Competitiveness and Economic Development of Gulf and Middle Eastern Countries

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The Competitiveness Challenge Facing the Gulf Economies

• Many Gulf and Middle Eastern countries have registered **solid economic growth** over the last decade

• **Reforms** have produced economic development outside of the oil sector, with only **mixed** success

• However, growth in per capita GDP and productivity growth have been **sluggish**, and negative in some countries

• Population and workforce growth will **challenge** economic development efforts

• Gulf economies must move to the **next stage of reforms** to attain true competitiveness and produce rising prosperity

• Progress must confront the legacy and **unique challenges** of oil-rich economies
Total Factor Productivity Growth by Region
Ten Year Averages

Foundations of Sustainable Prosperity

Sustainable Prosperity

Productivity

Innovative Capacity

Competitiveness
What is Competitiveness?

• Competitiveness is determined by the **productivity** with which a nation uses its human, capital, and natural resources. Productivity sets a nation’s or region’s standard of living (wages, returns to capital, returns to natural resource endowments)

  – Productivity depends both on the **value** of products and services (e.g. uniqueness, quality) as well as the **efficiency** with which they are produced.

  – It is not **what** industries a nation competes in that matters for prosperity, but **how** firms compete in those industries

  – Productivity in a nation is a reflection of what both domestic and foreign firms **choose to do in that location**. The location of ownership is secondary for national prosperity.

  – The productivity of **“local”** industries is of fundamental importance to competitiveness, not just that of traded industries

  – Devaluation **does** not make a country more competitive

• Nations compete in offering the **most productive environment** for business

• The public and private sectors play **different but interrelated roles** in creating a productive economy
# Sources of Prosperity

<table>
<thead>
<tr>
<th>Inherited Prosperity</th>
<th>Created Prosperity</th>
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<tbody>
<tr>
<td>Prosperity is derived from <strong>selling inherited natural resources or real estate</strong></td>
<td>Prosperity is derived from <strong>creating valuable products and services</strong></td>
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<tr>
<td>Prosperity is <strong>limited</strong> by the amount of natural resources available, and ultimately <strong>temporary</strong></td>
<td>Prosperity is <strong>unlimited</strong>, based only by the innovativeness and productivity of companies in the economy</td>
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<tr>
<td>Focus gravitates towards the <strong>distribution</strong> of wealth as interest groups seek a bigger share</td>
<td>Creating the <strong>conditions</strong> for productivity and innovation are the central policy question</td>
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<tr>
<td><strong>Government</strong> is the central actor in the economy as the owner and distributor of wealth</td>
<td><strong>Companies</strong> are the central actors in the economy</td>
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<td>The <strong>government</strong>’s role is to create the enabling conditions</td>
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Determinants of Productivity and Productivity Growth

Macroeconomic, Political, Legal, and Social Context for Development

Microeconomic Foundations of Development

- Sophistication of Company Operations and Strategy
- Quality of the Microeconomic Business Environment

- A sound macroeconomic, political, legal, and social context creates the potential for competitiveness, **but is not sufficient**
- Competitiveness ultimately depends on improving the **microeconomic capability** of the economy and the **sophistication of local companies and local competition**
Productivity and the Business Environment

Context for Firm Strategy and Rivalry

- A local context and rules that encourage investment and sustained upgrading
  - e.g., Intellectual property protection
- Meritocratic incentive system across institutions
- Open and vigorous competition among locally based rivals

Factor (Input) Conditions

- Presence of high quality, specialized inputs available to firms
  - Human resources
  - Capital resources
  - Physical infrastructure
  - Administrative infrastructure
  - Information infrastructure
  - Scientific and technological infrastructure
  - Natural resources

Demand Conditions

- Sophisticated and demanding local customer(s)
- Local customer needs that anticipate those elsewhere
- Unusual local demand in specialized segments that can be served regionally and globally

Related and Supporting Industries

- Access to capable, locally based suppliers
  and firms in related fields
- Presence of clusters instead of isolated industries

• Successful economic development is a process of successive economic upgrading, in which the business environment in a nation evolves to support and encourage increasingly sophisticated ways of competing
The Cairns (Australia) Tourism Cluster

- Travel agents
- Tour operators
- Restaurants
- Hotels
- Attractions and Activities (e.g., theme parks, casinos, sports)
- Airlines, Cruise Ships
- Local Transportation
- Souvenirs, Duty Free
- Banks, Foreign Exchange
- Local retail, health care, and other services
- Public Relations & Market Research Services
- Food Suppliers
- Property Services
- Maintenance Services
- Government agencies (e.g., Australian Tourism Commission, Great Barrier Reef Authority)
- Educational Institutions (e.g., James Cook University, Cairns College of TAFE)
- Industry Groups (e.g., Queensland Tourism Industry Council)

Sources: HBS student team research (2003)
The Norwegian Maritime Cluster

Norway has 0.1% of the world’s population, represents 1.0% of the world’s economy, yet accounts for 10% of world seaborne transportation.

Source: Sven Ullring, presented to M.I.T., Author’s analysis
Institutions for Collaboration
Selected Massachusetts Organizations: Life Sciences

**Life Sciences Industry Associations**
- Massachusetts Biotechnology Council
- Massachusetts Medical Device Industry Council
- Massachusetts Hospital Association

**General Industry Associations**
- Associated Industries of Massachusetts
- Greater Boston Chamber of Commerce
- High Tech Council of Massachusetts

**Economic Development Initiatives**
- Massachusetts Technology Collaborative
- Mass Biomedical Initiatives
- Mass Development
- Massachusetts Alliance for Economic Development

**University Initiatives**
- Harvard Biomedical Community
- MIT Enterprise Forum
- Biotech Club at Harvard Medical School
- Technology Transfer offices

**Informal networks**
- Company alumni groups
- Venture Capital community
- University alumni groups

**Joint Research Initiatives**
- New England Healthcare Institute
- Whitehead Institute For Biomedical Research
- Center for Integration of Medicine and Innovative Technology (CIMIT)
Influences on Competitiveness
Multiple Geographic Levels

- World Economy
- Broad Economic Areas
- Groups of Neighboring Nations
- Nations
- States, Provinces
- Cities, Metropolitan Areas

World Economy

Broad Economic Areas

Groups of Neighboring Nations

Nations

States, Provinces

Cities, Metropolitan Areas
Specialization of Regional Economies
Select U.S. Geographic Areas

- **Boston**
  - Analytical Instruments
  - Education and Knowledge Creation
- **Denver, CO**
  - Leather and Sporting Goods
  - Oil and Gas
  - Aerospace Vehicles and Defense
- **Chicago**
  - Communications Equipment
  - Processed Food
  - Heavy Machinery
- **Los Angeles Area**
  - Apparel
  - Building Fixtures, Equipment and Services
  - Entertainment
- **San Diego**
  - Leather and Sporting Goods
  - Power Generation
  - Education and Knowledge Creation
- **San Francisco-Oakland-San Jose Bay Area**
  - Communications Equipment
  - Agricultural Products
  - Information Technology
- **Pittsburgh, PA**
  - Construction Materials
  - Metal Manufacturing
  - Education and Knowledge Creation
- **Wichita, KS**
  - Aerospace Vehicles and Defense
  - Heavy Machinery
  - Oil and Gas
- **Seattle-Bellevue-Everett, WA**
  - Aerospace Vehicles and Defense
  - Fishing and Fishing Products
  - Analytical Instruments
- **Atlanta, GA**
  - Construction Materials
  - Transportation and Logistics
  - Business Services
- **Raleigh-Durham, NC**
  - Communications Equipment
  - Information Technology
  - Education and Knowledge Creation

Note: Clusters listed are the three highest ranking clusters in terms of share of national employment.
Source: Cluster Mapping Project, Institute for Strategy and Competitiveness, Harvard Business School
Shifting Responsibilities for Economic Development

Old Model

• Government drives economic development through policy decisions and incentives

New Model

• Economic development is a collaborative process involving government at multiple levels, companies, teaching and research institutions, and institutions for collaboration
Oil-Rich Economies
Issues for Companies

- Narrow role in the value-chain
  - Intermediating agents versus value creators

- Focus on the local market

- Heavy use of partnerships and joint-ventures

- Exports versus international production and service delivery
Natural Resources and Economic Performance

Natural resources and competitiveness

• In the Global Competitiveness Report 2003-2004 we find natural resource-exports to have a positive direct effect on prosperity
• However, the presence of high natural resource-exports is associated with declining competitiveness over time
  – Countries with a high natural resource share of exports register negative and significant shifts in competitiveness over time

Oil endowments and prosperity growth

• Research done for the World Bank finds natural resource endowments to have a significant negative effect on prosperity growth through having a negative effect on institutional quality
  – In contrast, natural resource price volatility and real exchange rate overvaluation (“Dutch disease”) register no significant additional impact on growth
• The negative effect of natural resources on institutional quality is especially strong in the case of oil exporters and increases more than proportionally with the size of oil endowments

Oil-Rich Economies
Issues for Competitiveness

Advantages
- Direct effect on prosperity via resource exports
- Investment capital for infrastructure and other projects

Issues
- Incentives
- Volatility
- Mindset and attitudes
  - Everything is free
  - Prosperity comes from capturing a part of the inherited wealth
Business Environment Quality in Oil-Rich Economies
Selected Observations

Context for Firm Strategy and Rivalry

+ Strong financial incentives for foreign investors

Factor (Input) Conditions

+ Strategic location and ports
+ High quality physical infrastructure
+ Low energy costs
+ Large pools of capital but largely invested outside the region
+ Rising educational levels of the domestic population
+ Government is relatively efficient

• Hardware is in place, but the “software” is still missing

Demand Conditions

Related and Supporting Industries

+ Free zones as a tool for attracting investment
Business Environment Quality in Oil-Rich Economies
Selected Observations

Factor (Input) Conditions

- Lagging and restrictive legal system and administrative structure
- Skilled citizens heavily employed in public sector
- Dependence on highly-skilled foreign specialists
- Lack of education for low-skill foreign workers
- Lack of first rate public schools and universities
- Financial markets remain inefficient
- Low level of R&D, science and innovative capacity
- Poor availability of data

Context for Firm Strategy and Rivalry

- Heavy government involvement in economic activity limits private initiative
- Limits on foreign ownership
- Incentive structure not tied strictly to merit and productivity
- Economies sheltered from domestic and international competition
- Few local exporting companies
- Weak governance systems and frequent conflicts of interest

Demand Conditions

- Lack of sophisticated local demand from business customers
- Sophisticated personal demand served by foreign companies
- Heavy government role in procurement

Related and Supporting Industries

- Weak clusters in the non-oil sectors of the economy
- Low level of integration between foreign investments and local industries
- Lack of specialized suppliers and service providers
- Free zones deter progress in improving the business environment in the overall economy
- Free zones focused on real estate rather than true cluster development
Export Processing Zones and Competitiveness

• Most oil-rich economies have made extensive use of “Free Zones” to attract foreign non-oil investments through tax incentives and dedicated infrastructure

• Export processing zones are more successful if they are targeted around the needs of specific clusters
  – Firms have common needs in terms of infrastructure and labor
  – Attracts additional companies as well as specialized suppliers and service providers

• Export processing zones (EPZ) can have a sustained effect on a country’s competitiveness under two conditions:
  – EPZ’s must not be enclaves but lead to economy-wide changes in the business environment
    • E.g., upgrading of rules and regulations
    • E.g., improving government services, such as customs
  – Linkages must be created between the EPZ and the rest of the economy, such as local supplier relationships and service providers

Clusters and Competitiveness
Houston Oil and Gas Products and Services Cluster

- Oil & Gas Exploration & Development
- Oil & Gas Completion & Production
- Equipment Suppliers (e.g. Oil Field Chemicals, Drilling Rigs, Drill Tools)
- Specialized Technology Services (e.g. Drilling Consultants, Reservoir Services, Laboratory Analysis)
- Subcontractors (e.g. Surveying, Mud Logging, Maintenance Services)
- Business Services (e.g. MIS Services, Technology Licenses, Risk Management)
- Specialized Institutions (e.g. Academic Institutions, Training Centers, Industry Associations)

- Export knowledge, not just products
Cross-National Cooperation in the Gulf Region

• The Gulf Cooperation Council has **begun** the process of regional cooperation
  – Defense cooperation is becoming more effective
  – A regional identity is starting to develop
  – Customs Union has been launched

• Other **bilateral projects** are starting to show benefits
  – E.g., gas pipeline between Qatar and the U.A.E.

• Regional cooperation has huge **economic potential**
• The **focus of cooperation** needs to shift from security to economic issues
• The **pace** of cooperation must increase significantly
• The region needs to overcome the tendency to view cooperation in terms of a **win-lose mentality**
Implications for Petrochemical Companies

- Nations in the Gulf region need **new economic strategies**
  - Created versus inherited wealth
  - New attitudes and mindsets

- Petrochemical cluster is becoming a model for how **competition must evolve**
  - Moving beyond low-cost feedstocks
  - Introducing state-of-the-art technology
  - Developing international channels
  - Beginning international production

- Petrochemical cluster also illustrates the power of **cluster development**
  - Local supplier capability
  - Technological capability in local universities
  - Specialized training

- Petrochemical cluster can become a **change agent** in transforming the business environment and redefine the role of the private sector in economic development