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Saudi Arabia: A challenging boom

This is a personal travel report from a short visit to Riyadh and Jeddah.

- **Saudi Arabia is in the midst of an economic boom, courtesy of high oil prices and a gradual opening of the economy.**
- **The Kingdom is dependent on oil revenue to stabilise the social situation and to finance growth projects. As the US dollar slides, pressure increases on the Kingdom to keep oil prices high.**
- **Even though the royal family has strengthened its position in recent years, external threats and domestic structural challenges are formidable.**

As oil prices and the USD remain vulnerable and geopolitical tensions in the Gulf area are palpable, the Kingdom of Saudi Arabia is squarely in the global focus. It is a country with a proud heritage, awash with oil money and the most important oil exporter in the world – but struggling to maintain a balance between the forces of economic and social liberalisation, on the one hand, and religious fundamentalism and traditions on the other.

Only a few years ago, pundits were predicting the imminent fall of the house of Saud. But this has not happened, for three reasons.

- The oil price hike has sparked economic activity and wealth creation. Last year, nominal GDP increased by almost 25 per cent; this year it will rise by around 16 per cent. And the money is now spent more wisely than after the first showers of oil revenue in the 1970s.
- The old king Fahd died and was succeeded by his more dynamic brother Abdullah.
- A highly efficient security service has tracked down and eliminated most of the potential domestic terrorists.

True, the country is still vulnerable from fallout from Iraq, the succession to the next generation of leaders is still uncertain, and the country is highly dependent on oil revenue; but at least for the time being, **stability has increased** quite markedly.

The great swing producer

This is of great importance to oil consumers across the world. Saudi Arabia is by far the world's largest oil producer; it is furthermore the only leading producer with capacity well in excess of output. The Kingdom is therefore in a **pivotal position when it comes to influencing oil production and prices.**

The oil price rise of recent years has sent export revenues sky high. The **current account surplus** reached 30 per cent of

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GDP in 2005; that year alone, export revenues were 15 times as high as the accumulated revenues in the 1990s! This year, the surplus is likely to be even higher, perhaps 34 per cent of GDP. In absolute terms, Saudi Arabia is showing the fourth largest c/a surplus in the world (after China, Japan and Germany).

As a result, external debt has fallen to 11 per cent of GDP – all of which is private, as corporations have raised international finance for investment. All central government debt has been amortised, and the central bank is instead accumulating foreign exchange reserves at a rapid pace.

Nominal or real GDP?
In most countries, the real GDP growth rate is more relevant than the nominal one. In Saudi Arabia, however, both are important. Real GDP is growing at around 6 per cent annually – actually a bit faster in the non-oil sector. In the oil sector, production has only gradually been increased.

Instead, the main revenue increase from the oil sector has come from rising oil prices, causing nominal GDP growth to deviate strongly from real GDP – nominal GDP is rising two or three times as rapidly.

But this huge revenue increase is not immediately translatable into inflation. Much of the oil money is funnelled into the public sector. Some of it used to increase public employment and for infrastructure investment. But much is also invested in foreign assets and results in burgeoning FX reserves in the central bank.

Consequently, the inflationary effect of this huge revenue increase is not necessarily large. Some trickles into the economy and increases demand – but the opening up of the economy has led to increasing competitive pressures while low-paid foreign guest workers hold down the inflationary effects on wages. The Saudi currency – the riyal – is pegged to the USD, but so far the sterilisation of foreign capital inflow has not caused any noticeable problems. As a result, inflation is very low, normally only 1-2 per cent, despite the huge nominal GDP increase.

Dollar sensitivity

Part of the oil money is spent on **improving the paltry infrastructure** of the economy. Roads, ports, railroads and refinery capacity are highly prioritised. Furthermore, several new “economic cities” are being planned – modern, high-tech, service- and education-oriented. As a result, the construction sector is booming.

Such projects are badly needed. But they **crucially depend on a continuous flow of oil money**. Likewise, the very generous salary and employment conditions for the public sector employees (mainly indigenous Saudis) demand a never-ending stream of oil revenue. Last year, public sector employees received a pay hike of 15 per cent and budget expenditure targets were sharply overrun. Spending has actually exceeded the budgeted level by about 15 per cent annually in the past decade.

Still, last year the **central government budget showed a hefty surplus** – 18 per cent of GDP – courtesy of high oil prices. This year, the budgeted surplus was supposed to be some 5 per cent of GDP; but higher-than-expected average oil price will mean a budget surplus perhaps on par with last year’s.

The budget is extremely sensitive to changes in oil prices and the USD. At oil price levels of USD 50/barrel and a steady USD, the economy will do fine. But **lower oil price and a weakening USD would mean a double whammy.** Oil prices below USD 35/barrel would mean serious problems for the whole development programme – and would, consequently, cause social problems.

This is the reason why **Saudi Arabia wants to stabilise oil prices at the present level – and possibly push them somewhat higher** should the USD weaken further.

Fixed currency

The riyal has been pegged to the USD at 3.745 for 20 years. The peg is guaranteed by a currency board arrangement (net foreign assets must provide full coverage of every riyal issued). The central bank is shadowing the Federal Reserve, albeit with some leeway.

Some international commentators are urging oil-surplus countries to revalue their currencies as a way to correct global imbalances and reduce the US c/a deficit. But this is not on the Saudi agenda, for obvious reasons that follow from the analysis above. Nor will the Saudi riyal be devalued, as that might increase inflationary pressures.

The political leaders of the Gulf countries[1] have stated that they want to create a **currency union by 2010**. It is still an open question whether such a union actually will become a reality; the Saudis want it, but there is some unease in the smaller states, and external shocks (political crises, oil price volatility etc) may cause some of them to jump ship. For Saudi Arabia, to change the USD peg arrangement during these sensitive years would be foolhardy.

Thus, **the fixed exchange rate will remain fixed at the present level** – meaning that Saudi Arabia will continue to be tremendously dependent on oil price and USD swings.

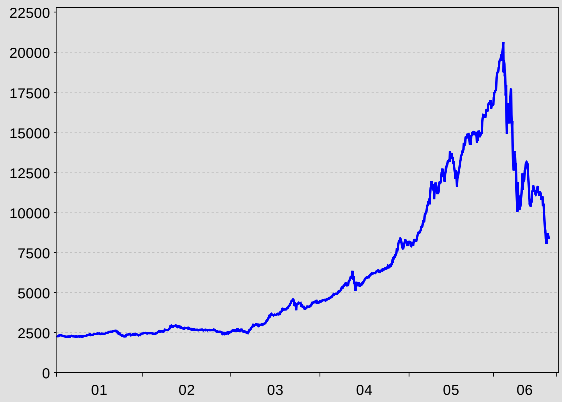
[1] The GCC (Gulf Cooperation Council) consists of Saudi Arabia, the United Arab Emirates, Kuwait, Oman, Qatar and Bahrain.

Stock market crash

From 2003 until early 2006, the Saudi stock market was one of the best- performing markets in the world. The benchmark index rose by over 700 per cent. The upswing was driven by strong liquidity and small investors.

By the end of the boom, the market was clearly overvalued, with the average p/e ratio close to 50. As the bubble burst, many small investors panicked and exited. The government regulator tried to stem the tide by narrowing the daily share trade price band to 5 per cent. Nonetheless, the market has continued sliding – in recent weeks also due to global nervousness. The **index has now fallen by more than 60 per cent from its peak**.

Saudi SE, All Share Index



Source: Reuters EcoWin

The repercussions have been severe for some small private investors who lost their savings. But the banking system is robust, and the regulator is now trying hard to improve the functioning and the ethics of the marketplace.

Social challenges

In recent years, the Saudi economy has gradually opened up. In 2005, the Kingdom became a WTO member after many years of negotiations. Its rankings in the World Bank "Doing Business" survey have steadily climbed.

However, the greatest challenges to the Kingdom are social rather than economic. If the country is to develop into a modern service-driven economy, it needs to continue to open up and invest in infrastructure – but above all to improve its human capital stock. Three interrelated obstacles must be tackled.

Firstly: For religious and traditional reasons, **women are still not participating to any significant extent in the workforce**. Actually, they are not even allowed to go out in the streets alone or to drive a car – meaning not only that they themselves have no physical mobility, but that the movements of their husbands are also limited since they have to spend an enormous amount of time chaperoning their wives.

Secondly: Expats from India, Europe and the US are doing much of the skilled work, while menial labour is performed by cheap immigrant labour from the Philippines, Africa and Pakistan – the latter group is actually about three times as large as the number of male Saudis. **Most male Saudis live a rather comfortable life in a protected, oil-revenue-swollen public sector**, without much pressure to perform or transform. The government is pursuing a policy of "Saudisation" – private companies that expand must hire a certain number of Saudis – but so far without any real success.

Thirdly: **Higher education is free for Saudis, but the quality is low and too often takes the form of consumption**; too large a share of young people go into social sciences and the arts – for which there is no real demand in the labour market. Religious studies still play a very important role. The government has tried to improve the situation by handing out generous scholarships to young Saudis who want to study abroad. But the stiffer competition and tougher demands on foreign campuses have so far proven to be difficult to handle for many of the Saudi students.

Even with continued oil revenue inflow and a more open economy, most economic analysts agree that big reforms are needed in these areas if Saudi Arabia is move up the ladder. But reforms are difficult to implement, since several of them collide head-on with strong and deeply-rooted traditions, not least the religious ones from which the Saudi royal family derives much of its authority[2]. The reformists in government are thus walking a tight-rope above an abyss.

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[2] The origins of the Kingdom go back to the 18th century, when the present form of strict Islam dominating Saudi Arabia – Wahhabi Islam – conquered most of the peninsula during the reign of the first of the Saudi rulers. This union was crushed by the Ottomans, but a new attempt to unify the country was made in the 19th century, also by a leader of the House of Saud. The present kingdom is the product of the third unification of the country, also this time by a leader of the House of Saud – Abdul Aziz, founder of the present state and the father of the present generation of rulers. The royal family is also the protector of the holy city of Makkah (Mecca) and the millions of pilgrims who go there every year.