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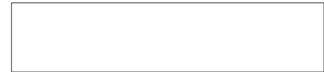

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The Gulf States: Changing Economic Opportunities

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An Intelligence Assessment

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NESA 87-10050
November 1987

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The Gulf States: Changing Economic Opportunities

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An Intelligence Assessment

This paper was prepared by 25X1
Office of Near Eastern and South Asian Analysis,
25X1 It was
coordinated with the Directorate of Operations. 25X1

Comments and queries are welcome and may be
directed to the Chief, Persian Gulf Division, NESA,
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The Gulf States: Changing Economic Opportunities

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Key Judgments

Information available as of 2 November 1987 was used in this report.

Economic opportunities in Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates are promising for the United States into the next decade. A number of nonoil sectors in the Gulf states' economies, in particular, are poised for substantial growth as oil revenues stabilize and rebound and as governments refocus their development priorities. The complementary nature of Gulf state service needs and US service industry strengths should give the United States a significant edge over Japanese and European competitors.

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Regional trade in services will probably outpace merchandise sales in the years ahead as governments strive to keep abreast of mounting demands for social services and attempt to consolidate gains achieved under previous development schemes. Waste and water management, data processing, financial services and technology, and administrative skills almost certainly will be areas of high demand as economic planners attempt to improve the rate of return on national investments.

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The US position as a leading merchandise supplier to the region probably will continue to deteriorate, but the dominant US position as a provider of services to the Gulf states is likely to offset most, if not all, of this decline. The United States now trails Japan as the single largest merchandise supplier to the Gulf states, and Washington's second-place position is under challenge from several European countries. Last year the United States ran its first merchandise trade deficit with the region since 1981.

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Investing in the Gulf is several times as risky as investing in the United States, according to our estimates, but diversification can achieve impressive rates of return. Nonoil sectors, in particular, have weathered the Gulf recession well, and performance in these sectors is largely uninfluenced by events in the US economy. Moreover, when oil demand and prices rebound, Gulf oil sectors will again produce handsome opportunities for US participation.

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Gulf state economies still retain significant barriers to foreign investors. Foreign ownership is often restricted, and financial kickbacks to key officials are frequently required to obtain contracts. Divergence from Gulf state views on the Palestinian issue and other sensitive political matters can lead to a boycott or other forms of discrimination. Conflicting business practices and a poorly trained work force often frustrate productivity and raise business costs.

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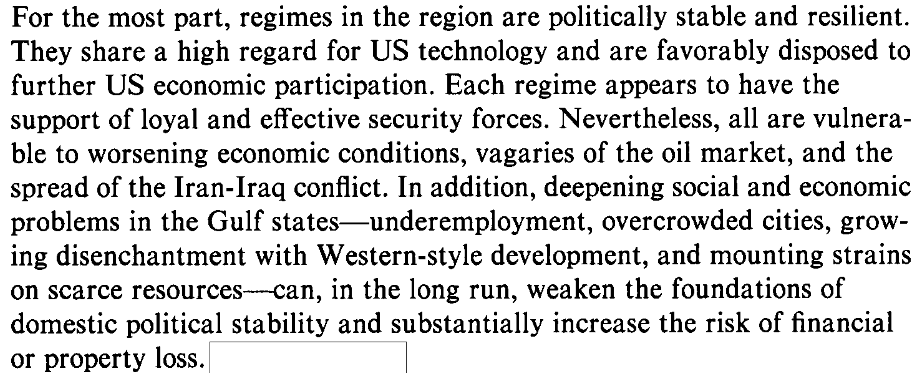

For the most part, regimes in the region are politically stable and resilient. They share a high regard for US technology and are favorably disposed to further US economic participation. Each regime appears to have the support of loyal and effective security forces. Nevertheless, all are vulnerable to worsening economic conditions, vagaries of the oil market, and the spread of the Iran-Iraq conflict. In addition, deepening social and economic problems in the Gulf states—underemployment, overcrowded cities, growing disenchantment with Western-style development, and mounting strains on scarce resources—can, in the long run, weaken the foundations of domestic political stability and substantially increase the risk of financial or property loss.

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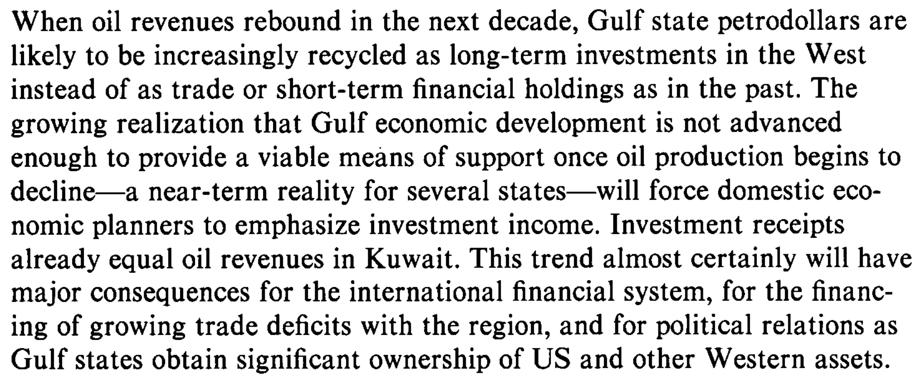

When oil revenues rebound in the next decade, Gulf state petrodollars are likely to be increasingly recycled as long-term investments in the West instead of as trade or short-term financial holdings as in the past. The growing realization that Gulf economic development is not advanced enough to provide a viable means of support once oil production begins to decline—a near-term reality for several states—will force domestic economic planners to emphasize investment income. Investment receipts already equal oil revenues in Kuwait. This trend almost certainly will have major consequences for the international financial system, for the financing of growing trade deficits with the region, and for political relations as Gulf states obtain significant ownership of US and other Western assets.

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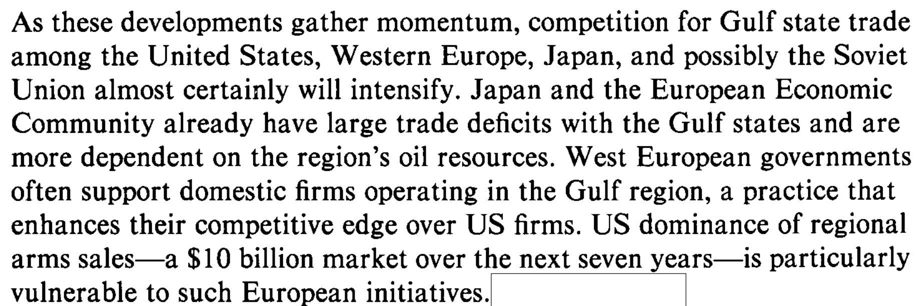

As these developments gather momentum, competition for Gulf state trade among the United States, Western Europe, Japan, and possibly the Soviet Union almost certainly will intensify. Japan and the European Economic Community already have large trade deficits with the Gulf states and are more dependent on the region's oil resources. West European governments often support domestic firms operating in the Gulf region, a practice that enhances their competitive edge over US firms. US dominance of regional arms sales—a $10 billion market over the next seven years—is particularly vulnerable to such European initiatives.

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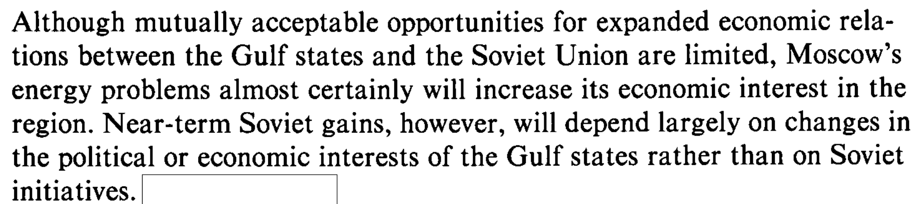

Although mutually acceptable opportunities for expanded economic relations between the Gulf states and the Soviet Union are limited, Moscow's energy problems almost certainly will increase its economic interest in the region. Near-term Soviet gains, however, will depend largely on changes in the political or economic interests of the Gulf states rather than on Soviet initiatives.

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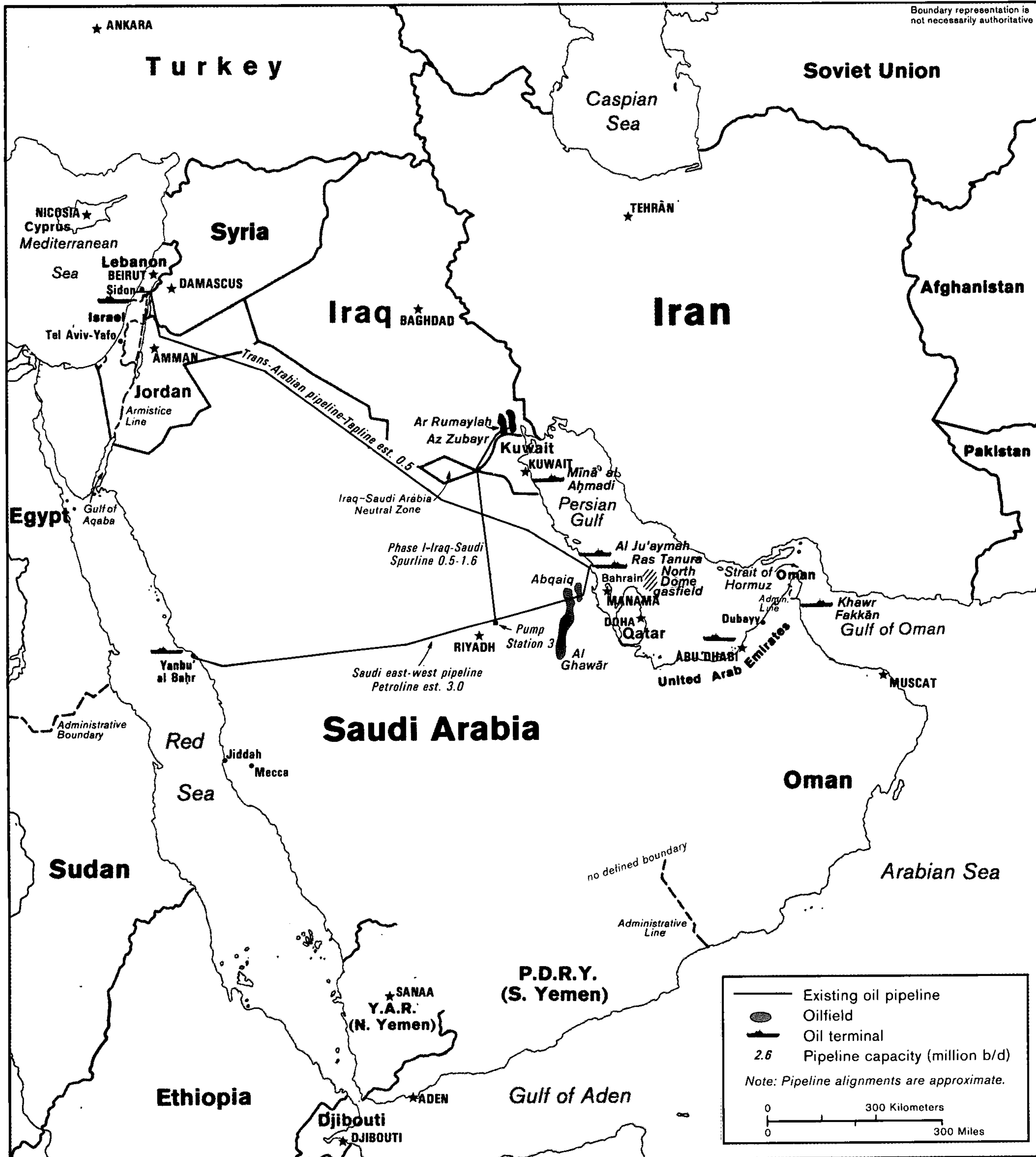
Figure 1
Selected Middle East Oil Facilities



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The Gulf States: Changing Economic Opportunities

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The Arab states of the Persian Gulf continue to offer substantial opportunities for investment and economic participation by the United States.[1] Overall, we estimate that development spending for the rest of the decade will top $40 billion annually, which implies a $30 billion market for merchandise imports and an equally large market for services. We expect that demand for services will be especially brisk as governments focus on consolidating economic gains achieved over the past decade, maintaining existing infrastructure, meeting the needs of rapidly growing populations, and establishing the foundation for the next round of development early in the next decade. The fact that the Gulf states have over 40 percent of the world's petroleum reserves suggests that they will continue to pay hard currency for large-scale development and import programs.

Development During the Boom Years, 1970-80

Economic development in the Gulf states has been a relatively recent and dramatic phenomenon. The rapid escalation of oil prices in the early 1970s provided the five Gulf economies—especially that of Saudi Arabia—with the financial wherewithal to embark on massive and pervasive development programs. the gross domestic product of these states in current dollars increased almost five times between 1970 and 1980 to $226 billion—a 17-percent average annual growth rate. Saudi Arabia accounted for more than two-thirds of the total GDP, the United Arab Emirates (UAE) and Kuwait contributed 25 percent, and Qatar and Bahrain made up the difference.

[1] Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates are defined as the economically important Gulf states in this Intelligence Assessment because of their large oil reserves and substantial opportunities for further economic participation by the United States. We exclude Oman from the list. Its relatively small economy, restricted trade relationship with the United States, limited long-term oil supply potential, and different demand prospects for US goods and services in the years ahead make it atypical in the region.

Development spending during the 1970s focused on the establishment of heavy industry and transportation networks. About two-thirds of available funds were earmarked for economic infrastructure, with less than 15 percent flowing into social development. During the decade the five Gulf states spent an estimated $230 billion on domestic development that generated over $150 billion in related merchandise imports.

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US firms have been instrumental in the development of the modern Gulf economies. Five major US oil companies—Exxon, Mobil, Gulf, Texaco, and Chevron—pioneered the discovery and exploitation of oil in all five states. Beyond oil-related activities, US firms established a secure foothold in virtually all aspects of the Gulf economies.

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US manufacturers and service industries were the largest suppliers to the Gulf economies during the 1970s. Trade statistics show that the United States accounted for up to 20 percent of regional imports. Japan followed with about 17 percent, and the West European countries collectively obtained an additional 40 percent of the Gulf import trade. Together, the Gulf states were the sixth most important customer of the United States behind Canada, Japan, West Germany, the United Kingdom, and France. We estimate, on the basis of US Embassy reporting, that 60,000 US citizens were directly employed in the Gulf states by 1980. US military sales to the region benefited from growing regional security concerns and topped $20 billion—a 68-percent market share during the 1970s. Strong US commercial relations also led government planners to rely heavily on US educational institutions as the chief source of training for thousands of Gulf Arab students, a measure that has served to cement business ties over the years.

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Table 1
Country Statistics

	Bahrain	Kuwait	Qatar	Saudi Arabia	United Arab Emirates
Ruler	Amir Isa bin Sulman Al Khalifa	Amir Jabir al-Ahmad Al Sabah	Amir Khalifa bin Hamad Al Thani	King Fahd bin Abd al-Aziz Al Sa'ud	President Zayid bin Sultan Al Nuhayyan
Ruler's age	54	59	57	66	71
Type of government	Nominal constitutional monarchy; National Assembly dissolved 1975	Nominal constitutional monarchy; National Assembly dissolved 1986	Traditional monarchy with appointed Advisory Council	Traditional monarchy	Federation of seven emirates; appointed Federal National Council
Population *(1,000 persons)* [a]	464	1,865	316	14,905	1,846
Population growth [a] *(percent)*	3.6	4.3	4.1	4.9	7.8
Population below age 15 *(percent)*	48	46	50	47	44
Literacy *(percent)*	64	64	34	35	68
Urbanization *(percent)*	78	89	86	71	74
Gross domestic product *(billion US $)*	2.88	13	5.75	86.92	22.89
Average GDP growth (1981-86) *(percent)*	−3.6	−11.3	−6.6	−8.9	−16.3
Inflation *(percent)*	−2.0	0.6	−2.0	−1.3	−4.2
Proved oil reserves *(million barrels)*	144	91,916	3,154	166,573	31,700
Oil production, first half 1987 *(1,000 barrels per day)*	43	1,146 [b]	252	3,979 [b]	1,338
OPEC quota, third quarter 1987 [b] *(1,000 barrels per day)*	NA	996 [b]	299	4,343 [b]	948
Foreign exchange reserves less gold, June 1987, *(billion US $)*	1.4	4.2	0.5	20.5	3.9
Foreign official assets *(billion US $)*	2.0	85.0	12.0	100.0	40.0
Exchange rate per US $ [c]	0.38 dinar	0.28 dinar	3.64 riyals	3.75 riyals	3.67 dirham

[a] Reflects immigration.
[b] Excludes Neutral Zone production of 374,000 barrels per day, which is equally shared by Kuwait and Saudi Arabia.
[c] Except for Kuwait, all currencies are pegged to the US dollar. Valuations are as of 30 June 1987.

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Economic Consolidation Under Austerity

Although development efforts in recent years have been hampered by sharply lower oil revenues—they have dropped 73 percent since 1980—the major aspects of previously planned development programs have been completed. Saudi Arabia, Bahrain, and Qatar, in particular, have drawn down their foreign assets to keep development schemes on track. The region remains financially healthy as indicated by still low debt burdens, high levels of gross fixed investment as a percent of GDP, and a substantial cushion of foreign exchange reserves. In addition, total imports

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Table 2
Gulf States: Current Account Balance, 1982-87

Billion US $

	1982	1983	1984	1985	1986	1987 [a]
Current account balance	**18.6**	**−6.7**	**−5.6**	**−0.6**	**−10.6**	**−18.8**
Trade balance	53.5	25.4	24.8	22.7	11.6	10.6
Exports (f.o.b.)	110.1	78.3	71.4	59.5	45.3	44.4
Oil	105.9	76.0	65.9	51.9	39.2	38.8 [b]
Nonoil	4.2	2.3	5.5	7.6	6.1	5.6
Imports (f.o.b.)	56.6	52.9	46.6	36.8	33.7	33.8
Net services	−28.0	−26.8	−26.2	−19.4	−18.4	−25.8
Grants	−6.9	−5.3	−4.2	−3.9	−3.8	−3.6

[a] Projected.
[b] Assumes combined oil exports of 6.4 million b/d at $16.50 per barrel.

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Table 3
Gulf States: Indicators of Financial Health, 1986

Percent
(except where noted)

	Ratio				
	Gross Fixed Investment to GDP	Foreign Exchange Reserves to Merchandise Imports [a] *(months)*	Debt Service	Merchandise Imports to GDP [a]	Debt to GDP
LDC average	23	3	23	15	27
Bahrain	15	7	4	59	25
Kuwait	28	9	5	32	56
Qatar	NA	6	3	17	11
Saudi Arabia	27	14	5	21	17
United Arab Emirates	25	7	8	29	35

[a] 1984-86 average.

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as a percent of GDP—a measure of development priority and domestic demand—has remained almost constant over the past five years at about 40 percent of GDP,

The sharp decline in oil prices and a growing awareness of the shortcomings of previous development efforts have brought about significant changes in the development priorities of the Gulf states. The current regional consensus on development stresses the need to reconcile the pace and direction of development with the needs of society. Specifically, each of the Gulf state development plans:

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- Deemphasizes further industrial expansion.
- Calls for the maintenance of the existing social and economic structures.

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Table 4
Gulf States: Total Real Growth by Sector, 1981-86

Percent

	Bahrain	Kuwait	Qatar	Saudi Arabia	United Arab Emirates	Weighted Growth
Petroleum	3.9	−43.0	−56.0	−57.0	−35.0	−49.8
Agriculture	6.0	92.0	45.0	44.0	50.0	50.8
Manufacturing	29.0	16.0	80.0	66.0	25.0	51.9
Construction	24.0	9.0	−32.0	−15.0	−6.0	−9.8
Financial services	7.0	40.0	11.0	15.0	21.0	19.1
Other services [a]	23.0	11.0	45.0	26.0	4.0	21.0
Weighted regional average						**−15.3**

[a] Includes government services.

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- Mandates the integration and consolidation of past development gains and improved rates of return on public-sector investments.
- Encourages further diversification of the national economy.
- Stresses increased efficiency and productivity.
- Calls for reductions in the foreign labor force and increases in the levels of domestic skills and participation of local workers in the economy.
- Underlines the importance of greater private-sector participation in the economy.
- Promotes the need to restructure the public sector and improve management in the civil service.

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Growth since 1980 in the nonoil sectors emphasizes the change in development priorities. Official country data show that activity in the construction sector fell off sharply in the last several years as major projects were completed and oil revenues dwindled. Agriculture and manufacturing, however, experienced consistent and rapid growth as governments attempted to close the growing gap between domestic demand for basic goods and local supply, At the same time, the demand for services blossomed as public and private sectors attempted to meet the needs of the region's increasingly affluent and urbanized societies.

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Emerging Opportunities for the United States

Oil prices and demand to a large extent will determine the pace of future development as they have in the past. We believe that OPEC's ability to support prices at $18 per barrel, its apparent commitment to restrain output, rising demand for Gulf oil, and dwindling supplies outside the Gulf are strong indicators that oil revenues in the Gulf states will begin to rise, though probably only gradually for the next several years. This trend almost certainly will buoy local economies. As long as the oil market is perceived to be tightening and revenues rising, we believe most Gulf states will proceed with modest development programs. We estimate that financial reserves will be sufficient to bridge revenue gaps in these states through 1990 at current rates of drawdown.

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Although governments will continue to direct development efforts in all five states, we expect private enterprise will play a growing role. We believe that changes in development priorities and other economic factors will lead to enhanced commercial opportunities for the United States in both the public and private sectors.

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Table 5
Gulf States: Development Spending by Sector, 1982-86

Billion US $

	Bahrain	Kuwait	Qatar	Saudi Arabia	United Arab Emirates [a]	Total	Percent
Infrastructure	1.83	10.50	2.31	81.80	7.22	103.66	37.8
Of which:							
Electricity	0.58	5.91	NA	NA	3.59	10.08	
Water and sewage	0.40	NA	1.26	NA	0.93	2.60	
Housing	0.44	3.06	0.56	NA	1.23	5.29	
Roads	0.14	1.53	0.49	NA	1.34	3.50	
Ports and airports	0.29	NA	NA	NA	0.13	0.42	
Social services	0.29	1.85	0.99	74.90	1.61	79.64	29.0
Of which:							
Education	0.11	0.58	NA	NA	0.13	0.83	
Health care	0.07	0.48	NA	NA	1.48	2.03	
Economic services	0.12	3.73	0.10	83.30	0.61	87.86	32.0
Of which:							
Agriculture	0.05	NA	NA	NA	0.31	0.36	
Industry	0.05	NA	NA	NA	0.31	0.36	
Defense and security	0.14	NA	NA	NA	0.24	0.38	0.1
Other	0.17	1.02	1.53	NA	0.32	3.04	1.1
Total	**2.55**	**17.10**	**4.93**	**240.00**	**10.00**	**274.58**	**100.0**
Share of total (*percent*)	0.9	6.2	1.8	87.5	3.6	100.0	

[a] Includes development expenditures of the UAE federal government, Abu Dhabi, and Dubayy.

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We believe that petroleum exploitation and development will remain the foundation of the Gulf economies and the primary source of economic growth, despite the contraction in this sector in recent years. Conversion industries such as plastics manufacturing offer significant growth prospects. Maintenance services are in constant demand and will probably grow—especially in Bahrain, Qatar, and the UAE—as aging fields require enhanced recovery technology to maintain production. Several Gulf states hope to use the leverage of trading as a bloc to increase their market share of petrochemical exports. Saudi Arabia offers the best prospects for petrochemical production because of its greater economic diversification and large petroleum reserves.

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Agricultural development and production have increased steadily since 1980 and, we believe, offer significant opportunities for further US participation. The Gulf states, particularly Saudi Arabia, achieved a high degree of self-sufficiency in some grains and dairy products over the past five years. 25X1 25X1 Processing, storage, and transportation, however, are the weak links in the otherwise impressive agricultural program. Saudi development plans, in particular, place high priority on overcoming these gaps. Moreover, Riyadh, which pays several times world prices for domestic production, is eager to

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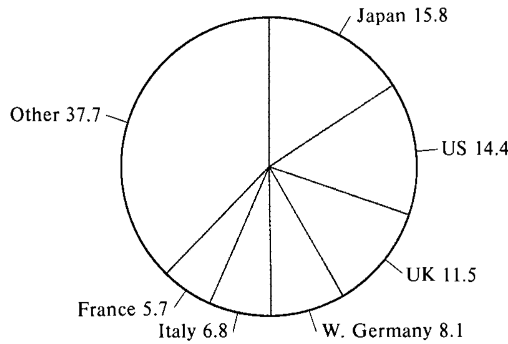
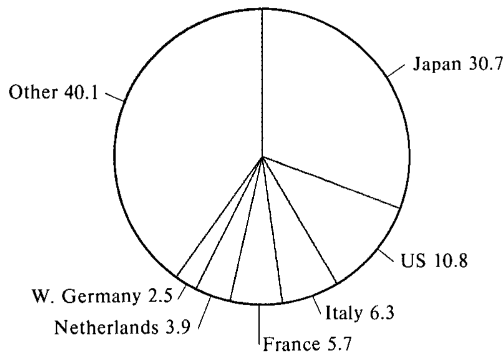
Figure 2
Gulf States: Direction of Merchandise Trade, 1986

Percent

Imports $33.7 Billion



Exports $45.3 Billion



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trim domestic farm subsidies by obtaining more cost-efficient production technology, according to US Embassy reporting. The other Gulf states also give priority to agriculture, but their smaller resource bases offer fewer opportunities for large-scale agribusiness. We believe that US technological strength in many areas of agricultural production should give the United States a distinct advantage in capturing a large share of this high-growth sector. US investment can have a significant impact on agriculture by helping the Gulf states work toward capital-labor ratios more consistent with their long-term plans for self-sufficiency in food production. 25X1

Regional governments continue to emphasize expansion of domestic manufacturing to offset increased imports. Labor and skill constraints mandate the use of capital-intensive technology. Most governments, particularly that of Saudi Arabia, are eager to consider joint ventures, according to US Embassy reporting. Joint production and maintenance of military goods are much sought areas of cooperation. The skills shortage, in particular, could create opportunities for foreign maintenance contracts in everything from janitorial work to skilled repair services in the manufacturing sector. 25X1

Financial services have experienced rapid and consistent growth since 1980 and will be a leading area for development by several Gulf states. Bahrain has taken the lead in establishing itself as the financial services center of the region to supplement its small and declining oil resources. Kuwait, Saudi Arabia, and the UAE also are developing domestic financial services. Despite this development, the budding money centers of the region lag major US financial institutions in technical and money management skills, 25X1 25X1 Communications, data, and financial management and technology almost certainly will be in high demand as both regional and international banks in the Gulf attempt to expand and improve the efficiency of their operations. 25X1

Service sectors probably offer the most promising areas for additional US participation. Partly because of lower oil revenues, the contribution of services to regional GDP matched that of the oil sector last year. Expansion in the service sector—a reflection of local demand and government priority—shows little correlation with events in the oil sector and has experienced growth in most states since 1980, according to US 25X1

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Prospects for Military Sales

Demand for military goods and services remains strong in the Gulf states despite reduced oil revenues. We estimate that over the next seven years these regimes will purchase $10 billion in new arms. Regimes are particularly interested in improving their air defense capabilities in response to heightened concerns over the spread of the Iran-Iraq war, according to US Embassies in the region:

- *Bahrain is seeking about $260 million in combat helicopters, antiaircraft defenses, and air transport.*
- *Kuwait is considering the purchase of over $2 billion in new fighter aircraft and armored vehicles.*
- *Qatar would like to buy 18 new combat aircraft and additional armor.*
- *Saudi Arabia represents the largest potential market in the region. Planned upgrading of Saudi defenses could top $6 billion before 1995, including tanks, antiaircraft systems, and possibly submarines.*
- *The UAE is moving ahead with plans to purchase 24 combat aircraft and additional armor in a modernization program likely to exceed $1.8 billion.*

Most states would prefer US military goods, but Washington's reluctance to sell sophisticated arms in the past and a desire to diversify sources of supply are causing Gulf states to consider West European and Third World equipment. As a result, the United States is likely to lose its dominant military supply position in the region to West European arms suppliers.

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Embassy Selected service areas where we anticipate significant growth in the coming years include:

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- Because of the large construction effort of the past and the increasing urbanization of Gulf societies, maintenance probably will be the boom industry of the next five years. High temperatures and frequent duststorms increase maintenance problems in virtually all areas of the economy. A trend toward growing capital intensity of industry and greater technological sophistication suggests an escalating demand for all types of services.
- A growing demand for data management and training is following the rapid development of the Gulf economies. Meeting government goals of better resource management and improved services will require the rapid development of data management skills and capacity.
- Waste management in the Gulf is following global trends. We believe that rapid urbanization, the shortage of water, and the Arab disdain for dealing with sanitary control combine to create a lucrative market for waste management in the Gulf states. Sewage and solid waste control and disposal and control of water supplies are top priorities

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- Health care, already satisfactory, is a top priority under regional plans to enhance living conditions. Here again, social customs—such as the prohibiting of women working as nurses—prevent the effective use of local human resources, creating opportunities for US health care specialists.
- Management and training skills in the civil service are inadequate to the task of efficient government operation and have been targeted for substantial

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improvement. A broad cross section of personnel, logistic support, and technical training will be required to improve government efficiency.

- Developing a cadre of skilled workers is a high priority for most governments in order to avoid complete dependence on foreign maintenance services. US Embassy reporting says that, as a result of long-term neglect, vocational training programs are inadequate to meet rapidly growing needs for mechanics, plumbers, electricians, and other skilled workers. This trend suggests opportunities for US training expertise.

- Marketing skills and technology, including distribution technology, will find broad application throughout all Gulf economies. Planning, producing, pricing, and promoting the output of the Gulf states' industrial base will be a priority in the years ahead. This area not only offers opportunities for new entrants to the Middle East but also a new outlet for firms with long-term regional experience. 25X1

Markets of Individual Gulf States

Although the Gulf region offers a broad range of attractive opportunities to US firms, the individual states differ sharply in the areas available for potential investment. 25X1

Bahrain is the smallest Gulf state economy in size, but it has the most fully developed nonoil sector. Manama is rapidly becoming the financial services center of the Gulf with a growing demand for communications technology, data management, and investment skills. The age of the domestic oil industry's oilfields suggests a growing need for enhanced recovery technology. Potable water supplies and waste management are growing concerns on the island and the focus of increased government spending. 25X1

Kuwait depends more heavily on oil. With almost 200 years of proved oil reserves at recent production levels, the government has considerable wealth at its disposal to finance development. Kuwait's emphasis on investing its wealth has opened opportunities for foreign financial managers. The government's movement into petroleum processing and distribution is also creating a demand for foreign management expertise. The pervasive social welfare system fostered by Kuwait's oil wealth provides growing opportunities for US health care and waste management services. The government also may require greater assistance in marketing technology to improve the prospects for domestic petrochemical and petroleum processing capabilities. 25X1

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Figure 3. *Saudi garbage generates business for US firms. A US company has a $155 million contract with the city of Jiddah.*

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Qatar is the second-smallest economy in the Gulf with a growing appetite for a wide variety of services, including petroleum development expertise. The small population ranks as one of the richest in the world, and Doha's oil wealth has provided a cradle-to-grave welfare state, according to the US Embassy. This affluence and the lack of a strong work ethic foster a great dependence on foreign expertise and management. Although the government has trimmed development spending plans to curb its growing budget deficit, Doha recently went forward with the first phase of its multibillion dollar North Dome gas project. We believe that this effort to tap one of the largest gas deposits in the world will generate substantial demand, not only for petroleum-related goods and services, but also for consumer goods and services by the large number of foreign workers employed by the project. Qatar probably will seek heavy US participation in this project, according to the US Embassy in Doha. The government is disappointed with past British management of petroleum operations and failure to include more Qataris in domestic oil operations.

Saudi Arabia's economy is the largest in the Gulf, and, as a result, the largest market for US goods and services in the region. Riyadh's large oil resources—about one-quarter of proved world oil reserves—underscore the potential of the Saudi market. The hundreds of billions of dollars spent on development over the past 17 years have produced a broad market for maintenance services of all descriptions. Rapid population growth and rising urbanization have created a growing demand for water and waste control. The US Embassy in Riyadh says that the government so far has expended an estimated $15 billion in financial assets this year to keep social and economic programs on track. We believe that a combination of improving oil revenues and additional drawdowns of reserves will allow Riyadh to maintain development spending and import programs over the next several years.

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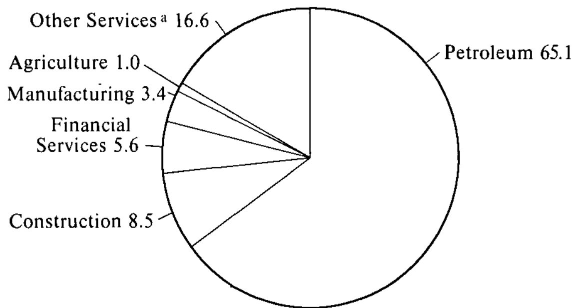
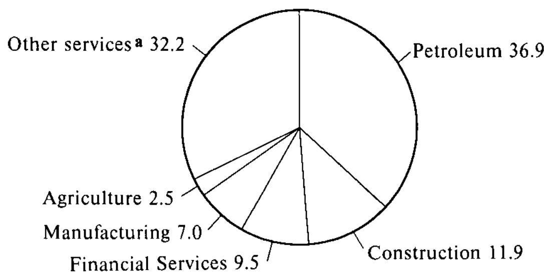
Figure 4
Gulf States: Composition of GDP, 1980, 1986

Percent

1980 Total GDP $225.5 Billion



1986 Total GDP $131.4 Billion



a Includes government services

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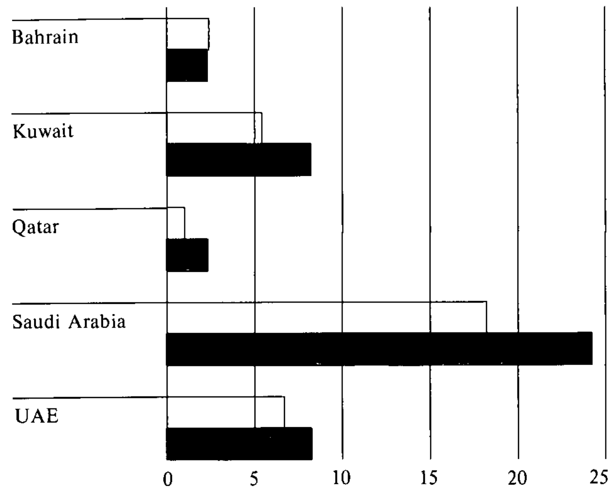
Figure 5
Share of Gulf State Trade, 1986

Billions of US$



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The United Arab Emirates represents seven markets, each with its own potential demand for US goods and services. Abu Dhabi and Dubayy are the two principal markets for US goods and services. Dubayy, in particular, is moving to develop its nonoil sector in advance of declining oil production, according to the US Embassy in Abu Dhabi. Dubayy's relatively advanced economy has a growing demand for financial services management, water and waste management, and advanced oil recovery technology. Abu Dhabi's oil reserves by comparison are projected to last almost 90 years. US Embassy reporting says that Abu Dhabi's relatively small population with a limited education demands a growing variety of services to keep the economy operating.

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Assessing the Investment Environment

We believe development priorities, and therefore investment opportunities, will be increasingly determined by changing social conditions. Deepening demographic problems—rapid population growth,

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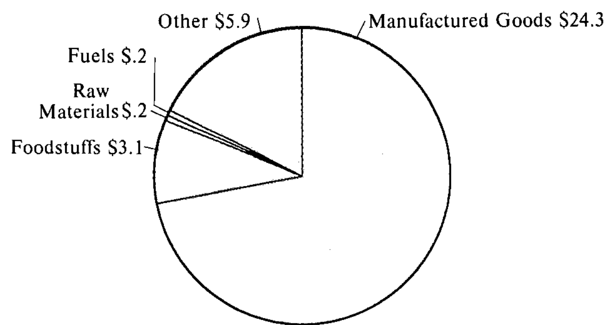
Figure 6
Gulf States: Composition of Merchandise Trade 1986

Imports $33.7 Billion



Exports $45.3 Billion

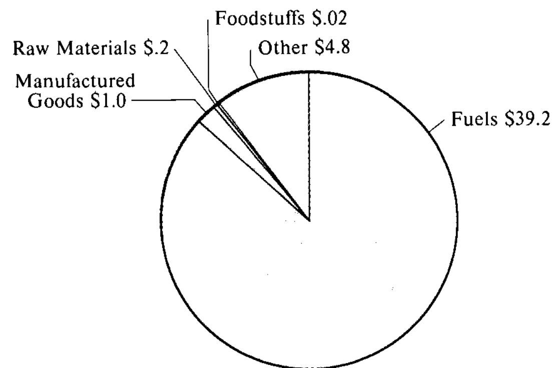


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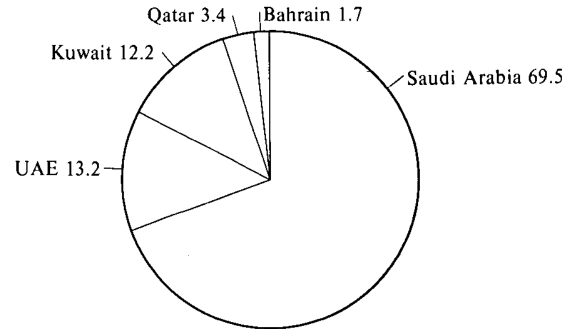
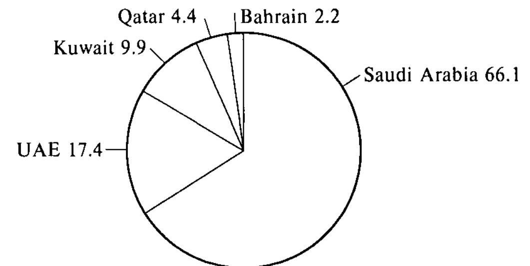
Figure 7
Gulf States: Contribution to GDP 1980, 1986

Percent

1980 Total GDP $225.5 Billion



1986 Total GDP $131.4 Billion



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overcrowded cities, underemployment, basic resource constraints, and conflicting social customs—are undermining the foundations of economic and political stability in the region. As these problems gather momentum, we expect alienation among traditional societies to increase the appeal of political radicalism and protest. Dealing with political challenges will tax domestic resources, test political wills, and leave foreign investments more vulnerable to financial and physical loss.

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Population Growth

Rapid population growth is a primary factor affecting social change in the region that almost certainly will direct future development priorities and investment opportunities. Explosive growth of the native population in the Gulf states of 3.3 percent annually will decline only slightly over the next decade, according to estimates by the US Bureau of the Census. Fertility control programs will not significantly alter this projection, because it would take two decades under the best of circumstances to stabilize lower birthrates. We believe that family planning will be slowed by government restrictions on the distribution of pertinent information as well as by the spread of Islamic fundamentalism in the region. Even though Islamic scholars acknowledge that no Islamic tenets directly prohibit the use of contraception, Islamic fundamentalists condemn family planning practices as a "Western evil." Even with native population growth held to 2.5 percent annually beginning in 1990 and no significant increase in the foreign work force (optimistic assumptions), projected population in the region would reach 25 million by the end of the century compared to 19.5 million today. Urbanization will exceed 85 percent of the population by the late 1990s, according to UN estimates, which will further strain social services budgets.

Resource Constraints

We believe that demand for water, waste management, and other services commensurate with population pressures will become major political issues for the Gulf states and lucrative areas for US participation. Demand for water, already in short supply, will probably double by the end of the century based on population growth, complicating social and industrial development, according to US Embassy reporting. Overuse of ground water resources has already left most population centers and many industrial facilities dependent on desalination plants that are vulnerable to sabotage or terrorist attack. Sewage and solid waste disposal problems already tax local sanitary control systems. We estimate that construction of new sanitary treatment facilities will require heavy expenditures of public funds over the next five years. We project that the demand for health care, housing, transportation, and other social services will rise rapidly in the next several years as governments strive to keep urban populations satisfied and minimize public criticism of national economic management.

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Traditional Values

Traditional values and education priorities prevalent in the Gulf states hurt economic development, contribute to growing unemployment, and raise the cost of doing business. Education systems in the Gulf do not stress innovation or creativity. The educational programs are not geared to provide the skills necessary for technical and industrial jobs let alone managerial positions. 25X1 Nevertheless, graduates expect better than entry-level positions, something that most governments will be increasingly unable to provide. We expect the economic cost of placing poorly trained graduates in senior positions will grow dramatically in the years ahead. As decisions become more complex and resources more limited, we believe that demand for foreign expertise will increase. 25X1 25X1

Foreign Workers

The Gulf states' heavy reliance on foreign labor puts a heavy burden on national finances which could slow the pace of development. Nearly 6 million foreigners—37 percent of the population—are required to fill highly skilled jobs that Gulf workers cannot perform or unskilled jobs they refuse to accept, according to US Embassies in the region. At the same time, the role of women in the work force is circumscribed by conservative social customs. Reliance on expatriates inflates the expectations of local populations, increases unemployment, and raises potential security and political problems for Gulf regimes. Foreigners do not contribute to domestic consumption in proportion to their numbers, because they remit a high percentage of their earnings to families outside the region, hindering the growth of domestic markets. But the foreign populations increase demands on already strained social services. Although all governments publicly acknowledge the need to reduce the size of the foreign work force, we believe that most will limit their efforts to reducing costs by substituting lower wage Asians for Western workers over the next several years.

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Table 7
Gulf States: Native and Foreign Populations, 1986

1,000 persons

	Native Population	Foreign Population
Total	**13,447**	**5,949**
Bahrain	364	100
Kuwait	731	1,134
Qatar	66	250
Saudi Arabia	11,005	3,900
United Arab Emirates	1,281	565

Islamic Fundamentalism

Religious extremism has not been a serious threat to Gulf regimes so far, but the close relationship between religious and political authority leaves ruling families—and the hospitable business environment—vulnerable to the spread of radical fundamentalism. Austerity and the growing social dislocation accompanying development have caused many to question the direction of society and the influence of Western development and to reassess their cultural identity, according to US Embassies in the region. This process contributes to the appeal of Islam and to militant fundamentalism in particular. Fundamentalism has spread throughout the region and extends beyond the unemployed youth and disfranchised to include the well-to-do and intellectuals. Tensions between Sunnis and local Shias are always simmering, complicated by the successful Islamic revolution in Iran. The bloody riot during the Hajj in Mecca in August, allegedly fomented by Iranian Shia pilgrims, underscores how quickly religious tensions can flare into violence. US Embassies in the region report Sunni-Shia tensions are of particular concern in Kuwait, Bahrain, and Saudi Arabia's Eastern Province—areas that have large and disadvantaged Shia populations. The greatest threat posed by the Islamic resurgence, however, stems from its manipulation by opposition groups or subversives as a tool for challenging established authority and Western-oriented development.

The Israel Question

The Arab boycott against firms assisting Israel remains a potential threat to US firms as well as an obstacle prohibiting some US companies from participating in Gulf development. The cost of the boycott to US firms in terms of lost business with the Gulf states is difficult to measure, but it probably totals in the millions of dollars annually. The boycott almost certainly will remain an impediment to US commercial participation in the Gulf economies, given the growing local concern over strong US-Israeli ties.

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Cultural Idiosyncrasies

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Arab culture poses significant obstacles to further development and foreign investment. Organizational and managerial skills are not traditional strengths of Gulf Arabs. Most Gulf managers exhibit an extreme reluctance to delegate authority and a misunderstanding of Western business methods, 25X1 25X1 The tendency to remain centralized, inflexible, and small, works against successful privatization and industrialization on a large scale. Preoccupation with maintaining control and Islamic tenets against usury have frustrated the development of efficient capital markets and hindered the spontaneous growth of new business ventures. A preference for consultation and consensus contrasts sharply with Arab perceptions that the US business culture is impersonal and exclusionary. Maintaining a public facade of prosperity supersedes the need for objective problem solving. In addition, a strong predilection toward fatalism, associated with Islamic values, dampens innovation and entrepreneurial spirit.

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Managing Investment and Political Risk

Our analysis shows that much of the business risk in the Gulf can be substantially reduced or eliminated by appropriate diversification. Although the Gulf business environment is several times more risky than the environment in the United States, much of the risk inherent in investing in the Gulf is specific to

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The Arab Boycott

Arab boycotts against the Jewish community in Palestine and firms dealing with this community predate the establishment of the State of Israel in 1948. Today, only companies considered to be significantly contributing to the economic development or military strength of Israel are subject to the boycott. The Arab League does not distinguish among the various types of boycotts it administers, but the world business community generally does. The primary boycott bans all direct trade between Arab states and Israel. Until the United States enacted strict antiboycott legislation in 1977, the primary ban was most commonly enforced by a negative certificate of origin stating that the goods in question had no association with Israel. Currently, the Gulf states accept a positive certificate of origin indicating where the product is produced and the name of the manufacturer.

A secondary form of the boycott, instituted in the early 1950s, expands on the type of activity considered to significantly benefit Israel's economy or military. A firm is blacklisted under the secondary boycott if it:

- *Has a plant, branch, licensee, or regional agent for the Middle East in Israel.*
- *Is a partner in any Israeli company.*
- *Advises Israeli manufacturers.*
- *Acts as agent or principal importer for any Israeli firm.*
- *Prospects for natural resources in Israel.*

Third-country firms suspected of proscribed activity in Israel are usually presented with a questionnaire asking if they are engaged in forbidden practices. A positive response results in blacklisting. US firms are prohibited from responding to boycott questionnaires under the 1977 antiboycott legislation. The law also requires US companies to report the receipt of questionnaires to the US Department of Commerce.

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An extended form of the secondary boycott requires the third-country firm to refuse to use products or services of blacklisted companies in fulfilling a contract or sale to enforcing countries. A clause requiring such a refusal sometimes appears as a contract condition. This requirement has been labeled a tertiary boycott in the United States. It is especially prevalent in international banking. As Arab financial institutions have increased their role as lenders to corporate and government borrowers, some borrowers have been pressed to refrain from dealing with blacklisted banks or other institutions with Israeli connections. This problem is likely to assume greater proportions as the international prowess of Gulf financial institutions grows.

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The boycott is administered by a Central Boycott Office (CBO) with headquarters in Syria and national boycott offices in each Arab country. A central committee composed of a representative from each Arab League state meets semiannually to revise the list of blacklisted firms. Implementation of the CBO recommendations is not compulsory, and compliance varies widely among the Gulf states, essentially creating five individual blacklists. In the region, Kuwait probably adheres most closely to the CBO recommendations, while Saudi Arabia exhibits the greatest flexibility in interpreting the committee's recommendations. A primary determinant of government support for the boycott is the relative availability of goods or services. Tenets of the boycott have frequently been overlooked by all of the Gulf states to secure badly needed goods or services available only from a blacklisted firm.

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Social Customs and Economic Development

Economic development in the Gulf states relies on a balance between the area's need to modernize and the conservative, traditional values of society. These two opposing and in some cases incompatible elements frequently frustrate development and influence opportunities for participation. Regional customs stemming from tribal origins, religious beliefs, geographical constraints, and tradition often have a direct impact on the commercial environment through higher costs or barriers to entry. Such customs include:

- *The exclusion of women from gainful employment outside the home. Segregated working areas must be provided for most women who work. Excluding women from the work force restricts the supply of labor and hinders productivity.*
- *Unemployment is not a disgrace, and prolonged effort to achieve a task is often the exception among the native work force.*
- *Islamic tenets against the payment of interest have frustrated the development of efficient capital markets in several Gulf states and hinder business transactions.*
- *The preference for consultation and consensus slows the decisionmaking process.*
- *Tribal allegiance and financial kickbacks continue to influence business decisions.*

each state and sector and is largely unrelated to external events in the world economy or the United States. This is especially true of most nonoil sectors.[2] The cumulative effect of appropriate diversification of foreign investments into selected Gulf nonoil sectors is to reduce the level of risk of investment. This would be especially true of joint US investments in the nonoil sectors of Bahrain, Qatar, Saudi Arabia, and the UAE. The risk associated with the oil industry is much higher and less subject to reduction through diversification. This sector, however, will remain the backbone of all Gulf economies, and improving prospects for oil sales and prices imply growing opportunities for profitable participation in this area.

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Overall, we assess the level of political risk, either of radical regime change or threat to US operations, to be moderate for the rest of this decade. Most regimes appear to be in firm control and supported by loyal, effective security forces, according to US Embassy reporting. Regimes in general are favorably disposed to the US business community and investment. Nevertheless, the proximity of the Iran-Iraq conflict, the growth of Iranian-inspired subversion, and incipient opposition movements raise the prospect of increasing social tension and political instability over the next several years.

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If the US military presence in the Gulf increases, the threat of hostile action against US operations almost certainly will rise—especially in Bahrain, Kuwait, and Saudi Arabia.

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Kuwaiti oil facilities were bombed—apparently by Iranian sympathizers—three times last spring, and eight Iranian Silkworm missiles have been launched at Kuwaiti industrial targets this year, damaging two tankers and a primary crude oil export facility. US operations that are most vulnerable to political violence include:

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- Obvious US firms. Companies that include "American" or "US" as part of their corporate name fall under this rubric as would firms marketing distinctly US products such a Coca Cola, IBM, Ford, and General Motors.

[2] For further details, see appendix.

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- Companies regarded as "multinational." Major oil companies, international construction firms, and financial institutions with global operations are examples of organizations facing a higher risk of political violence.

- Manufacturers of symbolic products. Companies that produce cars, cigarettes, soft drinks, or other products that have widespread distribution, high visibility, and evoke an image of superiority or dominance that is at odds with beliefs of the local population—especially the religious community—may be targets of political retaliation.

- Firms that lack local management.

- Businesses with poor labor or industrial relations.

- Companies with poor corporate-community relations. [ ]

Changing Rules of Economic Engagement

We expect that Gulf governments and private firms will subject international firms to greater scrutiny and operating restrictions as they deal with reduced oil revenues and the regional recession:
- Economic planners are placing greater emphasis on managing the cost of capital and improving the return on investment—virtually unconsidered concepts in previous planning periods.
- Governments are giving preference to national or regional companies more often than in the past.
- International firms have come under increased scrutiny for financial and technical strength.
- Price competition is an increasingly important determinant in contract negotiations.
- Quality control and time schedules are more strictly enforced and larger penalties assessed for deviations from contract specifications.
- Contract bids increasingly require project financing to be considered.
- Payment for contracts is often delayed to conserve foreign exchange. [ ]

The changing business environment poses significant obstacles to US participation in Gulf economies. We believe that US firms will be more acceptable if they:
- Consider establishing a local company, if regulations permit, or a joint venture with local or regional companies.
- Bid for projects that include a high content of technology, engineering, maintenance, and sophisticated management.
- Bid on projects for which acceptable financial packages can be arranged. Financing may become one of the most important factors deciding project awards.
- Allow for a long waiting period for contract acceptance and processing of payments. [ ]

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We believe that the rise of the service sector as an increasingly important source of GDP and target of government spending and the leveling off of merchandise imports will lead to fundamental changes in the nature of Gulf markets. Emphasis will shift from selling a product to selling the solution to a customer's problem in the years ahead. The shift to a service economy implies a longer term relationship between customers and suppliers that, once started, may be difficult and costly to change. [ ]

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Outlook

We believe rising oil prices in the early 1990s will help initiate another round of Gulf state development. We project that demand for Gulf oil will increase more rapidly early in the next decade as output outside the Gulf stagnates or begins to decline. Higher oil prices and exports will translate into accelerating growth in revenues and GDP in most Gulf states. Trade and budget deficits will be reversed, allowing depleted foreign exchange and investment positions to be replenished. [ ]

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We believe that rising oil revenues, increasingly apparent flaws in past development schemes, and a growing sense of the depletion of domestic oil reserves will combine in the early 1990s to give the third wave

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Figure 8
Gulf States: Composition of Merchandise Trade with the U.S.

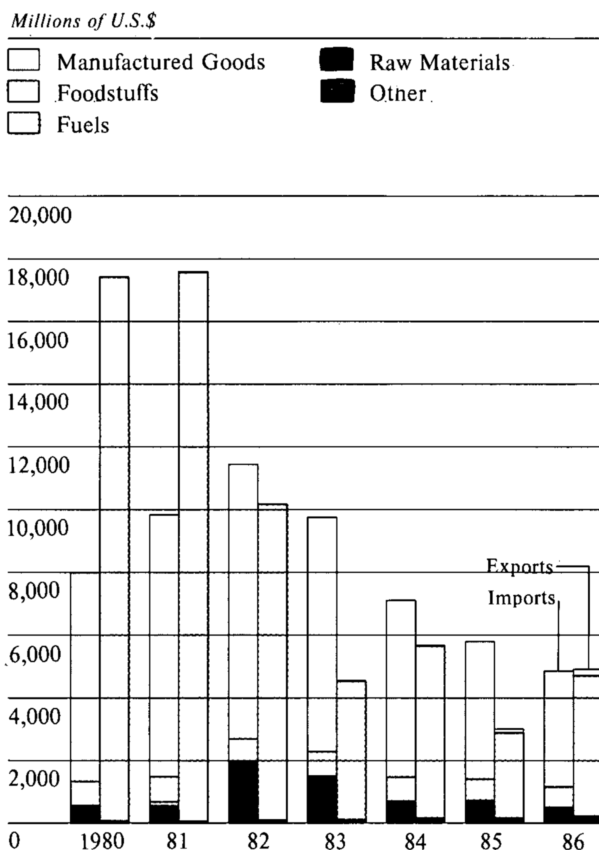

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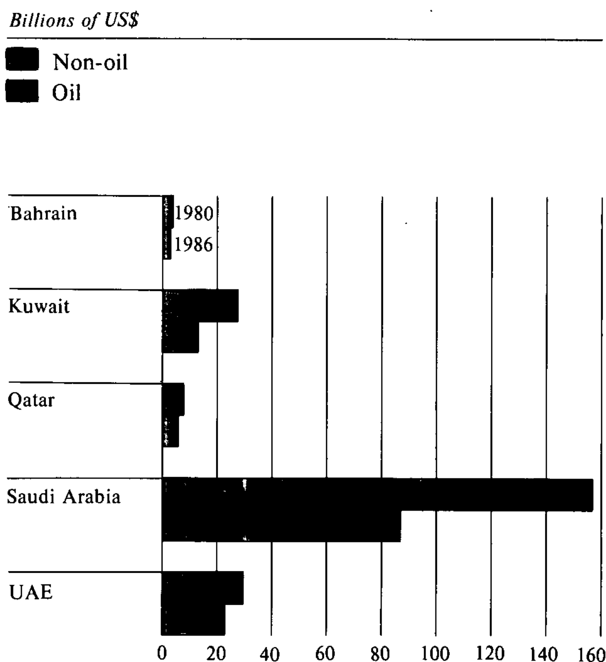
Figure 9
Gulf States: Origin of GDP



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of Gulf state development a much different look from the last two phases. In our judgment, this phenomenon will be confined to Kuwait, Saudi Arabia, and Abu Dhabi in the UAE because oil production in the other emirates, Bahrain, and Qatar will probably be declining. The third wave will most likely be characterized by further improvement in infrastructure and an escalating demand for services—especially social services. More important, however, an increasing share of Gulf state revenues is likely to be invested abroad—similar to Kuwait's current development strategy—as regional planners come to realize that past growth has not produced an economic base capable of sustaining national populations. Western

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The Kuwaiti Development Model

Kuwait's approach to development and long-term planning differs sharply from programs followed by the other Gulf states. Kuwait did not embark on massive development schemes during the boom years or attempt to diversify its economy into areas that ultimately could not survive or support the nation after oil reserves are depleted. Instead, the Kuwaiti regime placed a large share of its oil revenues in long-term foreign investments, deliberately tying their fate to the performance of Western economies. As a result, the Kuwaitis have established a world-class distribution network for their oil and purchased substantial stakes in a variety of foreign productive assets. Despite facing the same obstacles to development as the neighboring Gulf states, the Kuwaitis have ridden out the Gulf recession with less disruption to their economy. Investment income in recent years has surpassed oil revenues as a source of foreign earnings.

financial scholars have frequently noted the incongruity between the low levels of national savings and rates of return on development and the depletion of domestic oil reserves. In a sense, the Gulf states will buy the means of production that they have been unable to build locally.

As a consequence of evolving development strategies, we believe that trade patterns will change substantially. Merchandise trade will probably grow slowly. New investment policies for the Gulf states will probably accelerate the shift of their foreign investment portfolios away from short-term government securities to equities, land, and foreign production facilities. Fewer petrodollars are likely to be recycled to the West as trade or financing for budget deficits, and a larger share of Gulf state funds will return to the West as long-term ownership of productive assets—especially in the United States. The growing sophistication of Gulf banks augurs for a greater role for them in the recycling process. These changes in fund flows and investments probably will raise prospects for conflict over national ownership shares, investment laws, and international taxation.

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Implications for the United States

We believe that maintaining a large, if not dominant, trade position with the Gulf states will be increasingly important to the financial and energy security of the United States in the years ahead as US oil production begins to decline. Trade with the Gulf supports approximately 240,000 jobs in the United States, absorbs several billion dollars' worth of military sales annually, and in recent years has provided a source of financing for US trade and budget deficits, according to estimates by the US Commerce Department. About 40,000 US citizens are employed in the Gulf states, according to US Embassy reporting. We believe that real annual demand for services of all varieties will more than double to $60 billion by the late 1990s. Annual Gulf state merchandise imports, on the other hand, will probably remain in the $30-40 billion range unless Gulf governments undertake additional large-scale infrastructure development, which is unlikely. Moreover, the region will retain a high degree of financial liquidity and ability to meet its foreign payment obligations.

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We believe that competition among the United States, Japan, and Western Europe for lucrative Gulf trade—both goods and services—will become more intense and possibly contentious. Japan and the European Economic Community have taken the lead over the United States in adapting their trade strategies to the new commercial realities in the region by establishing greater government support networks for domestic firms, offering enticing financial packages, and expanding joint ventures and production roles

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An Alternative View

The view that oil revenues will increase in the years ahead and that economic prosperity will lead to lucrative opportunities for US participation in the Gulf economies is not the only interpretation possible. There is a considerable risk that oil prices could once again tumble. Wider fluctuations in oil prices and demand would leave most regimes vulnerable to destabilizing social turmoil or outside subversion. Stability in world oil markets and Gulf economies will depend heavily on continued OPEC discipline that is only partly under the control of the Gulf states—primarily Saudi Arabia. A substantial weakening of the Gulf economies would significantly raise the risk of financial or property loss.

The Iran-Iraq conflict could easily disrupt oil markets. Iran has threatened to expand the scope of the war to the Gulf states if they continue to assist Iraq. The conflict already has been internationalized and the threat to oil tankers in the Gulf significantly raised. Iran or Iraq could decide unilaterally to raise their oil production, forcing the Gulf states—especially Saudi Arabia—to cut production to maintain prices. Conversely, Riyadh could raise output and trigger a price war in the hopes of restoring OPEC discipline. Another round of uncontrolled production and price competition almost certainly would have a ruinous impact on several Gulf economies.

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Economic mismanagement or hardship have played a role in regime changes in several Gulf states and could easily become a rallying point for religious fundamentalists or others seeking to change the direction of Gulf societies. The coup attempt in the emirate of Sharjah this year and the deposition of Saudi King Sa'ud in 1963 were the results of the perceived ineptitude of these leaders in guiding their economies. The dissolution of the national assemblies in Bahrain and Kuwait and the autocratic style of government in the other Gulf states leave these leaders personally vulnerable to criticism for economic mismanagement.

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with Gulf firms. Already large trade deficits the EC and Japan run with regional states provide an additional strong motivation for enhanced trade ties.

The European Challenge

West European countries, especially the United Kingdom, France, and Italy, have deep-rooted commercial and historical ties to the Middle East that serve as a foundation for expanded trade relations. Western Europe's divergence from Washington on the Palestinian issue and other sensitive political matters has garnered considerable favor in Gulf capitals and created a more hospitable business environment for European firms.

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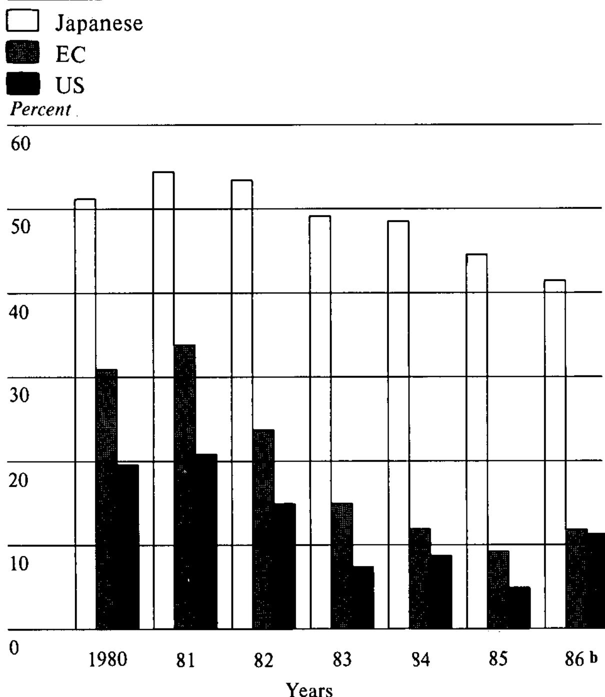
Figure 10
Percent of US, EC, and Japanese Petroleum Imports[a] 1980-1986



[a] Petroleum imports account for 33 percent of US demand, 70 percent of EC demand, and 100 percent of Japanese demand.

[b] Reflects impact of net back pricing arrangement.

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West European relations with the Gulf states will continue to hinge on oil and military sales. European dependence on Gulf oil will increase rapidly as North Sea oil production begins to decline, perhaps in the next few years, and bilateral trade deficits escalate. This trade imbalance almost certainly will raise European government interest in securing a greater share of Gulf trade. West European states are particularly well positioned to benefit from large military projects—over $10 billion by 1995—planned by Saudi Arabia, Kuwait, and the UAE. Lingering Arab perceptions of Washington's intransigence on past arms requests and a regionwide desire to diversify sources of military supplies underscore the European advantage in arms agreements. The sophistication of the large arms packages under consideration also implies a long-term service relationship.

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Japanese Competition

Japan's thirst for oil, dependence on export trade, and tendency to play to all sides in the Middle East combine to make Tokyo the favorite in the contest for Gulf merchandise trade in the coming years.

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Japan's virtual dependence on imported oil—over 55 percent came from the Gulf states recently—creates one of Tokyo's largest bilateral trade deficits and a strong motivation to balance commercial relations.

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We do not believe, however, that Tokyo's competitive edge is secure. A strong yen already is undercutting Japanese merchandise sales. Limited expertise in oil-related fields leaves Japanese firms at a disadvantage

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An Opening for Moscow

Although traditionally unreceptive to Soviet and East European economic overtures, most of the five Gulf states probably view some increase in commercial contact with Communist states as politically useful. This view is strengthened by a desire to balance relations with the superpowers. Improved relations

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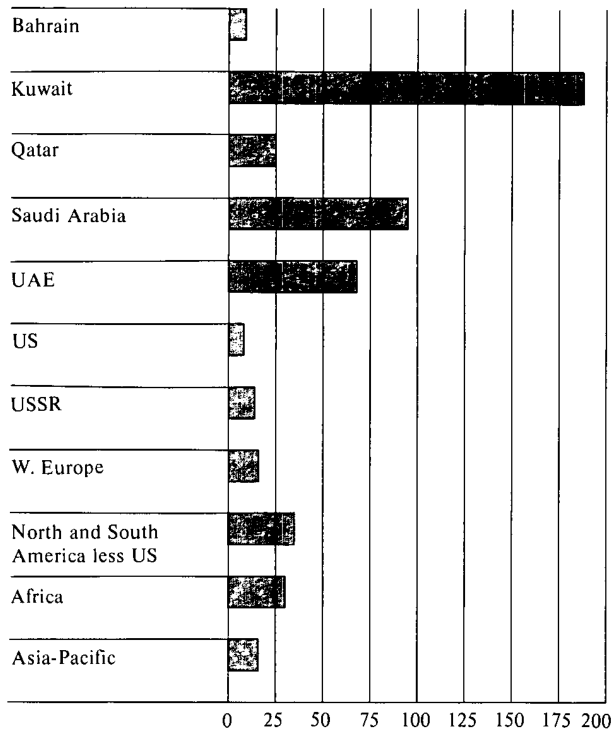
Figure 11
Oil Reserves to Production Ratio, 1986[a]



[a] Based on average oil production and reserve levels for 1986. Ratios can very greatly based on average oil production levels. Ratios for the Gulf states would be higher for 1987 because of lower oil production levels.

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with the USSR and its allies can also be used as a lever in relations with the West, as demonstrated by Kuwait's efforts to obtain protection for its tankers. On balance, however, there are few significant areas of mutual economic interest between the Gulf states and the Communist countries. Kuwait probably will move ahead with several energy-related joint ventures and further military trade agreements with the Soviets, [25X1] but the extent of the relationship will be limited by the poor rate of return on such arrangements, the relative inferiority of Soviet goods, and Kuwait's desire to maintain independence from either superpower. The other Gulf states almost certainly will take their cue from Saudi Arabia, which will move slowly in improving economic ties to the Soviets. [25X1]

Oil remains the single area of long-term mutual economic interest. Although the Gulf states have not had a significant petroleum supply relationship with the Communist countries, East European countries probably will seek Gulf oil as Moscow husbands its domestic oil resources. The weak foreign exchange positions of the East European states suggest that other means of payment will have to be found or political relationships significantly altered. [25X1]

Athough Soviet priorities in the Persian Gulf probably will continue to focus on Iran and Iraq, Moscow's style of operating in the region has changed under Gorbachev. He has pressed Soviet interests more vigorously and imaginatively in the area, responded to openings more quickly, and appears more attuned to regional subtleties than his predecessors. Still, Soviet initiatives over the next few years probably will not produce significant gains unless the Gulf states continue efforts to diversify their relations with the superpowers, enhance their nonaligned credentials, and expand the market for their petrochemical exports. [25X1]

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Appendix

Risk Methodology

Measuring the rate of real GDP growth—rate of return on the economy—over time, its variability, and its relationship to outside events is one means of defining and understanding risk. Average growth of gross domestic product (GDP) over time is a generally available and quantifiable measure of performance but gives no information about the dispersion of growth around the average. The standard deviation is a commonly accepted measure of dispersion—or total risk—around the average that makes possible meaningful statements about the probability of a given rate of growth. Finally, the correlation coefficient—specifically the Pearson Product Moment—measures the relative performance of two events over time. This measure ranges between 1 and −1 with estimates closer to either extreme indicating a strong direct or inverse relationship, respectively. The correlation coefficient, however, does not imply a cause-and-effect relationship.

Combining these measures provides a useful conceptual framework for defining and managing risk. For example, if two investments—in nations or firms—have the same average growth but different standard deviations of growth, the investment with the greater dispersion of growth over time—larger standard deviation—would be considered more risky. As a corollary, combining two investments in equal proportions that have the same average growth and standard deviation of growth and a correlation coefficient of +1 would yield a combined investment with the same average growth and standard deviation as the two separate investments individually. In sharp contrast, assuming a correlation coefficient of −1 between the same two investments would produce a total investment with the same average growth but a zero standard deviation—no risk. This last case demonstrates the advantage of diversification commonly referred to in modern investment theory.

Measuring risk, however, does not provide information about its cause. Business risk includes uncertainty about prices, the demand for output, cost of inputs, and technological and managerial efficiency. In turn, these factors are influenced by changes in the general level of business activity, the political environment, and international events. This framework suggests two separate, but related, risk components—a unique firm-specific risk component and an exogenous risk factor that measures how a firm's level of activity varies with general economic conditions. This separation of risk into specific and exogenous components is consistent with the tenets of modern financial theory and is the foundation of financial portfolio management.

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Using this framework and treating the economies of each Gulf state and that of the United States as discrete investment opportunities, one can obtain estimates of respective total risk, and this can be divided into its various components. For modeling purposes, the real growth of the OECD was used as a proxy for the international economy, and the real growth of world oil sales was used as a proxy for the oil industry sector. Using the ordinary least-squares regression model, these two independent variables were regressed against the five Gulf states' real GDP growth rates and real nonoil GDP growth rates. The amount of total risk—standard deviation—explained by the real OECD growth variable was assumed to provide an estimate of the exogenous risk component. The amount of total risk explained by the real oil variable was assumed to provide an estimate of one component of the specific-risk factor. The residual unexplained risk was assumed to explain remaining specific risk. The result of this analysis shows that the international

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Table 8
Gulf States: Risk Indicators, 1981-86

	Average Growth *(percent)*	Total Risk Standard Deviation [a]	Correlation With the US Economy [b]	Share of Risk Explained by OECD Growth *(percent)*	Share of Risk Explained by the Oil Market *(percent)*	Share of Unexplained Risk *(percent)*
World oil market	**−16.3**	**11.8**	**0.19**	NA	NA	NA
OECD GDP	2.4	1.6	0.98	NA	NA	NA
United States GDP	2.6	2.7	1.00	66	3	31
Bahrain						
Nonoil sector	−1.6	10.4	−0.15	1	2	97
Total GDP	−3.6	7.1	−0.04	10	17	73
Kuwait						
Nonoil sector	−3.3	7.9	0.14	1	7	92
Total GDP	−11.3	9.9	0.76	2	46	52
Qatar						
Nonoil sector	2.4	6.9	−0.46	2	7	91
Total GDP	−6.6	9.7	0.64	5	30	65
Saudi Arabia						
Nonoil sector	1.3	7.5	−0.51	9	10	81
Total GDP	−8.9	7.9	0.41	7	6	87
United Arab Emirates						
Nonoil sector	3.4	11.2	−0.71	9	13	78
Total GDP	−6.5	5.6	−0.44	16	20	64

[a] The standard deviation is a commonly used and generally accepted measure of the variation in a population. The variation of GDP is assumed to be a good proxy for the inherent risk of the business environment of the Gulf states. The standard deviation is the square root of the variance of the population.
[b] The correlation coefficient varies between 1.0 and −1.0 and measures the degree of association between two variables. An estimate close to 1 implies a strong positive association, whereas a value close to −1 implies a strong inverse relationship between the variables. The correlation coefficient does not imply a cause-and-effect relationship.

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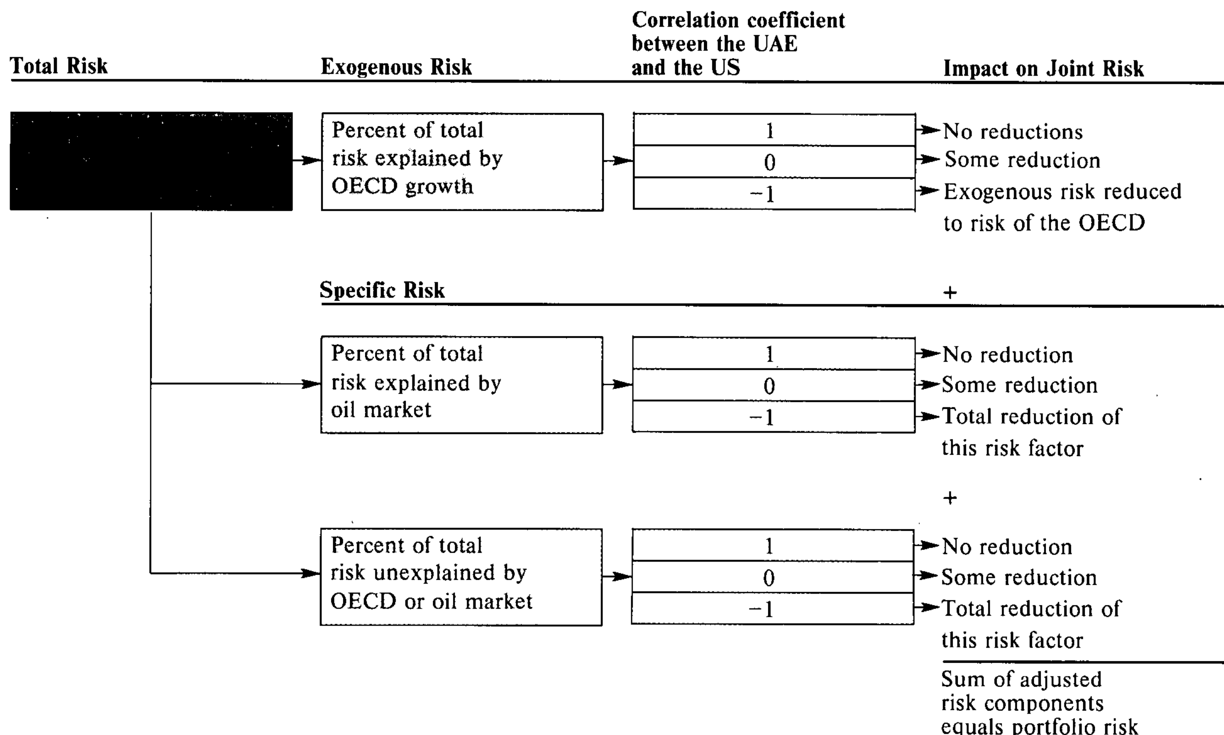
Figure 12
Risk Schematic: Joint investment in the United States and the UAE non-oil sector



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economy factor explains only a small amount of the variation in the economic performance of the five Gulf states. More important, the analysis shows that most of the total risk inherent in the economies of the five Gulf states is country specific—especially in the nonoil sector.

According to portfolio analysis, it appears that the country-specific risk component—the largest share of risk in the Gulf states—is the one most subject to reduction through appropriate diversification, especially when a low or negative correlation exists between a specific Gulf economy or economic sector and that of the United States. Through diversification of investments into selected Gulf economies, a significant reduction in investment risk can be achieved. For example, combining the information on average growth, total risk, and correlation between the nonoil sector of the UAE and the US economy demonstrates that an

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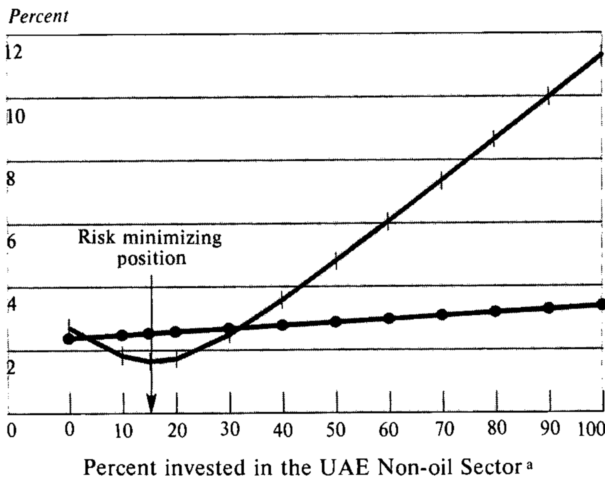
Figure 13
Example of Joint Investment in the United States and the UAE Non-oil Sector



[a] The percent invested in the United States equals one minus the percent invested in the UAE Non-oil Sector.

Portfolio	Percent in UAE	Percent in US	Portfolio Risk	Average Growth
1	0	100	2.66	2.37
2	10	90	1.78	2.47
3	15	85	1.60	2.52
4	20	80	1.68	2.57
5	30	70	2.46	2.67
6	40	60	3.57	2.77
7	50	50	4.8	2.87
8	60	40	6.07	2.97
9	70	30	7.36	3.08
10	80	20	8.67	3.18
11	90	10	9.98	3.28
12	100	0	11.29	3.38

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investment putting about 15 percent of assets in the UAE nonoil sector and 85 percent in the US economy would have maximized the rate of return and minimized the portfolio risk. The average return would have been slightly higher than that of the US share alone, while the risk would have been 40 percent lower than that of the US share. This level of performance and risk surpasses the levels available from a single investment in the United States or the UAE nonoil sector over the period and demonstrates the advantage of diversification and value of investments in selected Gulf economies.

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