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The political economy of oil and economic diversification: A neglected research field Robert Mabro would certainly like us to revive

This commentary is an authorized reprint of an article by Ali Aissaoui, Senior Consultant at APICORP and Research Associate at the Oxford Institute for Energy Studies. The article has originally been published in the 100th issue of the Oxford Energy Forum (May 2015) – a special release dedicated to Robert Mabro, the founder of the institute and founding editor of the Forum. The opinions expressed in the article are the author's own and not of the institutions he is associated with.

1. Between 1993 and 2001 Robert Mabro, in his capacity as Director of the Oxford Institute for Energy Studies, presided over the publication of a series of books on the political economy of oil (the series includes, in publication order, Venezuela, Nigeria, Indonesia, Libya, and Algeria). In a way, this initiative was in step with the prevailing renewed research trend. The emphasis was on the role of oil in shaping the political, economic, and social dynamics affecting the major oil-exporting countries of the developing world. However, while most relevant publications of that period were of a broad thematic nature, this series focused on the oil and gas industry of individual countries in the context of history, political economy, and international relations. As far as I am aware, the rationale for the book series was twofold – the obvious one being to make a contribution towards filling a research gap in the field. Given the countries' importance to the world's oil (and increasingly gas) markets, deeper insight was needed to form a better understanding of their policies and institutional constraints. The less obvious reason is that multiple country case studies can help reflect the diversity of contexts and conditions and draw on distinct sources of evidence to discern national idiosyncrasies.

2. To be sure, Mabro appreciated and acknowledged the quality of the research work the authors carried out (otherwise he would not have allowed its publication). However, I remember from my experience of interactions with him, as the author of the last book in the series, that he expressed concern about some weaknesses in the analyses of the relation between oil and economic development – or the illusion of development as we perceived it. In particular, he regretted the lack of interest in the countries' 'efforts to diversify their economies' despite this being explicitly mentioned in the description of the series. Indeed, a brief look at the books' indexes reveals that neither my former colleagues nor I actually said much on the theme. My justification, in the case of Algeria, was that economic diversification was not an explicit objective of government policies at that time.

3. This explanation could plausibly extend to the four other country case studies. Indeed, at that time the concept of economic diversification was only gradually entering the consciousness of developmental economists and development planners. But Mabro was often ahead on new policy ideas. He first considered the concept (or more precisely, the centrality of the concept to economic development policy) of economic diversification in the late 1960s when he became a senior research fellow in the economics of the Middle East at the University of Oxford. His early research focused on the Egyptian economy and the recurring theme of 'diversification of [its] productive structure.' As Mabro's interest in petroleum began to develop and his focus shifted to the economics, politics, and international relations of oil, he must have (rightly) thought that the concept had the potential to contribute to the economic development agenda of oil-exporting countries. Unfortunately, his attempt to align our research interests with the theme proved premature.

4. This special issue of the Forum makes up for that missed opportunity. To catch up with Mabro's expectations, I will present in the remainder of this article a brief review of issues and policies of economic diversification in oil-exporting countries. The review, which draws in general on some of my recent publications, is in two parts: the first highlights dependence and vulnerability; the second provides some insight into the policies and implementation strategies adopted across the higher-achieving Gulf Cooperation Council (GCC) countries.

Dependence and vulnerabilities

5. Although now familiar and relatively well explored, the concept of economic diversification is open to many definitions and interpretations. It commonly refers to the process of structural transformation aimed at reducing over-dependence on a single sector. More specific definitions have to factor in the nature of the dominant sector, the development stage of the economy, and the degree of exposure to global markets. In the case of oil-exporting countries, a policy-relevant definition should further take into account their vulnerabilities to both cyclical and structural threats.

6. These countries depend on petroleum exports as a major source of income and growth. As a consequence, they are extremely vulnerable to the instability and volatility of global oil markets. Since the 1986 oil-price collapse, such vulnerability has been a recurring risk and, because of the uncertain timing and magnitude of oil market downturns, a difficult one to mitigate. Among the risk mitigation tools available, fiscal stabilization funds are by far the most suited to a sovereign nation. Unfortunately, not all countries have such tools or enough surplus assets to source them. Those who do often fail the fiscal discipline test.

7. Furthermore, and even more importantly, oil-exporting countries face structural threats that have the potential to undermine their economic growth and wealth creation well into the future. The most far-reaching of these threats are in three areas: contraction of petroleum export markets; unsustainable fiscal patterns; and severe unemployment.

8. The first threat stems from the irreversible contraction of the oil market, something that had not previously been expected in mainstream forecasts, when demand growth seemed inexorable. Even today, there is an undue expectation that potential demand for petroleum in emerging economies will compensate for declining demand in the OECD region. For example, this expectation does not take into account the fact that China and India are seeking a similar energy path to OECD countries, with, in addition, a pursuit of clean coal technologies to make better use of their massive domestic resources. The major energy-consuming countries of the OECD–IEA have long shaped their energy policies at the confluence of energy security and climate change concerns. Accordingly, they have focused their efforts on the promotion of energy efficiency and low-carbon or renewable energies. Furthermore, in considering

their security of supply, they have emphasized independence from petroleum imports in general, and from the Middle East in particular; the USA has seen some success in this respect, thanks to the vigorous development of its shale resources.

9. The second threat comes from patterns of fiscal spending. Whatever the outlook for global oil markets, current hydrocarbon export-based fiscal policies are unlikely to be sustainable in the long run. This is particularly the case when oil revenues are eroded by increasing costs, lower fiscal take and, in some countries, by the additional impact on per capita revenues of a sizeable and rapidly growing population. Long-term fiscal sustainability cannot be achieved without rationalizing public spending (of which subsidies are a very large proportion) and diversifying budget revenues by reverting to general taxation.

10. The third threat is from rising unemployment, the main cause of which is the dominance of the economy by a highly technologically productive (and thus low job-creating) petroleum sector. Oil-exporting countries – particularly those under demographic pressure – have long realized that reductions in unemployment cannot be achieved without addressing two main economic and social dimensions: first, by encouraging non-petroleum sector growth and private sector development; and second, by preparing unemployed nationals to take full advantage of job opportunities.

Policies and strategies in the GCC countries

11. Dependence and vulnerability are more acute in some countries than others; in the GCC area, countries have pursued more vigorous economic diversification policies. Their overall strategies involve a three-pronged approach:

- vertical integration – developing businesses in the midstream and downstream sectors of the petroleum value chain;
- horizontal integration – supporting the establishment of local private providers of energy logistics and energy supply services;
- diversification into non-petroleum manufacturing and services.

These strategies have been supported with substantial financial resources and supply-side strengthening measures, which include sustained development of education, health, and public infrastructure. However, implementation of the strategies is still sketchy. What is clear from investment trends is that more emphasis continues to be put on the downstream sector, especially on its petrochemical segment.

12. This emphasis raises the question of whether the petrochemical industry actually contributes to economic diversification. Advocates of this option often point to the petrochemical industry's growth potential for higher value-added exports. They also highlight the opportunities it offers for further industrial development and industry-relevant research and education. While these arguments may be valid and should not be ignored it is also the case that the petrochemical industry tends to exhibit a pattern of performance, in terms of business cyclicality and low job creation potential, which is similar to the oil industry in general. Furthermore, governments have provided the petrochemical industry with strong policy support, including very low feedstock prices, in order to increase its competitiveness by enabling a low-cost structure. In so relinquishing the state resource rent, they have unintentionally encouraged rent-seeking behaviour. Hence investors and entrepreneurs may be reluctant to become involved in the more job-creating, but much less oil rent fetching, activities derived from the industry.

13. The implementation of these strategies would have been ineffective without state involvement – and the critical role that governments have played beyond supply-side strengthening. They have indeed been instrumental in developing consensual visions, devising policy frameworks, and shaping national development plans. In particular, to the extent that a credible economic diversification should rely on a growth strategy geared towards engaging the private sector in the development of non-oil tradable exports, they have focused their efforts on three state-level factors deemed most conducive to an enabling environment for enterprises:

- creating and maintaining a favourable and stable investment climate;
- accelerating reforms of the educational and vocational training systems;
- ensuring the availability of low-cost financing from both the state development agencies and a deepening regional capital market.

While much progress has been achieved, many challenges remain. Strengthening governance and creating an incentive structure that encourages competition and discourages rent-seeking behaviour are among the most important such challenges.

14. In this respect, one should not underestimate the difficulties of policy making and implementation in the face of social and political realities in the region. Success or failure depends to a great extent on political economy, institutional and behavioural factors including rent-seeking, and resistance to reform by vested interests. In the aftermath of the Arab Uprisings, even the countries relatively shielded from the subsequent turmoil – as has so far been the case for the GCC countries – have found themselves grappling with uncomfortable dilemmas. In the end, political expediency has taken prominence over economic efficiency, thus slowing down the momentum of governments' economic diversification agendas.

Conclusions

15. On reading this article Mabro would likely concur with the emphasis placed on oil-producing countries' dependence and their vulnerabilities to the resulting threats. He would even argue that these countries have now to deal with an obsolescent pattern of savings, investments, and expenditures that was originally based on the unlikely assumptions of steadily growing global oil demand and safely rising international prices. Today, with flat demand, greater uncertainty about the future direction of prices, and growing domestic fiscal needs, these countries face even more dire threats. Turning his focus to the economic diversification policies being implemented within the GCC, Mabro would probably not admit the perception of a common 'Gulf model' that my generic and high-level overview seems to convey. He would surely refer to the rationale of the original country case studies he once initiated (the series 'The Political Economies of Oil Exporting Countries', which did not survive his retirement) to suggest that important variations in contexts and circumstances critically affect each country's policy and implementation strategy. In particular, differences in resource endowments, institutional settings, and socio-economic dynamics are key considerations in explaining the observed different paths and paces of the process. This leads me to conclude that Mabro would certainly like us to revive this once neglected field of research to give more weight to an eventual new book series on the political economy of oil.