the purpose of present study, we include the following nineteen countries until stated otherwise: Yemen, Oman, UAE, Qatar, Bahrain, Kuwait, Saudi Arabia, Iraq, Iran, Syria, Turkey, Lebanon, Palestine, Jordan, Egypt, Libya, Tunisia, Algeria and Morocco. Israel is excluded owing to different economic structure of the country. We depict the countries under investigation below in Figure-1.

Fig-1: Middle Eastern Countries
Source: Created by Authors

Ironically, this region is essentially a mixture of heterogeneous countries with different levels of natural resources endowment among themselves. This difference largely attributes to significant variation is economic structure of the individual countries, as will be shown below. Broadly speaking, there are two groups of countries- namely net oil-exporters and net oil-importers. Most of the discussion regarding diversification will follow the same division of countries. Table-1 shows the basic macroeconomic aggregates of the selected Middle Eastern countries. A glance at the table reveals that, Oman, Qatar, Egypt and Jordan has registered a substantial increase in their levels of real Gross Domestic Product (GDP) over the period 1970-2014. While as Iran, Syria and Kuwait showed moderate improvement in real GDP levels over the same period. However, this consideration misses the important factor to take into account, namely population growth. It is most likely that increase in GDP levels may not translate into the improvements in living standards, if population growth far exceeds GDP growth.

Table-1: Basic Aggregates for Selected Countries in the Middle Eastern Region

(1) Countries	(2) Real GDP (Billion $)		(3) Population (Million)		(4) Real GDP per capita(Thousands $)	
	1971	2014	1971	2014	1971	2014
Oil-dependent countries						
Bahrain	4.32	53.29	0.22	1.36	19.55	39.13
Kuwait	102.03	260.11	0.81	3.75	126.30	69.31
Oman	4.61	161.08	0.75	4.24	6.15	38.03
Qatar	11.20	329.64	0.12	2.17	93.95	151.76
Saudi Arabia	201.24	1487.96	6.10	30.89	33.01	48.18
UAE	67.19	636.90	0.28	9.09	244.19	70.10
Iran	230.38	1218.37	29.28	78.14	7.87	15.59
Iraq	32.04	430.02	10.26	35.27	3.12	12.19
Algeria	93.34	509.31	14.96	38.93	6.24	13.08
Non-oil dependent countries						
Turkey	233.09	1525.26	35.61	77.52	6.55	19.67
Tunisia	14.21	118.66	5.17	11.13	2.75	10.66
Egypt	38.64	968.57	35.56	89.58	1.09	10.81
Jordan	5.31	88.01	1.74	7.42	3.05	11.87
Morocco	34.21	249.68	16.39	33.92	2.09	7.36
Syria	22.06	83.36	6.60	18.77	3.34	4.44
Middle East	1093.87	8120.23	163.84	442.19	6.68	18.36
Oil	746.35	5086.69	62.77	203.85	11.89	24.95
Non-oil	347.51	3033.54	101.07	238.34	3.44	12.73

Source: Penn World Tables (9.0) and authors own calculations.

Therefore, it is important to look at the evolution of GDP per capita. Column fourth of Table-1 shows the trend of GDP per capita over the period 1970-2014. With higher per capita GDP in 1970, oil-dependent countries registered higher population growth for the next 44 years coupled with higher per capita income relative to the non-oil countries. The last two rows of Table-1 shows substantial variations in the main aggregates between oil-exporting and non-oil-exporting countries. With higher oil prices the decade of 1970’s witnessed robust growth cycle that was not sustained as a result factor productivity growth turned negative [7]. Yousef [7] estimated that during 1980’s and 1990’s per worker GDP growth were less than 1 per cent per annum while as modest improvements in human capital was mitigated by continuous decline of total factor productivity.

It is commonly observed that oil as a natural resource play a significant role, directly or indirectly, in the economies of respective groups. Oil rich Middle Eastern countries are highly dependent on oil for fiscal revenue, export earnings and foreign exchange. Share of oil in government revenue ranges from 47% in Yemen to 97% in Iraq and averaged 77% across the oil exporting group [8]. Such a dependency makes countries highly vulnerable to oil price shocks. These shocks tend to be transmitted over the whole region because of the deep political, cultural, religious and geographic correspondence.

At the early stage of development, sound natural resources industries are a prerequisite for the development of other sectors. Here we will not pursue the issue of sources of growth any further, it is suffice to mention that literature supports the hypothesis that oil is the dominant sources of growth in both groups of the countries. However, the central theme of the present study is to review economic diversification achieved by the respective countries of the Middle Eastern Countries. Given the uncertainty associated with international oil market and exhaustible natural resources, almost every country faces the similar challenge of diversifying their economic base to generate a stable and sustainable source of income and employment.

In the context of present study, to get a better picture of the process of diversification, we now present the share of different sectors in total value added. Figure-2 below, shows the sectoral contribution in total value added for two groups of countries along the region as a whole. On the Y-axis of the graph, we take percentage share of different sectors in total value added or output. Non-oil dependent countries showed a clear transition from low productive agriculture to manufacturing, construction and services sectors over the time. With agriculture accounting for approximately 20 per cent share in total value added during 1970’s, its share declined to 11 per cent during the last decade. On the other hand, share of manufacturing increased from 12 to 16 per cent, construction from 5 to 6 percent and services from 56 to 59 percent respectively during the time between 1979 and 2016. The case for oil-dependent countries is quit staggering, with share of agriculture remaining nearly stagnant, manufacturing and construction sector achieved only a meagre increase over the last four years.

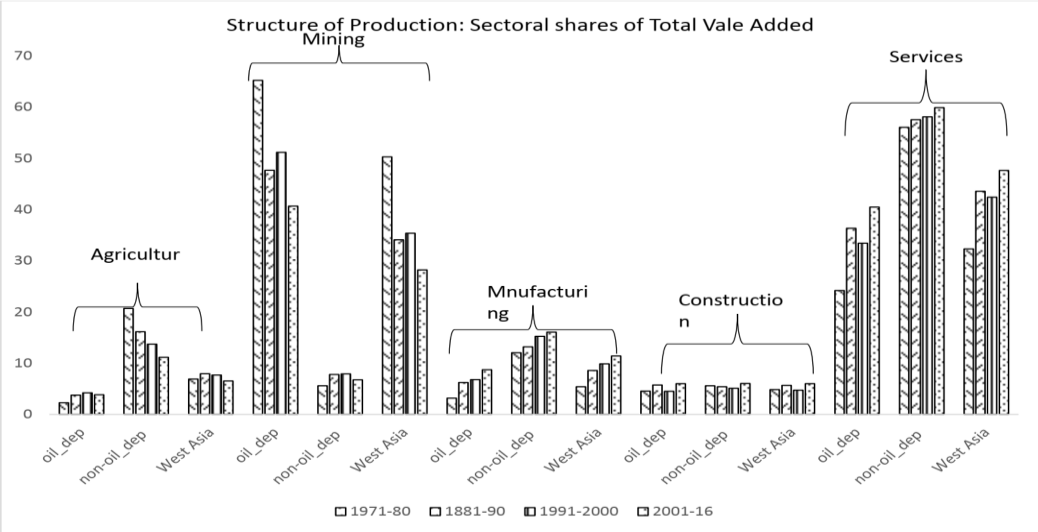

Fig-2: Contribution of Different Sectors in Total Value Added

Source: Authors own compilations using data from United Nations Statistics Division: National Accounts Main Aggregate database

Initially, during 1970's over 65 per cent of value added was derived from natural resources based industry particularly mining sector. Interestingly this was also the decade over which nearly all Middle Eastern countries achieved substantial growth of output and living standards. This points to the fact that natural resources play important role in the development of a country. However, over the next three decades, share of mining sector declined to 40 percent. Services sector registered a satisfactory increase over the same period. All these figures highlight the fact that countries has indeed witnessed a structural transformation over the last four decades. It is important to mention that natural resource industry based value addition or output involves substantial uncertainty. First note that the countries in the region are so closely linked to each other, that the shocks in one part are equally felt in other part. The boom-bust of international oil market has a profound impact on the oil and non-oil based countries directly and indirectly. It is found that increase in oil prices boosts the growth of counties. And negative oil prices shock savaged the economies. So this acts as a stimulus to accelerate the development of other industries. As Table-2 clearly reveals that oil based Middle Eastern countries has already started a tendency towards greater diversification in terms of output or value addition.

Now we will analyse the employment pattern across different sectors of Middle Eastern countries. In this section, we follow the same division of countries as articulated above. In Figure-3 below, Y-axis shows the percentage share in employment of various sectors across two groups of the countries over the last four decades.

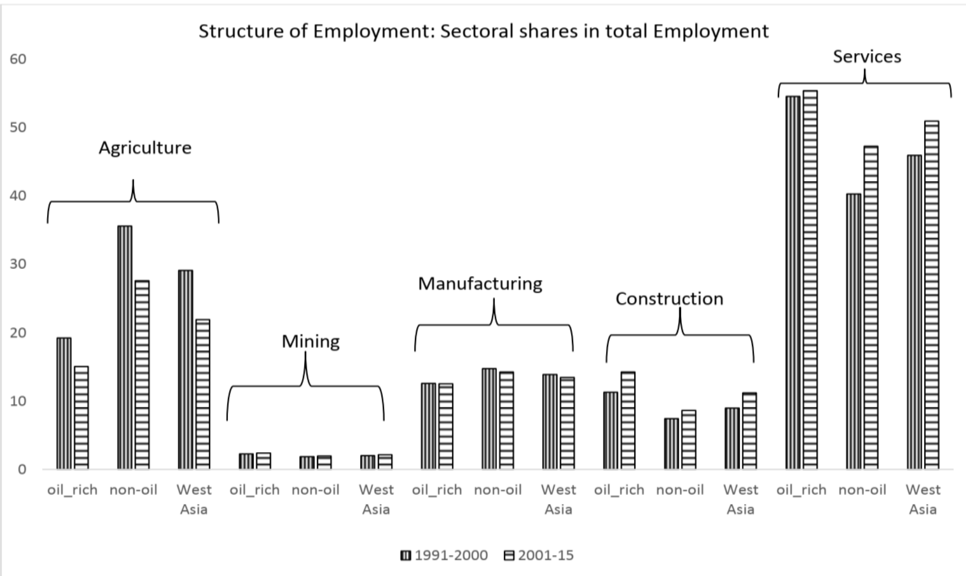

Fig-3: Employment by Economic Activity

Source: Authors own compilations using data from United Nations Statistics Division: National Accounts Main Aggregate database

Agricultural employment in non-oil countries decreased from 35 per cent in 1990's to 27 per cent over the last decade. Services sector showed expansion in employment generation from 40 per cent in 1990's to 47 percent in 2000's. Whereas, manufacturing and construction sector showed almost stagnation in employment generation over the last two decades. This clearly shows a shift away from agriculture to services sectors. Oil dependent countries showed a clear decline of employment in agriculture but the remaining four sectors showed very slow expansion in employment except construction sector. The region as a whole shows a changing trend of employment away from agriculture towards construction and services sector. It is interesting to note that oil-dependent countries derive substantial amount of output, nearly 40 percent from mining sector, but it has less than three per cent share in employment. It has to happen as mining sector is more capital intensive, where employability prospects of growing labour force are very low.

Figure-2 shows a clear expansion of value added by non-resources sectors such as services and manufacturing. It suggests a trend way from resource-based industry (mining) post 1970's. Although, oil-dependent countries witnessed faster growth during 1970's, but this was not a permanent increase. It was largely attributed to positive oil price shock. Here, large resource based sector acts as a catalyst to foster expansion of other non-resource sectors with positive price shocks. But a fall in prices can undo the positive external effects of resource based sectors. More specifically, Figure-2 reveals that, non-oil countries witnessed a steep decline in terms of agricultural contribution to total value addition over the last four decades. While as manufacturing and services sectors showed a steep increase in its contribution to total value addition during the same period. However, the contribution of mining and construction sectors remained more or less stagnant over the years. As for as oil-rich countries are concerned, Figure-2 clearly shows that contribution of mining sector in total value addition over the decade of 1970's remained dominant to other sectors owing to higher oil prices during the same decade. However, after the fall in oil prices during 1980's and 1990's, manufacturing, construction and services sectors showed a consistent increase in value addition. Similarly, agricultural sector showed a decline in employment over the last twenty years, but the contribution of manufacturing, construction and services sectors showed a moderate increase during the same period. This trend happened to be true for both groups of the countries.

CONCLUSION

The present paper highlighted the pattern of economic diversification witnessed in Middle Eastern countries. We employed two criteria's for measuring diversification namely 1) sectoral contribution in total value addition, 2) sectoral contribution in total employment. The study has found that the region as a whole is witnessing economic diversification in terms of both the criterions at a moderate speed. Dynamic tradeable sectors should be developed in order to enhance the pace of economic diversification to strengthen macro-economy [8]. It helps to maintain and/or create international competitiveness in the world economy. An obvious advantage of economic diversification is that, it help to create resilient economy able to mitigate the likelihood of occurrences of business fluctuations. It is the mining sector that enjoys a large share in total value addition for oil-rich countries. Booms and busts in this sectors are directly reflected in other sectors as well as transmitted to the entire region. This phenomenon highlights urgent need for diversification. However, given the heterogeneity among the individual countries of the region, diversification policies should be tailored according to country specific circumstances.

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