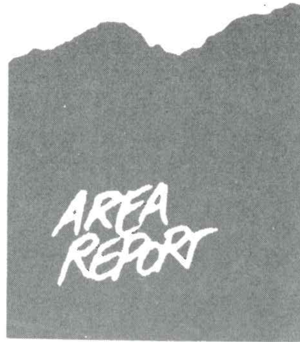

From pearls to plastics – from poverty to prosperity? Economic development policy in the Arab Gulf countries

By Paul Aarts & Gep Eisenloeffel

A "free flow" of oil and gas from the Gulf region is a vital interest for the industrialised countries. Paul Aarts and Gep Eisenloeffel give a background to economic development policies in the region and how these affect the oil importing countries.

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> "But the Arabs are a race which produces its best only under conditions of extreme hardship and deteriorates progressively as living conditions become easier"
>
> Wilfred Thesiger, *Arabian Sands,* 1985(1959): 97.

Thanks to massive oil revenues and increased control over their oil production in the mid-1970s, Gulf countries embarked on an impressive industrialisation programme. Hydrocarbon-based industry (ie oil refining and petrochemical production) was to form the *pièce de resistance* of a growing involvement downstream. At that time, many a pundit echoed sceptical feelings about building 'white elephants' in the desert, paradoxically soon to be followed by apprehensive Western industry spokesmen, using monumental phrases like 'a tidal wave of Middle Eastern oil products flooding the already depressed market'. Today, as most industries planned are up and running, one is able to pass judgement on a good ten years' period of Gulf economic development policy.

Here, we will start by giving an overview of motives which apparently dominated the rationale for industralisation. Second, a survey is given of (mainly downstream) industries which have been established to date. Third, a series of constraints will (extensively) be dealt with. In conclusion, an attempt is made to assess the prospects of the chosen development policy.

Motives

A number of arguments in favour of a vigorous industrialisation policy have been raised:[1]

1. The most powerful motive surely was the need to *diversify* the mono-cultures (in most cases oil revenues represent more than 90 per cent of budget revenues, 95 per cent or more of exports). There was a growing awareness that a continuing dependence on volatile primary products markets would endanger the basis for long term modernisation and development efforts. Subsequent price irregularities of the crude oil market underlined this general feeling: from a height of almost 40 USD in 1980-81 oil prices took a nose dive to less than 10 USD in 1986. At the moment of writing (June 1990), oil prices in real terms are little better than they were before the 1973-74 oil shock, demonstrating once again the danger of being a one commodity exporter.

2. Closely related to the diversification argument was the *economic development motive:* with the new-found wealth a responsibility was felt for furthering economic growth and development. To date, this argument is mainly understood as being synonymous with industrialisation.

3. Reaping the benefits of *value-added production* was the third argument forming part of the 'industrialisation ideology'. Protagonists of this line of thinking assumed that cheap feedstocks (and fuel) for both refining and petrochemical manufacturing provided Middle Eastern producers with a large advantage over their competitors in the industrialised world.

4. A less explicit (and less 'economistic') argument – but certainly not the least important – concerns the obvious need to use the very industrialisation process as a means to *state-building* (rather than the state helping to build a national industry). As most Gulf states are confronted with major problems of building domestic order and regional stability, "they use economics as a way of solving strategic puzzles."[2]

A strategy for industrialisation

'The power of the purse' inspired the Gulf producers to launch an ambitious industrialisation policy, turning empty sites of barren desert land into huge manufacturing complexes and (less often) putting money in overseas downstream establishments.

First the oil producing countries started building huge *refinery complexes*. Not surprisingly, they started from a relatively small base and growth figures were rather impressive: installed refining capacity in the Middle East rose from 2.270 million barrels/day (4.4 per cent of world capacity) in 1970 to more than 4 million barrels/day (5.3 per cent) in 1989.[3]

Expansion figures are now flattening out, though, due to an increased awareness of global overcapacity and sharply reduced oil export revenues. Impressive as these growth figures may be, there still is a wide discrepancy between these oil producing countries' share of refining operations and its still far bigger share of world crude oil production: 5.3 per cent vs. 26.3 percent (1989). Compared to the region's share of global oil and gas reserves (more than 65 per cent)' the margin of course is even much larger.

Refinery expansion took place mainly in Saudi Arabia and Kuwait. As the Saudis showed a preference for joint-ventures with multinationals, the Kuwaitis refrained from this and followed a strategy of self-reliance. Another difference in strategy is Kuwait's growing emphasis on petroleum product exports[4], compared to Saudi Arabia's continued commitment to exporting crude. Both countries have managed to become nearly self-sufficient as far as the demands of the domestic market are concerned.

Besides erecting its own inland refineries, Kuwait (recently followed by Abu Dhabi and Saudi Arabia) showed an emphatic appetite for refinery complexes *overseas*. Here again, the more conservative oriented Saudis are following the more traditional avenue of cooperation with oil multinationals (ie Texaco), while Kuwait is entering directly and purchasing or developing downstream operations on its own.[5]

Second, millions of dollars were invested in *petrochemical* industry, mostly within the region itself. Huge basic petrochemical plants have come onstream in the early 1980s, although many projects that were under consideration at the end of last decade have been shelved as a result of declining oil revenues. By far, Saudi Arabia is the biggest investor in this field, putting up a remarkably sparkling performance.[6] On the whole, however, one is struck again by the wide discrepancy between the regions huge oil and gas reserves and its modest share in global petrochemical production.

Third a number of other industries were built, less directly related to locally available oil and gas reserves. Large *aluminium* smelter plants were erected in Bahrain and Dubai, *steel* plants in Saudi Arabia and Bahrain, and shipbuilding and repair yards were set up in Bahrain and Dubai. The respective shares of these industries in world capacity are (and will stay) negligible.

Constraints

Apparently, some industries are starting to pay off handsomely.

For instance, *Saudi Basic Industries Corporation* (SABIC), responsible for the petrochemical sector) seems "almost irrepressibly cheerful about the future"[8] and a recent analysis by Petroleum Intelligence Weekly concludes that the big Mideast export refineries are performing quite well.[9]

However, these incidental rejoicing notes sharply contrast with more frugal assessments, some of which have a bearing on 'technical' economic problems, while others touch upon more wide-ranging aspects of the development process as such.

• The first problem to be mentioned is the conspicuous *lack of regional coordination*. Although shocking duplications that were mostly common during the 1970s (eg seven international airports and two sets of ship repair facilities within a hundred mile range) tend to be evaded nowadays, the existing coordination is mainly politically inspired, by the *Gulf Cooperation Council* (GCC, founded in 1981), much less economically *Organisation for Industrial Consulting*, (GOIC, established in 1976). Nationalistic and, although less than before, megalomaniac ambitions continue to dominate, leading to the highly undesirable situation of competing industries in an already oversupplied market.[10]

• A second note to be made concerns the *cost structure* of the industrial plants which have been built. Several factors tend to offset the advantage of low variable costs for feedstocks and fuel: high investment costs (lack of infrastructure and logistic support pushes up the initial investment costs in the Middle East by between 1.5 and 1.8 times the level in a developed country), operating costs and marketing costs.[11]

The end result is that Middle Eastern petrochemical production costs are not lower, and are often higher, than those in Europe, Japan or North America.

Experts seriously disagree on whether these export plants will be able to compete with established producers. Only when investors are prepared to accept a return on fixed capital which is lower than normally required at non-traditional locations, will these industries in the Gulf countries have a chance of being competitive.[12]

Besides, as a result of depressed oil prices, refiners and petrochemical producers in the industrialised world profit from a nice combination of cheaper raw materials with buoyant demand for products. Thereby, the competitive feedstock advantage of Gulf producers is gradually being eroded.

• Under the label of (problems with) *market access*, a third set of problems should be dealt with.[13] Among these, two are prominent: continuing overcapacity in the international market,

Despite major investments the Middle East countries, with a 26.3 per cent share of world crude production in 1989, and 65 per cent of global oil and gas reserves, still control only 5.3 per cent of global refining capacity.

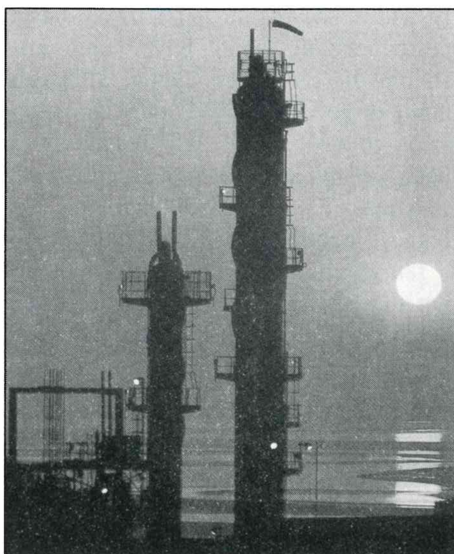
evoking a trend of protectionism; second, the lack of marketing networks and the attendant negative influence of the spot market.

Although in the past decade Western Europe's refining industry has shrunk by more than a third of its present capacity, a major surgery is still needed to cut surplus capacity. Generally speaking, things are better in the United States. Understandably, Europeans are likely to feel a greater competition from the new Gulf refineries and show some resistance to future petroleum product imports. To date however, in the field of refined products there is no general movement towards protectionism.

This does not apply to petrochemicals. Especially during the early 1980s public perception of a 'threat' to the European oil product market was focused on Middle Eastern projects. In spite of different positions taken by the companies involved, there was clearly a general undercurrent among industry officials in favour of a policy erecting further barriers to imports. At that time, the EEC Commission was attacked for 'selling out' the European chemical industry to Saudi Arabia. It is only recently, as a result of continuously booming petrochemicals markets, that the clamour for further protection seems to have died down.

However, every now and then, industry spokesmen stubbornly raise the alarm over the threat of duty-free access of Gulf states' petrochemicals which "would be to let a 'Trojan Horse' into Europe."[14] In this context, it is also worth pointing out the seemingly insurmountable obstacles in reaching a proper cooperation agreement between the EEC and the GCC countries.[15]

The second problem related to the issue of market access has to do with the *lack of distribution networks* in the consuming countries, with the partial exception of Kuwait (and, lately, Saudi Arabia, although on an even more modest scale than Kuwait). As world markets are already flooded with surplus products, the issue of pricing is of crucial importance for their efforts to sell their output.



The Gulf countries face a particular hard choice in refined products. If they offer their oil products at prices too high they will be unable to penetrate export markets. If they price them too low, consuming countries will prefer buying products rather than crude, further undermining crude oil prices. As it is, 'market realities' are forcing exporters to choose the second action. OPEC has no collective authority over its member countries' pricing and export volume for refined products. Members with ambitious refining plans are primarily interested in selling as many products as possible. They are in conflict with those members which rely to a larger degree on crude oil exports and are first of all concerned with the stability of crude prices. Pricing of products manufactured in the Gulf states is likely to be made under a formula more or less openly tied to price quotations on the spot market. Spot quotations for refined products are in most cases even lower than crude oil prices, undermining the viability of the producing countries' downstream efforts.

The situation in the petrochemical sector is somewhat different. Here the spot market does not yet carry weight comparable to that in refining. However, in as far as Third World producers lack marketing networks, they feel obliged to hand over their products to Western European distributors.

• The fourth and most fundamental issue has to do with the character of the *'rentier state'* itself and, consequently, the lack of a balanced economic development.[16] In pure rentier or 'allocation' states rulers usually pay lip-service to industrialization, without trying to give real answers to such fundamental questions as linkage effects, economies of scale, labor training, market size, or insertion in the world economy. Industrialisation strategies tend to be not much more than spending programmes.

Apparently, governments and ruling elites are aware of risks attached to production-oriented economies (class struggle, strikes) and therefore try to uphold the allocative or distributive character of the state as long as possible. In that context, industrialization efforts are less committed to selecting objectives, than to selecting appropriate means: "it is the very industrialization process which contributes to state-building rather than the state which helps to build a national industry."[17]

Rulers try to buy legitimacy by spending huge amounts on industrial projects, at the same time using these 'industrial achievements' as a symbol of national identity, trying to impress the international community and getting accepted.

Although the Gulf states are not all alike, (eg Bahrain and Qatar both exhibit a more dynamic industrialisation process compared to Kuwait and Saudi Arabia), none seems able to escape the limitations of productive efforts in a pure allocation context. In no case, manufacturing contributes more than 10 per cent to GNP. Besides that, the economies have been infected with the so-

called 'Dutch disease' and its perverse effects on the non-oil sectors: as a result of an over-valued national currency an addiction to imports is hardly avoidable, consequently ruining agricultural production and hampering industrialization efforts, if any, in the non-oil sector.[18]

There is a real danger that the Gulf's grandiose industrialisation schemes will develop into not more than another enclave in the domestic economy, far away from a development process in which oil wealth is being transformed into a non-oil based productive system which can become self-sustaining and self-generating of savings and state revenue.[19]

Results and lessons for the future

To start with, allocative use of available oil revenues and, otherwise, purely political considerations should no longer be valid as primary guidelines with regard to industrial policies. Antiproductive biases must be substituted by production-oriented behaviour, the state helping to build a national industry, rather than the other way around.

A successful industrialisation process will more and more depend on the capacity of the Gulf states to coordinate their activities: regional integration is a sine qua non — irrespective of the widespread assumption that the 'seven lean years' of low oil prices will be followed by a period in which OPEC (ie Saudi Arabia, Kuwait, Iraq, Iran and the United Arab Emirates) will be "back in the driving seat."[20]

The second generation of industrial projects will not stand a chance of success if the whole peninsula's market is not taken into consideration. A regional approach to the problem of mass production of consumer goods also seems to be the only sensible way out, due to a reduced import capacity and a diminishing ability to subsidize inefficient local producers.

If the countries involved do not come alive to the fact that a balance should be ensured between revenues from oil and those from other resources, then dependence on one single primary commodity export (like pearls) threatens to be replaced by another, with all the dismal consequences belonging to that.

Notes:

[1] For a recent survey, see: *The Middle East*, December 1988: pp 5-10. Cf Yusuf Sayigh, *Arab Oil Policies in the 1970s*, London/Canberra 1983; Zuhayr Mikdashi, *Transnational Oil*, London 1986.

[2] Cf Michel Chatelus and Yves Schmeil: "Towards a new political economy of state industrialization in the Arab Middle East", in *International Journal of Middle East Studies*, 16 (1984): 251-265.

[3] Source: *BP Statistical Review of World Energy*, issues 1980-1988.

[4] Kuwait nowadays is able to refine almost 90 per cent of its OPEC production quotum (through domestic as well as Europe-based refineries, see below). Se *Petroleum Intelligence Weekly*, 26 June 1989, p 2: *The Economist*, 24 June 1989, p 82; *Petroleum Economist*, May 1989, p 152.

[5] See Paul Aarts & Gep Eisenloeffel, *Kuwait Petroleum Corporation as new Seventh Sister?*, Amsterdam: MERA Occasional Papers, no 2, April 1989. A more general introduction is given by Giacomo Luciani, *The oil companies and the Arab world*, London/Canberra 1984.

[6] See *The Economist*, August 22 1987. On the whole, Saudi Arabia is and will remain the leader in plastics in the Gulf region (OPEC Bulletin, February 1990: 74; Financial Times, December 13 1989, Survey 'Saudi Arabia', "Cause for mild celebration": IV).

[7] See *The Middle East*, December 1988 p 7, and March 1990 p 42.

[8] See *The Middle East*, December 1988, p 7; Financial Times, 5 January 1989,"Sparkling SABIC dogged by private sector sceptics."

[9] *Petroleum Intelligence Weekly*, October 24 1988.

[10] For a broader analysis, see Abbas Alnasrawi, "Economic integration: a missing dimension of Arab nationalism", in *Arab Studies Quarterly*, Vol 11, nos 2 & 3, Spring/Summer 1989, pp 287-302.

[11] See OECD, *Petrochemical industry: energy aspects of structural change*, Paris 1985, p 93; also several contributions in R El Mallakh (ed), *The Middle East Pacific Basin, and The United States: Refining and Petrochemicals*, ICEED, Boulder, 1986.

[12] See OECD, op cit : p 97, Also: F Fesharaki & DT Isaak, *Impact of OPEC export refineries on the world refining industry*, Hawaii 1985: 18; M Sigurdsson & DF Rudd, "World-scale model predicts petrochemical trends" (part I, II and III), in *Hydrocarbon Processina*, June 1988 (pp 98-B–98-N), July 1988 (pp 34-E–34-L), August 1988 (pp 50-E-50-L).

[13] For a recent analysis, see RM Auty, "Oil-exporters' disappointing diversification into resource-based industry. The external causes", in Energy Policy, June 1988, pp. 230-242

[14] *European Chemical News*, April 4, 1988, p 4.

[15] See "A search for the right balance", *Financial Times*, Survey 'Saudi Arabia', December 13 1989: IV.

[16] Much of the following is based on Chatelus & Schmeil, op cit and M Chatelus, "Policies for development: Attitudes Toward Industry and Services", in H Beblawi & G Luciani (eds), *The Rentier State*, London 1987, pp 108-137

[17] Chatelus & Schmeil, op cit, p 257.

[18] See C Ominami, *Le tiers monde dans la crise*, Paris 1986: 126-130; A Gelb and Associates, *Oil windfalls. Blessing or curse?*, New York etc, Oxford University Press, 1988; Robert E Looney, "Oil revenues and viable development: impact of the 'Dutch disease' on Saudi Arabian diversification efforts", in *American-Arab Affairs*, Winter 1988-89 (no 27): 29-35 generating of savings and state revenue.

[19] This definition of 'development' is borrowed from SK Farsoun, "Oil, State, and Social Structure in the Middle East", in *Arab Studies Quarterly*, Vol 10, no 2, Spring 1988: 160.

[20] See James Audu, "OPEC and change and innovation in the energy marketplace", in *OPEC Bulletin*, January 1990: 4-9, 8; "Preparing a return to power", *Financial Times*, January 22 1990. ■