

Economic Diversification in Kuwait Macroeconomic Implications

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Abstract

The extraction of oil remains the single dominant economic activity in Kuwait. While it has long been understood that economic diversification is needed to support a more stable economic base and a higher standard of living, this has been challenging in Kuwait and other GCC countries. The petroleum revenues of Kuwait cannot last forever, however public and private sector industry is nearly entirely dependent on this source of revenue. Various planning and projects have been undertaken as a means of achieving some measure of economic diversification. This paper undertakes an integrative review to synthesizing the measures undertaken in Kuwait towards the aim of economic diversification and evaluation of those projects, considering current evidence and frameworks. The study found that one area where the economic future needs of Kuwait and the cultural sensibility align is in small business ownership, and this in combination with the latent and undercapitalized, well-educated labor force presents many opportunities for growth, diversification, and innovation by providing for new opportunities for Kuwaiti citizens in Kuwait.

Keywords: diversification, economic development, GCC, oil

1. Introduction

The extraction of oil remains the most dominant economic activity in Kuwait. While it has long been understood that economic diversification is needed to support a more stable economic base and a higher standard of living, this has been challenging in Kuwait and other GCC countries. Various planning and projects have been undertaken as a means of achieving some measure of economic diversification. This paper undertakes an integrative review to synthesizing the measures undertaken in Kuwait towards the aim of economic diversification and evaluation of those projects, considering current evidence and frameworks.

2. Problem Statement and Significance

Kuwait has unique concerns and contexts that are shared with other GCC nations, namely a dependence on oil revenues and therefore volatility in income, current affluence, and issues of employment rates of nationals.

The significance of economic diversification lies in supporting a more stable national economy, better labor participation and employment rates of Kuwait nationals. Oil and gas are a volatile industry, with the world market prices elastic to supply and demand. For example, there was a sharp decline on oil prices between 2014 and 2016 from \$120 per barrel to \$22 per barrel in the first two weeks of 2016, and back to \$80 in October 2018 then dropped to around \$20 in April 2020 and back again to around \$120 in 2022 and dropped again to \$70 by late 2022.

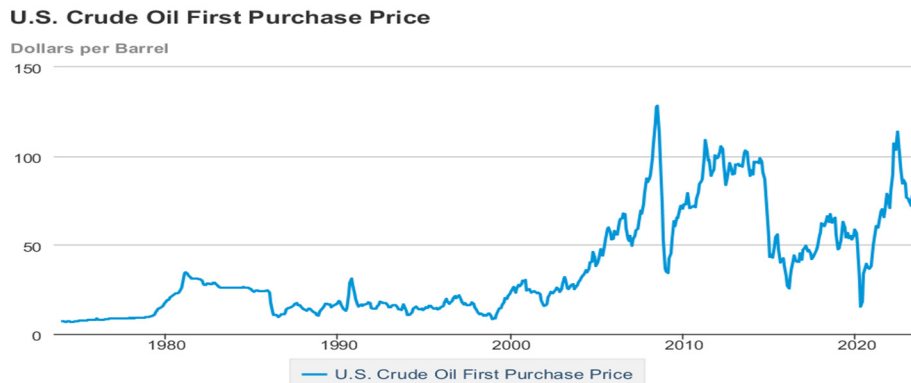


Figure 1. Crude Oil Purchase Price 1974-2023

Source: U.S. Energy Information Administration

The above Figure 1 shows the fluctuation of crude oil prices between 1974 and 2023. It shows that revenues are therefore uncertain, and planning becomes difficult based on future revenue streams. Further, petroleum, as a driving single factor in the national economy, risks disaster in the long-term. Preparations and development of a more economically diverse markets is needed before petroleum reserves run dry. The past oil fluctuations have been driven as a consequence by either a shortage in demand or excess supply, but the price downfall of 2020 has been driven from both, massive shortage in demand accompanied with a huge supply, which is unusual trend in oil market history. In addition, the Russian-Ukrainian war continues to intensify geopolitical negative consequences in the crude oil market and, hence, affecting the Kuwaiti oil supply expectations.

An issue which deepens the need is the fact that the population of Kuwait is growing. The data from Public Authority for Civil Information (PACI) indicates that population has increased from 2.26 million in 1998 to around 4.27 million in 2020, an annual GCC countries growth rate of 3.7% which includes more than one million of Kuwaiti citizens and over than two million expatriates. These trends indicate that new sources of revenues and increased infrastructure and improved efficiency are therefore needed to meet the future growth in population.

Kuwait is affluent, and this is reflected in consumption and citizen expectations. Wood and Alsayegh (2014) described how the consumption of electricity and water rise and fall with the price of oil. This is interesting in terms of diversification, since it seems to indicate that both economic demand and supply are driven by petroleum, speaking to an even greater need for diversification. The affluence of Kuwaiti society has resulted in modern social infrastructure including free healthcare, education and provisions for social security (El-Katiri, Fattouh, and Segal, 2011). Some of Kuwait's policies regarding allocation of oil revenues remain fragmented and counterproductive, such as subsidies for power and utilities, and an overstuffed public employment structure (El-Katiri et al., 2011).

Labor force participation and employment rates are traditionally higher in Kuwait than in other GCC nations, however there is considerable room for improvement (Al-Qudsi, 2006). While education and specialization have been promoted as features of an economic diversification strategy, the result has been an even higher unemployment rate for those with post-secondary education (Al-Qudsi, 2006). Like many GCC states, the residents of Kuwait are mostly the foreigners who compose 84% of the labor force, and compete with local residents for employment (Cadera, 2014). Al-Qudsi (2006) described a brief history of unemployment in GCC nations, and his studies of the root causes, included a test of the hypothetical explanation that unemployment levels reflected voluntary participation rates. Instead, Al-Qudsi found that unemployment is mostly involuntary, and it is disproportionately a problem of youth under the age of 30 (Al-Qudsi, 2006). Unemployment of Kuwait nationals from 15 to 29 years of age accounts for 86% of the incidence of unemployment (Al-Qudsi, 2006). Between 1980 and 2000 there was a great increase in university-educated Kuwaiti from 7.5% of workers to 24% in 2000. (Al-Qudsi, 2006, p. 8). Unemployment has been generally higher for Kuwait nationals with higher levels of education, which was 24% in the year 2000 for those workers who had completed secondary schooling and 42% for those who had completed university (Al-Qudsi, 2006, p. 8). The public service provides some relief to highly educated Kuwait nationals by providing an income premium, however this is supported currently by oil revenues (Al-Qudsi, 2006).

Considering the recent Middle East crisis, (particularly the Israel-Hamas conflict), the oil market is expected to remain volatile. Economists anticipate oil prices to surpass the current price of US\$94.00 per barrel. However, this

increase may contribute to higher inflation rates, leading central banks to raise interest rates. These consequences will impact many oil-consuming countries, potentially reducing or even eliminating their demand for oil, which may negatively affect the Kuwaiti export of oil.

During the Covid-19 pandemic, which was accompanied with low oil prices, “the liquidity crisis has all come together in a perfect storm”, according to Bader al-Saif, and assistant professor of history at Kuwait University. This has led the finance minister to warn the Kuwaiti government that soon would not be able to pay salaries and the country’s deficit could reach 40% of its gross domestic product in 2020 (The Economist Time, 2022).

Therefore, economic diversification is needed to increase economic and political stability by ensuring stable income and a thriving economy. It is further needed to maintain consumption, social programs and lifestyle in Kuwait which has been established by natural resource rents. It is also a potential solution to the problem of high levels of employment, particularly for those Kuwait nationals who have invested the most in their education and human resource potential.

Economic diversification is therefore seen as a foundation for economic growth and improved economic conditions for citizens.

3. Current Concepts and Frameworks for Economic Diversification

The purpose of economic diversification is the development of an economy for the purpose of affluence, or in the case of a single dominant sector, in order to reduce risks and maximize returns. There are other advantages, which can include more competitively priced or locally appropriate goods and services and leveraging human resources capacity.

Freire (2017) notes that economic diversification is considered a critical aspect of development for underdeveloped regions and nations. That need has been recognized in key internationally agreed development goals. Despite this, there is no proven, empirical basis for the assumption that economic diversification leads to improvement in economic outcomes (Freire, 2017). An evidence-based approach along with reflections on purpose and assumptions would provide the needed economic framework for strategies leading to growth, trade, and transformation (Freire, 2017). Instead, the dynamics supporting economic diversification blur the ends and the process for achieving it, with a great deal of ambiguity regarding outcomes which are sought and how they are related to the strategic approach (Freire, 2017). Is the purpose of economic diversification the replication of the economies of the stable first world, or is the key to creating a stable and developed economy? These questions of which come first are not addressed in the current literature which seeks economic diversification. While very good reasons are clear given that the dominant source of revenue is non-renewable, the underlying rationale is not always as clear.

While economic diversification is considered a necessary part of economic development for poor countries, it is also an acknowledged need for the relatively well-off, single resource-based, economies of the Gulf region. Ahmadov (2012) sought to understand the factors that contribute to the success of economic diversification in natural resource rich nations. Ahmadov came to the conclusion that diversification strategies must be aligned with the political and institutional realities of that nation and culture (Ahmadov, 2012).

Diversification strategies are sometimes contrasted with specialization strategies. While diversification promotes different types of economic activity and multiple sectoral development, specialization promotes market leadership in a specific area, thereby potentially catalyzing market and economic growth. An easy example of specialization would be South Korea in the last half of the twentieth century, where government support and subsidies helped to catapult electronic and digital manufacturing and design with the launch of companies such as Samsung, Hyundai and Daewoo. In terms of economic development paths and milestones of growth, these are relatively unknown; studies have shown, however, that the antecedent to change is increased revenues, and economic diversification of exports follow (De Benedictis, Gallegati, and Tamberi, 2009). Specialization can be vaguely related to the rise of revenues in some case, however it happens over time (De Benedictis et al., 2009). The implication is that regression analysis of diversification does not reveal its use as a strategy, but rather it is the outcome of strategies which increase revenues, thereby increasing markets for export and import including diversification of the same. Still, both diversification and specialization are considered to be important strategies in the modern market driven global economy, however balance requires specialization which is attractive to global markets, as well as the risk reduction and improvements to balance of imports and trade to improve local commodity prices.

4. PESTEL Analysis

The current paper is going to use the PESTEL analysis (Political, Economic, Social and cultural, Technological, Environment and Legal) that looks and analyse what is happening in the environment of business and economics.

Such analysis will help in analyzing all important factors that might affect the steps taken towards the diversification of economy in Kuwait.

4.1 Political Factor

Political aspects of economic diversification in Kuwait include the vision statements and five-year plans which have been presented by policy makers, power structures and political sentiment. Malik (2016) further proposes that macroeconomic and fiscal policy are driven by underlying political sentiment of the population regarding redistribution of natural resource rents. For this reason, traditional domestic fiscal targets such as inflation are determined by markets more than they are by policy decisions (Malik, 2016). Malik believes this to be due to the weak production in combination with few or no institutional barriers creating a greater interface directly between the private sector and the sovereign power. This is related to an important finding in the study, which is that political stability in resource rich nations of the Persian Gulf “is almost entirely predicated on the uninterrupted flow of oil rents rather than resilient institutional structures” (Malik, 2016, p.1). This presents a new reason for economic diversification, but it also predicts outcomes that could upset the balance of power if economic diversification is successful, given the ideal that diversification is supported by institutional infrastructure.

Hvidt (2013) was critical of economic diversification in Kuwait and other Gulf Cooperation Council (GCC) countries based on previous capacity to achieve published vision statements relating to diversification. Noting that all of the GCC countries pointed to economic diversification as the solution to revenues which will end with the supply of oil, Hvidt also outlined how few projects had actually been designed and implemented, and the results of economic diversification strategies in all of the countries have been poor (Hvidt, 2013). Even where great investments have been made, such as tourism in the United Arab Emirates, the long-term profitability and sustainability as a revenue stream seems questionable after petroleum revenues cease to drive spending in cities like Dubai (Hvidt, 2013). Hvidt (2013) was doubtful about the capacity of GCC governments to allow for the flexibility needed for private sector innovation when the traditions of control, patronage and central planning are so entrenched, and this is stated to be true of Kuwait as well.

Herb (2009) in fact states that a barrier to economic diversification is the will of the people, as Kuwait’s citizens have supported oil dependency in policies. The implication then, is that there is a tension between the interests of the population as represented by economic diversification and the maintenance of the status quo (Herb, 2014). Successful economic diversification would result in change; it is not clear what these changes might be, and this could be relevant to the hesitancy to complete what is required for a more economically diverse society (Herb, 2009).

4.2 Economic Factor

The recent IMF study showed that the fluctuation of oil prices may deplete the financial wealth for Kuwait and other GCCs and affect its timing whatever the alternative price expectation may be. In other words, a real oil price of \$20 a barrel would delay the time of wealth exhaustion only until 2027 (Mirxoev, et al, 2020).

There are both microeconomic and macroeconomic aspects to economic diversification in plans and projects in Kuwait and their outcomes. Al-Kawaz (2008) describes that economic diversification has been touted as all things for all economic concerns, but it is only a necessary precondition of economic progress in Kuwait and represents more of a byproduct of other economic achievements than an objective on its own. Al-Kawaz further explains the thinking around investment in economic diversification that drove initial projects in the manufacturing sector. The idea was that the creation of jobs in manufacturing would create demand for a strong service sector, which would power new banking, real estate, transportation, and retail activity (Al-Kawaz, 2008). The diversification plan of the time has been largely successful in creating an oil dependent manufacturing sector which had impressive growth of up to 26.3% in the years before the financial crisis of 2008 (Al-Kawaz, 2008).

Agriculture sector in Kuwait contributes around 0.5% of the country’s GDP. This is due to fact that Kuwait is water scarce country. In addition, the labor force engaged in this sector is not promising and the climate change may affect the agricultural sector of Kuwait (Al-Menaie, 2014).

Beblawi and Luciano (2015) distinguish between two activities in the manufacturing sector of Kuwait, that being oil-based manufacturing, and manufacturing for the purpose of reducing import reliance. Oil-based manufacturing includes the downstream refinement and processing of petroleum as well as energy intensive, capital intensive industries such as aluminum (Beblawi and Luciano, 2015). The import substitution sector is small and fragmented, including food preparation and light manufacturing relating to construction (Beblawi and Luciano, 2015).

Hvidt (2013) further notes that the promotion of manufacturing as a diversification strategy in light of the eventual running out of oil is ridiculous, since the sector is dependent on the energy needs of cheap petroleum.

Diversification away from oil in Kuwait has focused on import substitution on a very small scale, and private sector firms have been more successful than public ventures (Hvidt, 2013).

4.3 Social Factor

There is general agreement that economic diversification is less likely to succeed from central planning, and more likely to follow from increased private enterprise activity. Cadera (2014) notes that there are 25,000 private business establishments registered in Kuwait, employing 55,637 Kuwait nationals. Al-Wugayan and Alshimmiri's (2010) study of Kuwaiti university students found great interest among both genders in this subpopulation in pursuing entrepreneurship rather than employment.

Cadera (2014) investigated socioeconomic and cultural factors of Kuwaiti society shapes entrepreneurial outcomes using a survey of new entrepreneurs in Kuwait. These businesses tend to be small and motivated by financial aspirations as well as independence.

Economic diversification is intended to result in increasing types and sophistication of employment. This would ideally involve less reliance on public service position and higher rates of employment, particularly for those Kuwaiti nationals with advanced education. Cummings (2018) looked at the similarity and difference in circumstances between Singapore and GCC countries with a view to understanding whether the Singapore model for economic diversification which leveraged innovation theories and the creative cities concept could work in Kuwait and similar environments. One of those similar factors are the high rates of employment of foreigners, and in Kuwait it creates ongoing tensions as highly education Kuwait nationals face a difficult job market.

4.4 Technological Factor

The linkage between technology and economic diversification is largely believed to be innovation. Innovation is a buzz word today which refers to new, disruptive business models as well as advancement in sciences and new uses for technology. Cummings (2018) described the great interest in the Singapore model for economic diversification by GCC countries, and this is driven by the similarities in climate, foreign national labor force and other factors. Asheim (2015) provided a general report on the application of the Scandinavian model of innovation driven economic diversification could be implemented in Kuwait, with a goal of transition to a knowledge-based economy, however much of it is abstract and remains to be translated into practical terms. More importantly, it did not address the current latent human resources capital of highly educated Kuwait nationals whose skills, talents and training are not being connected by the current economic climate and opportunity. Alsayegh, Saker, and Alqattan, (2017) described the integration of sustainable energy plans within the vision of development as an influential strategy intended to support the transformation of Kuwait into a financial and commercial center by 2035. This has been a common theme in GCC strategies and planning, however as an investment it is positioned in terms of energy diversification rather than economic diversification.

One of the most challenges to the current oil reserves of oil in Kuwait and other GCCs is the rise of the shale oil industry. The recent IMF study clarified that shale oil industry is expanding rapidly and has reshaped the market landscape. Not only the U.S. is going to be the largest oil producer, but China will follow suit. (Mirxoev, et al, 2020). This shows that the global oil supply is going to increase and made the market more competitive resulting in more price-elastic in the supply side of the oil market.

There is emerging, but still fragmented initiatives to increase innovation and technology across the GCC countries. These have been leveraged through partnerships where the GCC host country provides impressive, world class facilities for research, and it has also resulted in demonstration projects, particularly with regard to renewable resource energy and sustainability. While the clear connection to future revenues has not yet been made, the potential of these activities to power energy diversification makes them worthwhile from a business perspective. There is also the potential for a result such as new economic specialization in renewable energy capture and delivery design.

4.5 Legal Factor

The legal aspects of economic diversification refer to the structural aspects which facilitate or impede those activities that are believed to lead to economic diversification including investment, entrepreneurship, and innovation. The financial crisis which affected world financial systems in 2009 revealed several weaknesses in the investment sector of Kuwait, and the provisions for insolvency were important ones (Mako et al., 2013). As with other analysts, increased small and medium private firms were viewed as the key to economic diversification and increased employment rates (Mako et al., 2013). Without a legal structure that supports modern conceptions, rights and realities of debts and credit, it is difficult for such businesses to seek start-up capital as investors avoid the risks. This is just one structural change that would be needed to support the activities that would result in economic

diversification.

5. Analysis and Discussion

Perhaps it is not economic diversification that Kuwait is being challenged by, but rather finding a substitute revenue source, and untying all aspects of the economy from oil, in preparation for the inevitable end of oil. Initially the objectives of diversification strategies were for increasing profitability, and these were successful; the problem as it is constructed today in Kuwait and GCC nations is concerned with preparing for transition to an economy that is not based on oil revenues. The shape of sectors today, including the public sector and manufacturing industries are unlikely to keep their present form after this occurs. The ambiguity of the use of the term economic diversification serves to disguise the real strategic needs of the situation, which amount to detailing what currently depends on oil revenues, predicting impacts, and minimizing the shocks as oil ends. In order to retain standard of living and programs, revenues will need to be replaced, but specialization in an area of goods or services for export might be a more productive and efficient means of catalyzing economic growth rather than diversification. Given that diversification appears to occur spontaneously following economic growth, specialization in an area with future expected demand is perhaps the economic diversification strategy with the most practical application and the least risk. This idea also aligns with current research and development activities, particularly in the green energy area. It does of course create a catch-22, in that economic progress, improvement and growth are the key to economic progress, improvement and growth; on the other hand, it does streamline the understanding of what is necessary to achieve the vision of a more sophisticated, self-sufficient and thriving economy.

It is curious that, despite extremely high rates of participation in small business ownership, this has not resulted in greater economic diversification. This may be in part because the size of oil revenues overwhelms the revenues which are created by small business, but the potential economic growth of these businesses as they and their markets mature is ideal. Further, given that small business provides most of the employment, support for small business development which is not oil-dependent, or oil-revenues dependent may be an ideal strategy. Given the wide breath that is covered by the idea of economic diversification, small business development support can be considered as contributing to these goals. While it is possible that the assumption of small business leading to economic diversification is potentially not valid, the resulting progress in business development and employment opportunity is reason enough. It has the potential to contribute to the same goals as the intended economic diversification strategy, namely better economic conditions and lifestyle for the people who live in Kuwait.

A final consideration is the extent to which economic diversification serves specific needs, and specifically identifying those needs in order to determine approaches that go beyond a vague understanding of economic diversification. There continues to be little evidence of successful long term economic diversification of the kind envisioned in the development literature despite decades of attempts, particularly in the undeveloped and underdeveloped nations of the world.

6. Summary and Conclusion

Kuwait's past economic diversification has been focused on capitalization of value from oil and gas through value-added refinement and manufacturing. While this has increased short term profitability, the long-term needs for increased sources of revenue to fuel the national economy remain. The petroleum revenues of Kuwait cannot last forever, however public and private sector industry is nearly entirely dependent on this source of revenue. This is a problem across the nations of the GCC, who also suffer from similar concerns about the employment of nationals and meeting long term energy needs. It is true that Kuwait's government is developing ambitious plans towards oil industry diversification. However, economic diversification has shifted away from value added activities in the oil sector towards various industries, including ideals of tourism, hospitality, and innovation. The measurement of economic diversification in studies has revealed that economic diversification is usually the result of economic progress, and to that end, it may be economic progress in combination with a move away from oil revenue based economic activity which is needed rather than an ambitious economic diversification agenda. The difficulty may be in creating consensus around the goal of movement away from oil revenue-based activities. One area where the economic future needs of Kuwait and the cultural sensibility align is in small business ownership, and this in combination with the latent and undercapitalized, well-educated labor force presents many opportunities for growth, diversification, and innovation by providing for new opportunities for Kuwaiti citizens.

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