

The Influences of Economic Diversification and the mediating Effect of Industrial Development on Economic Growth in Oman: A Conceptual Framework

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ABSTRACT

Industry is at the heart of a government's plans to transform the economy from a resource-based economy to a value-added one. Economic diversification is vital to countries' long-term economic growth, but many resource-rich countries remain heavily reliant on revenues generated by natural resources such as mineral or oil production. In Oman, the fall in price oil compelled the government to rethink about development and economic plans in order to improve the living conditions of the population. The main objective of economic diversification agenda is to increase the contribution of these sectors to the gross national product (GDP) of Oman, raise production and create more jobs for these sectors. New technologies will promote the achievement of inclusive, sustainable industrial development through its creation and absorption. New innovations allow businesses to bring new products into the market and improve production efficiency. In addition, industrial development generates new employment and profit incentives. More products and productivity of production also add to the growth of the economy. Industrial development at the same time leads to the manufacture and diffusion of emerging technology. Only by industrialization can economies, industries and businesses build and maintain the requisite technical transition capabilities. This paper presents a conceptual or research framework that identifies the mediating effect of industrial development in the relationship between economic diversification and economic growth in Oman. Two main factors are considered, i.e., the strategic drivers consisting of economic and non-economic variables, and industrial development initiatives. The paper concludes with the discussion on the formulations of hypothesis statements that describe the inter-relationships between the constructs in the conceptual framework. It is expected that the

proposed framework can be further verified and tested by using empirical research work.

Keywords: Economic Diversification, Industrial Development, Economic Growth.

INTRODUCTION

Economic diversification can be related to the theory of economic growth, trade, technological change and structural transformation, and it is beneficial to provide job opportunities for each country and to encourage structural change and economic development (Friere, 2017). Economic diversification is characterized as a move towards a more diverse trade and domestic production structure in order to increase productivity, create jobs and provide the basis for sustainable growth in poverty reduction (Gill et al. 2014). More specifically, the diversification of domestic production results from a shift in domestic production across sectors, industries and companies. This reflects systemic transition dynamics as a productive diversification of domestic production includes the re-allocation of capital from low productivity activities to those with higher productivity across and/or within industries.

This paper offers a holistic view of cause-and-effect relationships among various drivers of economic diversification that subsequently leads to economic growth. The aims of this paper are to assess the theoretical underpinning of economic growth with the special focus on economic and non-economic drivers of economic diversification, and industrial development as the mediating factor, respectively.

This paper is about providing a definitive response to the call for an establishment of an integrated economic diversification framework. The specific objectives of the study are as follows;

1. To incorporate the roles of industrial development as the mediating factor.
2. To establish the hypothesized relationships among the constructs that may significantly exist in the proposed conceptual framework.

This paper is structured as follows; first, we review the previous works based on the literature and highlight the existing arguments on causal relationships in the economic diversification framework. Second, we formulate the conceptual model, which offers a holistic framework for future research. Third, we formulate hypotheses statements associated with the inter-relationships that may exist in the conceptual framework.

PROBLEM STATEMENT

Economic diversification is regarded as one of the key goals for achieving the vision for the Oman economy, as part of a number of economic development plans in Oman. Oil is the major source of income for the Oman's economy and more than 80% of the country's economy is from oil. In recent years, due to decline in the oil prices has slowed down the economy and the Government is taking several measures to improve its economy. Realising this critical issue, Oman has been taking the necessary steps to adopt various diversification policies so as to reduce dependency on the oil revenue and the country can be protected from the risk incurring due to the change in oil prices. The government is now trying to increase the contribution of non-petroleum activities to GDP

within its plan to diversify sources of the national income (Mubeen et al., 2017).

In order to reduce its over-reliance on oil and gas, Oman initiated a national programme for enhancing economic diversification in 2016 (National Programme *Tanfeedh*, 2016), which is part of the 9th Five-Year Development Plan (2016-2020). While *Tanfeedh* is not perceived as a new plan or strategy; it is rather an accelerator that creates an easy business environment in the region. This paves the way for increasing bureaucracy and a better understanding between the private and government sectors and civil society. As previously stated, the Government has chosen five areas with the best potential: manufacturing, transport and logistics, tourism, fishing and mining. The results of the study provide useful information for the implementation of policies to improve Oman's program of economic diversification. It also provides additional details on whether existing policies need to be reorganized to facilitate a more favorable environment and sustainable development in Oman (Al Waihab, 2016).

It has been noted that Oman has been working hard to diversify his economy. The Vision 2020 for the period 1996-2020 has strategic goals that include a variety of priority topics, including manufacturing, tourism, infrastructure, services, etc., and development of human resources. The 2020 vision anticipates major structural change in the economy from 62.4% in 1991-1995 to 81% in 2020, with a net rise in non-oil GDP. However, Oman faces serious challenges, because non-oil GDP has declined steadily since 1995 to 52.9 per cent in 2010, instead of increasing its share. Given this trend of diversification, the 81 percent target in 2020 is uncertain.

However, the lack of a concrete economic diversification approach that can be converted into an action plan that has acceptable benchmarks and a tracking and assessment mechanism poses a significant deficiency in vision 2020. The various development plans include a juxtaposition of projects with little coherence and integration between them in the various socio-economic sectors. The Vision does not clearly state what measures are required to provide the necessary conditions for economic diversification to be achieved.

There is a need for re-assessment of the factors that inhibit the progress of the economic diversification agenda from the economic and non-economic perspectives. While these two perspectives are necessary for a better performance of the agenda, a new pushing factor such as industrial development may speed up the rate of progress of this important agenda for Oman. Ensuring the achievement of these two factors through a proper monitoring and control would lead to a steady economic growth of the country.

In this paper, we review some of the economic and non-economic determinants of economic diversification and the role of industrial development in spurring the growth of Oman's economy

LITERATURE REVIEW

Drivers of Economic Diversification

The degree and rate of diversification in a country is influenced by a number of political, structural and economic factors. When the economy relies heavily on oil revenue, the sustained long-term growth in world oil prices is daunting. As oil prices fall, the associated decrease in public income triggers public spending cuts that slow growth in the non-oil sector and thus affect diversification (Kasem and Alawin, 2019).

Economic Determinants

The economic determinants that drive economic diversification include real exchange rates, inflation, net inflows of foreign direct investment (FDI), trade and investment per share of GDP. An high exchange rate discourages investors due to reduced productivity from new activities. In relation to economic diversification, Kasem and Alawin (2019) demonstrated that GDP per capita is a significant factor. It has a negative correlation, however, that a 1% increase in GDP per capita will lead to the decline of the diversification index by 0.414 units. Such results are in line with the reports of Alameen (2016) and Al-Kawaz (2008). It has been said that abundant natural resources create better conditions for economic diversification, while attempts to diversify export have difficulties in resource-dependents countries, such as Oman. They concluded that GDP, development, population, institutions and the choice of trade are the main drivers of diversification. Substantial financial resources are important for economic and export diversification and, naturally, they are helping nations that have rich natural resources.

Economic activity indicators have repeatedly been shown to impact economic diversification in previous studies. Increasing government expenditures, FDI and increasing government spending or consumption share of the economy would help increase economic diversification (Imbs and Wacziarg, 2003; Klinger and Lederman, 2004). The economic diversification of FDI is also higher. Based on the massive oil and gas investments, the economy could be less diversified (Kasem and Alawin, 2019).

In a monopolistic market situation, export diversification is also influenced by export size. The export ratio is directly linked to the export ratio to domestic consumption or sales. Export volume therefore also influences the export diversity. Market divide and destination size (country size) impact bilateral trade heterogeneity (Amurgo-Pacheco and Pierola, 2008; Navarro-García, 2016). They are regarded, when GDP per capita is regulated (Parteka and Tambari, 2008), as the most important and strong determinants of export diversity. Such findings are consistent with earlier studies that demonstrate that distance from trading centers and market access are key determinants of diversification (through bilateral and multilateral trade arrangements, i.e. trade liberalization) (Dutt et al., 2009).

Trade liberalization (i.e. elimination or reduction of trade barriers between countries) promotes competition and investment and helps to create employment and increase revenue (OECD 2011). The trade factor is statistically significant in a study by Kasem and Alawin (2019), which shows that the relationship between trade and diversification is negative. Open market access is also having a beneficial effect on the overall competitive variable, which increases the number of companies that can export and therefore provide opportunities for greater diversification of exports (Agosin, 2012; Melitz, 2003). A recent study using a balanced model found that the export quality in the OECD countries was positively influenced by trade openness (Ratnaik, 2012).

Non-economic Determinants***Human Capital, Quality of institution***

The positive effects on economic diversification are structural factors, including people in the country, human capital and the performance of institutions. As local firms have access to a larger market and thus benefit from economies of scale, diversification increases with an ever-increasing population. Human capital enables economies to move from basic products to more knowledge-

intensive manufactured goods. Competent and well-trained workers and the accumulation of human capital contribute to economic diversification and promote technological and industrial development. Kasem and Alawin (2019) have asserted in their study that labor power is a major factor in their relationship to economic diversification, but it is linked negatively. The result is consistent with the results of Al-Kawaz (2008) and Alameen (2016) that state that the key drivers for diversification, i.e., political and economic institutions promote trust in business and foster growth of new business activities through the generation of a friendly investment. Diversification includes increasing national employment in the private sector in order to contribute to economic prosperity. The high investment rate could indeed speed up diversification.

Infra-structure

In any economic diversification agenda, the most important step a government can take is to focus on the fundamentals, that is: to invest in infrastructure (roads, communication and access to electricity and water. Better infrastructure increases diversification on both intensive and extensive margins. This is particularly true for non-oil products that require good transportation facilities for shipment of those products from one location to another.

Remoteness (Distance between trading markets)

According to the OECD (2011), distance between trading markets and the size of destination markets (country size) has a significant effect on the diversity of bilateral trade (Amurgo-Pacheco and Pierola, 2008). They are considered to be the most relevant and robust determinants of export diversity, once GDP per capita is controlled (Parteka & Tamberi, 2008). These findings are consistent with an earlier study that showed that distance to trading centres and market access (through bilateral and multilateral trading arrangements, i.e. trade liberalization) are key determinants of diversification (Dutt et al., 2009).

Industrial Development

Another key factor that accelerate economic growth is by developing industries for certain sectors that associated with non-oil products. According to Kasem and Alawin (2019), industry development that includes manufacturing and comprises value added in mining, manufacturing construction, electricity, water, and gas can contribute towards economic growth of a country. This will lead to the conclusion that 'industry development' can act as a mediating factor in the relationship between economic diversification and economic growth.

CONCEPTUAL FRAMEWORK

Based on the arguments presented earlier and a comprehensive review of previous studies, a conceptual framework is proposed to model the relationships between the drivers of economic diversification and economic growth (see Figure 1).

In this conceptual framework, the independent or exogenous latent variables or constructs are economic diversification (economic and non-economic determinants). Meanwhile, the endogenous or dependent latent variables are economic growth, while the industry development represents the mediating factors, respectively, in the relationship between economic diversification and economic growth. This framework is developed based on several studies focusing on the general concepts of economic diversification and guidance on how to approach economic diversification at the national level by the United Nation's Convention on economic diversification initiatives by United Nations

(2016), OECD (2011), Kasem and Alawin (2019), and mediating effect concept by Baron and Kenny (1986).

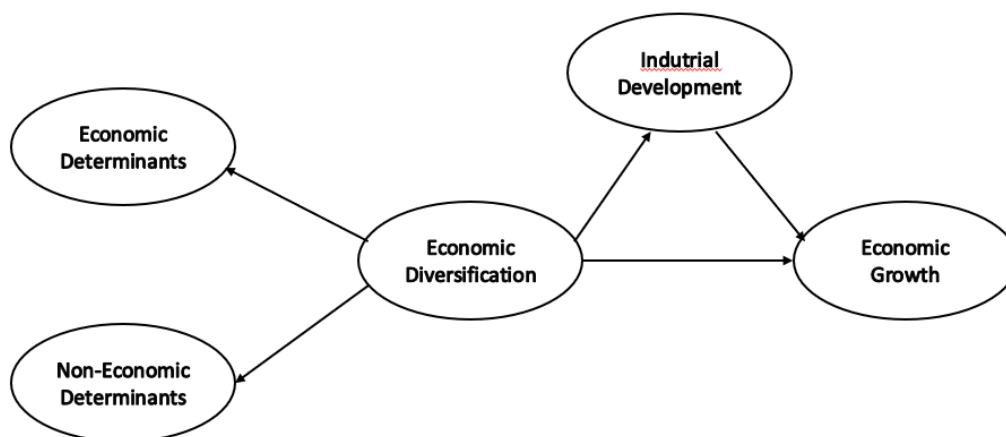


Figure 1: The Conceptual Framework for Economic Diversification Agenda

Hypotheses Statements

Based on the conceptual framework above, the following hypotheses statements are developed:

1. H1: Economic diversification has a significance influence on the economic growth
2. H2: Economic determinants have a significant influence on the economic growth
3. H3: Non-economic determinants have a significant influence on the economic growth
4. H4: Economic diversification has a significant influence on industry development
5. H5: Industrial development has a significant influence on economic growth
6. h6: Industrial development mediates significantly in the relationship between economic diversification and economic growth

CONCLUSION AND RECOMMENDATION

The empirical literature of the study has led to the development of a conceptual framework on the economic diversification, industrial development and economic growth in Oman. The study also provides useful information to the policy maker particularly Oman government. As an oil-reliant economy, Oman has a major contributor to government income, it needs to develop new technology plans and policies, diversify the economy, track inflation, undertake unemployment and aspire to diversify the economy and develop the region. To stabilize the earnings and increase the income of the entire economy, diversification is required. Diversification can be accomplished by encouraging the industries to increase production by satisfying demand in the local market and by exporting large quantities, which in turn increase the entire economy. Government can also help foreign direct investment and encourage it. This needs an upgrade of infrastructure and modest fiscal reform, i.e. the rate of interest so that privately held enterprises can be funded by lending and market promotion for non-oil products.

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