

# Chapter 1

## Overview

*We should never create by law what can be accomplished by morality.*

Montesquieu

### Introduction

The Kingdom of Saudi Arabia has witnessed a dramatic rise in the pace of economic and social change since the succession of King Abdullah bin Abdulaziz to the throne in August 2005. The country had been going through a transformation prior to the succession, but the pace and urgency was more evident in the domestic economic, social and educational sectors, as well as in Saudi Arabia's new-found confidence in establishing strategic economic alliances in the Far East.

This book builds upon the period covered by the first edition and examines the key factors of change that have taken place since 2005 and are continuing to shape the future destiny of the Kingdom on many fronts.

While the book covers some distinct groupings of chapters under a common theme, it becomes apparent that there are certain overriding issues that prevail in all chapters and often overlap. This is to be expected, as Saudi Arabia's economic development path is multifaceted and many factors affect the final outcomes, whether they are in education reform, economic restructuring or globalization. The key issues that remain facing Saudi Arabia include continuing to diversify the economic base and reduce the country's heavy dependency on hydrocarbons, managing expectations based on a narrow revenue base, coping with the needs of a young and growing population as well as rising youth unemployment for both males and females, empowering the private sector to become the engine of growth through meaningful Saudi national job creation and exports as well as meeting the Kingdom's new international obligations since accession to the World Trade Organization (WTO) in 2005. Many of these issues have remained the same since the first edition was printed, and this is necessarily so as fundamental changes affecting a nation take more than a few decades to be set on a right footing.

This hurdle of simultaneous challenges would be a tall order for any nation to handle. For Saudi Arabia, it also includes reforming the educational system to be in line with market needs, establishing a knowledge-based economy, opening up to the rest of the world by a process of inter-faith dialogue, fostering a culture of moderation and dealing with other nations and cultures based on mutual respect. The country also seeks to meet the increasingly vocal aspirations of its female population through expansion of their participation in the economy and society at large, but without compromising on basic religious beliefs, customs and traditions.

## Setting the Stage

The first broad themes are covered in [Chapters 2 and 3](#). [Chapter 2](#) addresses how economic planning was introduced and implemented in Saudi Arabia, and examines its evolution and whether it had managed to lay the framework for meeting future challenges. The chapter examines the strategic economic decisions Saudi Arabia made in the early boom era, the consequences of which are still apparent today. These consequences include investment in capital-intensive infrastructure and basic industries, reliance on cheap energy input, the use of subsidies and incentives to promote economic growth and the import of a large number of foreign workers. Planning during this period evolved from being directive to indicative, as the economy expanded and opened up to international trade. It also focused more on the private sector and started to set qualitative indicators, rather than the quantitative indicators of earlier planning periods. [Chapter 2](#) points to Saudi Arabia's need for a more strategic and flexible short-term planning process that is better suited to a faster-evolving global economy.

The accelerated pace of key reforms in the economic, judicial and political sectors are examined, all of which are beginning to lay the foundation of a modern Saudi state. The empowerment of the consultative council or *Majlis Al Shoura* and the revamping of the judicial process are key measures that are helping to promote more transparency and accountability in the government system. The emphasis on increased education spending as a national priority stands out as a prerequisite for economic growth.

[Chapter 3](#) assesses the Saudi budgetary framework and the urgent long-term need for a wider revenue base diversification. Recent high oil prices have moved Saudi Arabia back into a surplus position after nearly a decade of budget deficits and ballooning domestic debt, with the Kingdom now enjoying substantial foreign reserves. The chapter also discusses the possible crowding out of the private sector, which the government hopes will assume the future capital project funding needs of the Kingdom, estimated at around \$400 billion over the next 20 years. It then examines the centrality of oil revenue and the lack of government control over nearly 90% of its revenue sources, pointing towards the need to adopt a new strategy to meet future fluctuating oil fortunes in order to move away from being a hostage to a *petrolized* economy.

Saudi Arabia is now a prominent member of the G20 group of nations and, by virtue of its economic size and holding the largest known reserves of oil in the world, Saudi spending and investment policies in key sectors such as oil have an important influence on world economies. The chapter explores the Kingdom's need to build true wealth rather than remain oil-dependent, for which end capital expenditure has been rising over the past few years.

## The Financial Sector

We explore our second major theme in [Chapters 4, 5 and 6](#), as we examine the evolving and, in some respects, mature financial sector of Saudi Arabia. [Chapter 4](#) analyses the evolution of the Saudi de facto central bank – the Saudi Arabian Monetary Agency (SAMA). It looks at how SAMA has assumed a wide range of responsibilities and supervisory regulatory powers despite being constrained in the use of more traditional central bank policy tools, such as discount and interest rate instruments. However, SAMA has effectively managed the other range of monetary and exchange rate policy tools available to it in combating rising inflation in Saudi Arabia during 2007–2009, as well as ensuring that the Saudi banking system today is one of the most capitalized, liquid and profitable in the world. At the same time, SAMA has supervised the smooth transition of the Kingdom's foreign bank presence to joint partnerships, that is, a *Saudized* banking framework. This has turned out to be an effective partnership tool for transferring technology and management skills to the Saudi financial sector. The chapter also examines how SAMA has coped with the new wave of foreign banks operating in the Kingdom following Saudi Arabia's accession to the WTO, and how it managed to steer the Saudi banking sector safely during the global financial crisis of 2008/2009. [Chapter 4](#) explores the growing sophistication of SAMA's use of *repos* and *reverse repos* as proxy monetary instruments, as well as SAMA's management of the national debt and foreign asset reserves. It also considers the rationale of SAMA's fixed exchange rate policy for the SR and the Kingdom's money supply creation process.

[Chapter 5](#) further develops this theme and examines the broader financial markets that have evolved in the Kingdom, especially in the commercial banking sector and SAMA's supervisory process and results of such oversight in the Saudi banking sector. This sector is comprised of a mix of wholly owned "pure" Saudi banks, joint-venture *Saudized* banks, the newly approved foreign banks and other financial sector players, such as the specialized government financial institutions. The latter played a crucial role in providing long-term concessionary credit for Saudi economic development when most commercial financial institutions preferred to take short-term risks. [Chapter 5](#) examines the core strength and market strategies of these various financial institutions and their financial performance. The emerging insurance sector is also discussed, as well as the growing role of Islamic financing in Saudi Arabia and how the Kingdom's financial sector hopes to cope with globalization threats and opportunities.

The focus on the financial sector concludes with [Chapter 6](#), which analyses the Saudi capital market through a discussion of the evolution of the domestic capital market, the operating regulatory framework and the various obstacles. This is followed by an assessment of the new Capital Market Law and the establishment of an empowered Capital Market Authority (CMA), which has carried out a series of operational and supervisory reforms to make it one of the strongest capital market regulators in the Gulf. We explore the issue of ownership concentration and the lack of depth of the Saudi capital market, in contrast to the Kingdom's dominance of the Arab stock markets in terms of size and performance. This chapter analyses the sectoral composition of the Saudi stock market and the inherent weaknesses of having a thin market base. We assess investor behaviour, and take an in-depth look at the Saudi mutual fund market, the largest and most diverse in the Arab world, as well as the participation of foreign investors in the Saudi market through share swap facilities, and the opening up of the Saudi capital market to foreign investment banks and their impact. The Saudi government debt market's structure is closely examined, as well as the future evolution of the Saudi capital market in the face of ongoing liberalization and privatization.

## **The Heart of the Kingdom: The Hydrocarbon Sector**

The third theme of the book revolves around the private sector and the challenges it faces, and Saudi Arabia's hydrocarbon and mineral sector – truly the heart of the Kingdom's revenue generation, diversification prospects and value-added job generation.

[Chapter 7](#) critically examines the challenges for the Saudi private sector as it shoulders the responsibility of transforming the Saudi economy into a market-driven generator of wealth. It is important to assess whether an appropriate business environment exists in the Kingdom today, one that enables the private sector to take up these challenges. Therefore, we examine the legal, corporate and economic environments under which the private sector has to operate. We look, too, at the issue of foreign labour participation and current Saudi government pressure on the private sector to accelerate the process of *Saudization*. The role of the small- and medium-sized enterprises (SMEs), as well as the obstacles they face and how the government is trying to overcome these obstacles, is examined, given the importance of the SMEs to Saudi Arabia's goal of job generation and regional economic diversification. [Chapter 7](#) also explores the role of the Saudi family businesses and their structures, and advocates for some changes to family businesses for enabling them to meet the future challenges of globalization following Saudi entry to the WTO, and some well-publicized family Saudi business problems.

This chapter also considers Saudi women and their growing importance in the national economy; we note the obstacles currently faced by women in managing their own businesses, and investigate how they are overcoming these barriers. During the past few years, there has been a greater momentum to generate

more female job opportunities, to increase women's participation in economic nation-building and to open up more sectors for them. We analyse the potential impact of the ongoing Saudi "mega-city" projects on private sector participation with the government on a Private Public Partnership (PPP) basis and set out a model of private sector–government cooperation.

We look at the government's role as a planner, financing entity, buyer and seller, regulator and revenue collector. The issue of *Saudization* and how the private sector views it is examined in some detail, showing that the private sector and the government have divergent views. The private sector argues that *Saudization* can only succeed when a supply of skilled labour exists such that it meets market needs at competitive wage levels.

**Chapter 8** discusses the oil and gas sectors and explores the opportunities that lie in the as yet relatively untapped non-carbon minerals sector. The importance of oil, its dominant effect on the Saudi economy and the Kingdom's pivotal role in this energy sector are highlighted. The chapter also thoroughly examines Saudi oil policy and its constraints. The record oil prices experienced during 2008, with oil prices reaching \$147 per barrel on fears of supply shortages, underscored the Kingdom's importance as the major excess capacity producer of the world. Saudi gas, a new and important energy sector, is appraised in light of Saudi Arabia's attempts to attract foreign investment and technical partners to this field. Besides having a quarter of the world's proven oil reserves, Saudi Arabia also has the world's fourth largest gas reserves and is a significant natural gas liquid (NGL) exporter.

**Chapter 8** also looks at the Saudi petrochemical industry, particularly as it could be the major beneficiary following WTO entry. Today the Saudi Arabian Basic Industries Corporation (SABIC) is a significant player in the world's petrochemical markets, with expanded operations both at home and abroad. For some products, SABIC's world share stands at around 18–20%, and it is a credit to the Kingdom that this was achieved in fewer than 20 years' time, literally created out of the desert. Saudi Arabia's evolving overseas energy markets are explored, as it has become evident that the export focus has shifted towards Asian markets for both crude and petrochemical products. **Chapter 8** carries on exploring the Kingdom's mining sector and its potential to diversify the economic base and generate an integrated mining industry. If developed, the Kingdom's extensive mining resources could lead Saudi Arabia to rank as amongst one of the leading mining countries in the world.

The privatization of the Saudi Arabian Mining Company (*Maaden*) involves the restructuring of the company into separate units for gold, phosphate, bauxite, aluminium and other minerals. Foreign investors in the mining field will be encouraged to explore under planned new mining law concessions. **Chapter 8** presents a new model of mining cooperation with foreign companies that will assist in taking the privatization forward. This model could help shield the Kingdom from fluctuations in basic commodity prices, such as oil, resulting in a narrow revenue base, despite the record 21-year-high oil prices seen during 2008 and the subsequent fall in oil prices triggered by the global financial crisis of 2008/2009. The chapter also examines Saudi Arabia's policy to develop alternative renewable energy solutions,

especially solar energy, in order to meet growing domestic energy consumption and conserve oil reserves for future export revenue generation.

## The Foreign Sector

Chapters 9 and 10 deal with the theme of Saudi Arabia's foreign trade relations and the impact of the Kingdom's accession to the WTO in 2005.

Saudi Arabia has embraced an open, market-based economy with few restrictions on goods and service, except for those that are in direct conflict with religious beliefs (including the import and consumption of alcohol and pork-related products). This liberal market policy is reflected in the Kingdom's trade relations with the rest of the world. Imports come today from virtually all continents, while Saudi exports flow to all major industrialized and developing countries. Saudi Arabia's major trading partners continue to be the United States, the European Union and the Far East; China is viewed as a major trading partner of the future and is now Saudi Arabia's second largest trading partner compared with negligible amounts only 20 years ago.

Exports from the Kingdom follow the same import trading patterns, and some effort has recently been made to ensure that Saudi exports become more diversified. Currently some 90% of total exports are made up of oil- and energy-related petrochemical products. It is this narrow export base that is worrying those who see potential problems for Saudi non-oil exporters post-WTO entry for the Kingdom. While Saudi Arabia has run relatively consistent trade surpluses, the Kingdom suffers from capital outflows due to large remittances by foreign workers, averaging around SR 60 billion per annum, as well as private sector capital outflows.

An analysis of Saudi Arabia's trade patterns reveals a shift in the type of products imported over the past three decades: during the earlier boom period, the imports were of capital goods, construction and machinery. Later these imports gave way to spare parts, food and consumer goods. The inter-Gulf Cooperation Council (GCC) trade still plays a small part.

Chapter 9 also discusses in detail Saudi Arabia's overall competitiveness and ease of doing business and finds that major advances have been made placing Saudi Arabia ahead of all the other GCC and Arab countries in terms of world competitiveness and ease of doing businesses, largely due to the activities of the Saudi Arabian General Investment Authority (SAGIA). However, some competitiveness obstacles still exist, with restrictive labour regulations being the most cited, besides an inadequately educated workforce.

Chapter 10 discusses Saudi Arabia's decision to join the WTO after 12 years of negotiations and its accession in 2005. The chapter explores the background to the establishment of the WTO and the benefits and costs of globalization for countries, as well as the various agreements that the Kingdom had to sign upon accession in the various trade, services and intellectual property areas. The Kingdom obtained several exemptions on WTO entry, including the prohibition of imports of goods in conflict with Islamic *Shariah*, as well as continuing with a policy of *Saudization*

quotas for domestic and foreign companies operating in the Kingdom. Analysis of the potential impact of globalization on various Saudi manufacturing and service sectors revealed that some will be impacted, especially those with the highest levels of subsidies and tariffs, but that the petrochemical sector stood to gain the most from WTO accession. The chapter also examines the current Saudi legal system and its WTO conformity and the legal reforms that have been instigated by the Kingdom to ensure WTO compliance in certain areas such as arbitration procedures.

## Meeting Future Challenges

The final theme involves analysing some key challenges faced today by the Saudi economy as it goes through painful structural adjustments. These challenges overlap, as they often do, since economic transformations do not occur in compartmentalized isolation, but rather react to one another in a dynamic fashion.

The challenge to the Kingdom's policy-makers is to try and identify key positive drivers operating in the economy that will lead the country forward towards set objectives while minimizing the negative consequences to society at large.

Under this broad theme, [Chapter 11](#) examines the Kingdom's hopes and aspirations for foreign direct investment and the strategic option for liberalization and privatization. This chapter illustrates that Saudi Arabia's problem is not a lack of good intentions or of proper priorities, but rather that there is no matching consensus as to how much action is needed, and how quickly the Kingdom should act. Some tangible progress has been made through the establishment of the Supreme Economic Council, which has focused on developing the regulatory environment that will allow a successful privatization programme to emerge. The chapter examines the options for privatization and the sectors that have been targeted and the results to date, as well as analysis of private–public sector cooperation. Another positive development involves the enhancements of the Foreign Investment Law that offer a number of benefits, including a reduction in taxation levels to 20% on foreign companies' profits and which has now made Saudi Arabia one of the major recipients of FDI, after lagging at the lower end of the Middle East table for many years.

The critical issues of the moment – employment, *Saudization* and the structure and composition of the Saudi labour market – are dealt with in [Chapter 12](#). With nationals accounting for just under 13% of the total private sector labour force, or around 829,000 Saudis, the government is making copious attempts to ensure that more jobs are found for nationals, either through creating new jobs or replacing foreigners through an invigorated *Saudization* programme. Planned versus actual *Saudization* results indicate that targets have not been met.

The government, however, can only push so hard. In the final analysis, Saudis with the appropriate market-driven skills will be employed. Others seeking jobs will realize that it is necessary to change their mindset and to accept positions previously deemed to be either too menial or socially unacceptable. The “duality” of the Saudi



labour wage structure is examined to explain wage differentials between Saudis and non-Saudis.

The mindset *is* changing, and some sections of Saudi youth are beginning to be more realistic in their job expectations as they compete with other new labour entrants, a result of one of the world's highest population growth rates.

Windfall gains arising from one or two years of higher than expected oil revenues, such as those experienced during 2007 and 2008, might produce a short-term “feel good” factor, but cannot solve such long-term demographic realities. This chapter also looks at the issue of female labour participation, since the Kingdom has one of the lowest female labour participation rates in the world.

Saudi female participation tends to be higher for those in the older age group, forcing younger Saudi women to prolong their entry in the labour market either by pursuing higher education or seeking less qualified jobs. Once again, the Saudi government recognizes these problems and the Saudi cabinet recently approved a nine-point plan to create more jobs and business opportunities for women, including the restriction of expatriate jobs in areas dealing with women-only services.

In any society, unemployment is a cause not only of social problems and of increased unemployment-related crimes but also of potential loss to national output and productivity. [Chapter 12](#) calculates the cost of such a potential Saudi output gap. Using *Okun's Law*, this was estimated at around SR 1,021 billion for the period 1993–2008, based on fairly high levels of voluntary (or “natural”) rate of unemployment for Saudi society. If this natural rate of unemployment was much reduced, then both the output gap and real rate of unemployment would be much higher using *Okun's Law* than those estimated in [Chapter 12](#). The chapter also examines a new worrying trend for “educated unemployed” amongst Saudi nationals, both male and female, who are driven to seek higher education to enter the public sector or high wage resource-based jobs, and preferring to remain unemployed until such jobs are found. This differs from traditional developing countries' educated “brain drain,” with educated nationals seeking jobs overseas and preferring to remain in transitory employment or unemployed until they find higher paid jobs overseas. In both cases – the Saudi model and the “brain drain” model – the success of those who seek jobs attracts others to obtain higher education to follow in their footsteps, except that in the Saudi model the number of new jobs in the public sector or in the high wage resource sector are limited.

Our analysis of earlier themes clearly marks the important role that quality education and the acquisition of market-related skills play in shaping Saudi economic development.

This issue is examined more closely in [Chapter 13](#), which analyses the current Saudi educational structure's achievements and problems. Technological progress and the diffusion of scientific and technical innovations lead to higher productivity and improvement in all sectors of the economy. The ability of any society to produce, select, adapt and commercialize knowledge is critical for sustained economic growth and improved living standards. In relation to its population, size and undoubted quantitative educational investment, Saudi Arabia has produced



negligible commercial patents compared with other developing countries such as Malaysia or Singapore.

Quality education output is now a key priority for the Saudi government. The 2008 and 2009 budget allocation for education showed that the Saudi government is beginning to direct resources towards higher education and vocational training institutions that are graduating students who meet labour market needs.

Saudi education had been driven by an “education-push” quantitative aspect in the early days of Saudi economic development, but over the past few years it has been driven by “jobs-pull” in the private sector. The Kingdom has also taken bold steps not to be left out of the global knowledge-based economy, and has established a world-class scientific research and teaching university – King Abdullah University of Science and Technology (KAUST) – to spur changes and reforms in other Saudi educational establishments. At the same time, a number of government and private sector higher education institutes have been established, with nearly all having international strategic alliances and cooperation to ensure that Saudi education remains relevant and up to date.

The Kingdom is not an isolated island. Regional developments, whether positive or negative, have profound consequences on internal stability, and on economic and social developments. [Chapter 14](#) explores Saudi Arabia’s multifaceted relationship with the five other members of the GCC, as developments within the GCC could have far-reaching economic consequences for the member states. This chapter examines why the GCC union was established in 1981 and discusses its developments to date, as well as Saudi Arabia’s decision to establish new strategic relationships with the emerging economic giants of the 21st century – China and India – without disturbing traditional relationships and alliances with the USA and other European countries.

[Chapter 14](#) aims to impart an understanding of the internal economic dynamics of the various GCC member states and of how far similarities and differences could accelerate or impede planned full monetary and customs union planned for 2010. The issue of a common currency and whether it will be implemented in light of two members of the GCC opting out of the plan (Oman and UAE) is examined in detail, as well as options for a GCC currency, whether pegged, managed or linked to oil, are explored. Economic diversification, generating employment for their young and growing populations, and economic integration is the destiny of the GCC countries. Oil is central to their well-being. Between them, the six GCC countries sit on some 45% of the world’s total oil reserves, illustrating the magnitude of the region’s importance. [Chapter 14](#) shows that some success has been achieved, albeit on a modest scale, in the effort of individual GCC member states to diversify away from a narrow oil and gas revenue base. Dubai and Bahrain are leading the way, but the global financial crisis of 2008/2009 has also affected some countries of the GCC more than the others, particularly the Dubai emirate of the UAE, and most of the GCC countries are now refocusing on strengthening their domestic financial and capital market base to be able to withstand the global contagion.

Integration of various capital markets could be a first step in mobilizing domestic financial resources into large, economically viable inter-GCC or national projects.

Integration would also help facilitate a greater degree of inter-GCC job seeker migration and ease unemployment problems faced by some GCC countries while filling the job openings of other member states. In the long term, it is important to ensure that the GCC becomes open and accessible to its ordinary citizens so that they understand the objectives of the GCC, why it was established and how it affects their lives. It is only by doing this that the viability of the GCC's long-term future can be guaranteed, and that the "GCC family" survival as a stronger political and economic entity in the 21st century can be ensured.

## Conclusions

Following these broad themes, [Chapter 15](#) concludes by reviewing some key structural issues affecting the Saudi economy and highlighting some of the problems that need to be addressed going forward. There is a new sense of realism in the Kingdom amongst policy-makers, the private sector and the population at large. Despite domestic terrorism issues, there is a mood of determination to tackle pressing problems. Reforms and domestic changes are important, but they must not be seen as a competition between external and internal domestic reform agendas. Both need to progress at a comparable pace, without external pressure. Managing both expectations and the pace of reform will be a key challenge as things progress, as will be the management of the *Saudization* process and the maintenance of harmonious relations with expatriate labour.

Reforms, although implemented gradually, can be cumulative in effect. Gradual change may seem slow or less impressive to those outside the Kingdom, but if reforms are to endure and be effective, they have to respond to the needs, customs and mores of all society. Far too many experts have misjudged and underestimated the resilience of Saudi Arabia or the adaptability and creativity of Saudi society in meeting future challenges. Consensual change will be the means of change. The key will be a process of evolution and consensus-building, the hallmark of Saudi government, thus allowing for longer-term economic planning and stability.