

Economic Insights

SEB ECONOMIC RESEARCH

2008-03-14

Saudi Arabia: Boom faces challenges

- With the world's largest oil production and the largest known oil reserves, Saudi Arabia is a global power player.
- The oil boom is creating strong growth and enormous wealth. Both economic and political stability have improved in recent years. The royal family has managed to steer the country in a cautiously reformist direction.
- The dollar slide has triggered speculation that the fixed riyal/dollar exchange rate will be eliminated. This seems unlikely. However, plans for a Gulf States monetary union in 2010 will probably be shelved.
- Huge infrastructure projects are planned. But there are major social challenges related to the labour market and education. The boom is thus more fragile than it seems.

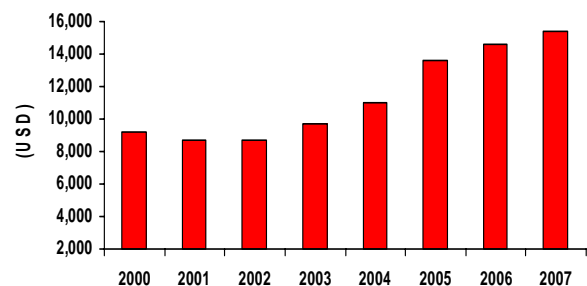
Increased stability

During March 2008 a group of representatives of the Nordic business community participated in a trip to Saudi Arabia organised by SEB. During several intensive days, the delegation – led by Marcus Wallenberg and Annika Falkengren – met numerous Saudi decision makers. This article summarises my own impressions from the trip.

It is striking how **economic and political stability has increased**. At the turn of the millennium, the future outlook seemed

gloomy. A decade of low oil prices and weak growth, together with a rapidly growing population, had led to huge budget deficits, central government debt exceeding 100 per cent of GDP, high unemployment and falling real income. The ailing King Fahd was unable to take the reins to start necessary reforms. After World Trade Center attack on September 11, 2001 – which was planned and carried out by Saudis – the security alliance with the United States was also shaky. Various observers predicted chaos and the collapse of the Kingdom.

GDP per Capita



This did not happen. Three factors have transformed the scene.

- High oil prices in recent years have led to **rapid real-term and financial growth**. GDP per capita has risen by more than 60 per cent since 2002. Budget surpluses are large and central government debt is

falling rapidly. Central bank reserves are growing by USD 5 billion a month.

- King Fahd was succeeded by his more dynamic brother Abdullah, who has **skilfully balanced his reform efforts** against conservative and religious traditionalism.
- **The threat from Al-Qaeda has been disarmed.** The terrorists lost most of their potential support in Saudi Arabia when they attacked domestic targets in the aftermath of September 11. The security service has wiped out most of the leaders, while some of their foot soldiers have been re-assimilated with the help of heavy social pressure.

The world's largest oil reserves

Saudi Arabia is not only the world's largest oil producer. The Kingdom is also the only major producer capable of greatly increasing production. It is also the country that is sitting on by far the largest known oil reserves. In addition, it possesses large natural gas reserves.

The quality of these resources is admittedly a matter of dispute, as is the potential for finding new oil. Advocates of the "peak oil" hypothesis believe that the largest fields are now being emptied significantly faster than the authorities want to admit. But obviously our delegation did not receive anything but the official figures.

The various long-term scenarios presented by such bodies as the International Energy Agency assume that fossil fuels will continue to dominate. In the IEA's latest long-term reference scenario, fossil fuels still account for 80 per cent of world primary energy consumption in 2030. Meanwhile the relative weight of the Middle East as an oil producer is increasing, since oil wells in Norway, the UK and a

number of other countries are running out faster than Arabian ones.

Despite all the uncertainty and the varying opinions of quarrelling experts on the exact size of reserves, the main conclusion is that **over the next few decades, Saudi Arabia will remain the world's largest oil producer** – and that its share of known reserves will probably *increase* for another while.

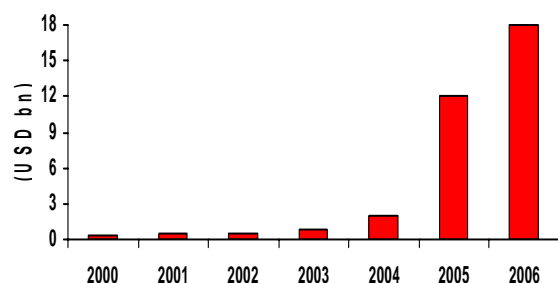
The implications of this will depend on oil prices. Reference scenarios in international studies ordinarily assume long-term prices of around USD 60-70 per barrel. Prices may fall below that level during economic slowdowns or due to rapid technological developments and large investments. But prices may also be pushed upward due to supply disruptions and continued rapid growth in China and elsewhere. Since the extraction costs for Arabian oil are only USD 3-5 per barrel, the conclusion is obvious: Saudi Arabia faces **decades of continued rapid income growth** and wealth.

The implication is that the **political significance of the Kingdom will continue to grow**. For many years Saudi Arabia has been the major power in its region, but there is no doubt that hopes of future wealth have also awakened the appetite of the elite for a more prominent international role. The alliance with the US remains firm, but the Kingdom gradually wants to assume a larger role as a spokesman for commodity producers, for Muslims and for the region as a whole. Its rivalry with Iran will intensify but can presumably be kept under control, provided that Iran is not further radicalised.

Huge investments

The rulers of Saudi Arabia are well aware that the country's economy is lopsided and that more balanced development will require massive investments. Long-term budgets include plans for **projects totalling nearly USD 400 billion** over the next decade. This applies to infrastructure and the construction sector (including several new high-tech cities to be designed from scratch), agriculture and desalinisation of water, plus of course the development of the petrochemical industry – the task ahead is not only to extract oil from the ground but also process it. Given its supply of cheap energy, the country will also invest in energy-intensive industries such as aluminium. If private sector follow-up investments are included, the total sums are larger. What is taking shape is the world's most massive overall investment programme outside of China.

Foreign Direct Investment



The regime is also working ambitiously to **improve the business climate in order to attract foreign investments** and know-how. We heard captivating, enthusiastic presentations from reformist decision makers on how the tax cuts and elimination of red tape are now having an impact on international ranking lists. In the World Bank's "Doing Business" rankings (which measure how easy it is to start and run companies), Saudi Arabia has climbed to

23rd place in "Ease of Doing Business". In the latest World Economic Forum Global Competitiveness Index, the Kingdom is ranked number 35. The result has been a sharp increase in the inflow of direct investments.

The target is to be ranked as one of the world's ten leading economies as early as 2010. This will certainly be impossible to achieve – but the fact that it has been launched at all is a sign of high ambitions.

Inflation climbing – but peg will survive

It is hardly surprising that furious growth has meant the return of inflation. After a decade of stagnant prices, **during the past two years, inflation has accelerated to above 5 per cent year-on-year**. Food prices, in particular, have caused inflation to be noted, debated – and widely resented.

Inflation is among the reasons why the Saudi riyal's US dollar peg has begun to be questioned. For more than 20 years, the fixed exchange rate has been kept at SAR 3.75 per dollar. The country chose a fixed exchange rate against USD because of the need for stability and because the dollar so totally dominates foreign trade (due to oil). In practice, a kind of currency board system is in effect: The central bank, SAMA, must keep enough dollars to cover to quantity of bank notes outstanding. There is hardly any speculation against the peg.

Some private sector players are nevertheless counting on a small revaluation against the dollar during the coming year. This would lead to a slight curbing of inflation via imports – but offsetting this, a revaluation would also result in reduced oil revenue in local currency and a weaker budget and would lower the value of the foreign exchange reserve. So **right now a**

reevaluation seems unlikely, despite inflation.

Major changes in foreign exchange policy, such as a transition to floating exchange rates or a currency basket, are not in the pipeline. One reason is political. At a time when Saudi Arabia's most important ally – the United States – is in an economic crisis, officials do not want to disrupt economic relations through actions that may be interpreted as questioning the dollar.

Within a few years, however, plans call for the six countries of the Gulf Cooperation Council (GCC) – Saudi Arabia, the United Arab Emirates, Kuwait, Oman, Qatar and Bahrain – to enter into a monetary union. **Today few people believe that this union will actually start up as planned** by 2010. Preparations have fallen behind schedule, and Kuwait has disrupted the process by switching to a currency basket.

Uncertainty about the monetary union is another argument against touching today's dollar peg. But when the day comes that monetary union plans are scrapped or postponed until the distant future, the riyal is likely to re-emerge on the agenda. A small, controlled revaluation is not unlikely at that time. The motive is likely to be that the currency is somewhat undervalued. However, there will be no transition to floating exchange rates.

Challenge: The labour market

Saudi Arabia is thus a nation with robust growth, large reserves and high ambitions. But the country is also weighed down by a non-functioning labour market and with enormous reform needs. This involves everything from education, mobility and the position of women to the relationship between Saudi and imported labour.

The country is experiencing a **rapid population increase**. Nearly one third of the population is between 15 and 30. Youth unemployment is 30 per cent. Saudi Arabia shares this challenge with many other emerging nations, but what makes the Kingdom special is the oppressed role of women and the huge scale of foreign labour.

In the private sector, guest workers make up more than 90 per cent of the labour force, and only 1 per cent of employees are women. In the public sector, both Saudis and women are more numerous but are still only a small minority. Women are hired mainly as teachers and nurses (to teach and care for other women). Adult Saudi men are often employed in the public sector in what, in practice, are sinecures. Many people told our delegation about **poor discipline and workplace morale**; the Saudi middle class is simply accustomed to being supported without having to exert itself. Real work is done by temporarily hired Western ex-pats (engineers and consultants) and low-paid unskilled manual workers from the Philippines, Pakistan and other Asian countries.

In the long run, this extremely stratified labour market is unsustainable. For many years, the authorities have pursued a "Saudization" policy: private companies that want to expand must hire a certain quota of local natives. This policy has, however, encountered great difficulties. Quota employees often perform so poorly that they become a burden to companies.

To create genuine domestic human capital and strengthen the position of Saudis in the labour market will **require a significant improvement in education** – which has focused too much on Arab history and Islam – and a cultural revolution in the

Saudi view of work and the position of women. The regime is now spending billions worth of oil profits on education, but naturally it will take time to turn developments around, recruit and train teachers – and above all to change the attitudes of the more conservative groups in the population.

Reforms from the top

Large portions of the Saudi population, especially among older rural people, are very traditionalist and do not want any change that might be suspected of leading to a loosening of the Islamic social structure. The Saudi state is based on a strict, fundamentalist interpretation of Islam – Wahhabism – that has been deeply rooted for generations. The history of the royal family has been intimately associated with Wahhabism for 250 years, and the legitimacy of the king is based, among other things, on being the guardian of the holy cities of Mecca and Medina.

Nevertheless, **today's reforms ultimately emanate from the king**. King Abdullah is the son of the Kingdom's founder and is now more than 80 years old. But he has skilfully balanced between the need to reform the economy, on one hand, and not to alienate traditionalists, on the other.

The labour market is gradually being opening up to more women and to improved secular education. The power of the religious courts is coming increasingly under question and the religious police are less visible on the streets nowadays. In a highly publicised case late last year, the king pardoned a gang-raped young woman who had been sentenced to six months in prison and 200 lashes because she had been seen outside her home with an unrelated man while not accompanied by a male relative. Meanwhile Saudi Arabia has

become of member of the World Trade Organisation, a ministerial reform has streamlined the bureaucracy, taxes have been lowered, the court system has been modernised and education is expanding.

What is paradoxical is that this reform policy is being driven – and legitimised – by an absolute monarch. This makes it fragile, too. The present king is old, and the crown prince – one of his brothers – likewise. Within not so many years, power will be transferred to the next generation (today around age 50). A kind of internal “nomination committee” has been appointed within the royal family in preparation for this generation shift, but there is no democratic influence over the process in a Western sense.

So no one knows which way things will move, but the consensus opinion is that **the cautious reform policy will probably continue**. The further it progresses, the more difficult it will probably be to reverse. Among younger city dwellers, old values are loosening up – satellite TV and the Internet are exposing them more and more to Western thinking.

Attractive for Swedish companies

For Swedish companies, Saudi Arabia is an increasingly attractive destination, both for exports and production. The Kingdom is the economic centre of a region that continues to grow in importance. Very large natural resources are available there, huge investments will be implemented and purchasing power is rising rapidly. The challenges for those wishing to establish a presence mainly concern difficulties in the labour market – being able to recruit and retain a workforce. For many new arrivals, their encounter with traditionalist Saudi domestic culture will be another stumbling block.

But despite all these problems and the growing pains that can be expected, Saudi economic expansion exerts **a powerful attraction for Swedish companies today**. Trade with Saudi Arabia as well as investments and interest in the country are greatly increasing. What I saw during the

SEB delegation's visit there strengthens my view that this trend will continue.

Klas Eklund
klas.eklund@seb.se