The Saudi Arabian Economy:
Policies, Achievements and Challenges
The Saudi Arabian Economy: Policies, Achievements and Challenges

by

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Springer
Dedicated to the memory of my beloved parents and best teachers Ali and Mahassen Ramady, to my wife Fatina and to my children Ali, Faisal and Layla with thanks for their patience and support
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Acknowledgments

This book has been a long time in the making. It draws upon classroom notes from the course I teach on the Saudi Arabian economy at King Fahd University of Petroleum and Minerals (KFUPM), as well as on my experience working in Saudi Arabia and other Gulf countries in banking, finance and business. Some excellent books exist on the Saudi economy but the moment seemed right to bring out a current Saudi economy book, especially given the continuing world-wide interest in the Kingdom.

The characteristics of the Saudi economy have changed beyond recognition since the heady oil boom days of the early 1980s. This book attempts to bring the story forward, analyzing challenges and major issues facing the Kingdom in the modern period. We hope to provide a cohesive picture of what has taken place over the last three decades, and use it to help look forward into the new millennium. At the same time, the book emphasizes aspects of human and social development that have taken place in past periods, and looks at the accelerated pace of change in today’s Saudi Arabia.

This helps to identify a unique “Saudi” model and identity on the economy. In this respect, this book differs from others written on the Kingdom, which have tended to examine the economy from the more limited perspective of available data and statistics. They have often neglected to delve deeper into aspects of Saudi human capital development. Saudi Arabia is fully aware that developing its human capital, both male and female, in order to achieve self-sustaining growth, is key to a more prosperous future.

The name Saudi Arabia conjures up different images to different people. These might range from a romantic idealism of the purity of desert life to a place of unchecked commercialization – with all that implies. The truth, as ever, lies somewhere in-between. Saudi society is still imbued with the dignity of traditional desert hospitality, warmth and a noble culture; at the same time, it is part of a fast-moving, consumer-orientated and impersonal world. Society will be truly the poorer if the former is eroded in the face of a relentless march to the latter.

My personal interest in Saudi Arabia goes back to the first “boom and slowdown” period of 1979-1986, when I worked as Vice President with Citibank as well as Assistant General Manager with Saudi American Bank in Jeddah and Riyadh. Some of the material explored in this book, especially
concerning the financial and banking sectors, has been augmented by personal experiences, and the direction of research was stimulated and sustained over the past 25 years by a continued interest in the welfare of the people of Saudi Arabia.

The Kingdom, despite its fluctuating fortunes, still attracts an enormous amount of interest worldwide. The Riyadh bombings of May, 2003, and the domestic terrorism that followed propelled Saudi Arabia and its citizens into the limelight – reluctantly and for the wrong reasons. This forced an accelerated internal debate on economic and social reforms that had started prior to these events. This book will attempt to explain how the desert Kingdom’s economic systems are opening up and evolving, faster than some would want, slower than others hope for, but evolving and changing, they are Saudi Arabia today is beginning to reflect some of the problems and strains of other developed nations, both in terms of structural adjustments of the economy and of meeting the aspirations of its largely young population. How it handles such issues will be of interest to others facing the same dilemmas, especially those in the Arab world, as well as to the wider international community of nations wishing to see the Arab region make economic, political and social progress.

The Kingdom has left an indelible mark on millions of expatriate workers as well as others who have passed through the country. It has been a good experience for the overwhelming majority. For those who were positively challenged, Saudi Arabia has provided an unique opportunity to assume greater responsibilities, manage mega-scale projects, make substantial financial savings, take bold initiatives, and, in so doing, enrich their professional lives. Few other countries could have afforded them such an encounter. For those experiences, especially the chance to contribute to the development of the current Saudi banking structure, I am grateful.

Any book benefits from the influence and support that others give to its author to help bring it into the public arena.

My grateful thanks go to my colleagues at KFUPM, including Their Excellencies the present and previous Rectors, Drs. Khaled Al Sultan and Abdulaziz Al Dukhhayil, for encouraging me on this book-writing project, and to Professors Mohamed Budair, Abdulaziz Al Swaiyan, Aref Al Ashban, Ibrahim Al Gahtani, Sulaiman Al Sakran, Mohammed Al Sahlawi, Musa Essayad, Zohair Yamani, Usamah Uthman, Mohammed Al O’Hali, Mobarak Al Ghamdi, Abraham Abraham, Fazal Sayyed, Mohsen Al Hijji, Yakubu Umar, Bassam Hamdan, Abdelwahab Al Gahtani, Khaled Al Zamil, and Mohammed Al Homoud. I appreciate their willingness to discuss issues affecting the Saudi economy and society at large and to be a valuable sounding board for ideas, even when we disagreed.
My thanks also go to my many KFUPM undergraduate and postgraduate students of the Econ 306, Econ 305, MBA 501, and Executive MBA 561 classes, for encouraging me on this path and for sharing their thoughts on the aspirations of Saudi youth. In particular, the following students are to be commended for their perceptive class contributions: Mohammed Al Saleh, Nayef Saleh Al Hamdan, Yasser Al Jeraisy, Fahd Khaled Al Saud, Wael Al Gudaibi, Emad Nashar, Ali Al Gafeli, Yousef Al Humaid, Ibrahim Al Nuaim, Mishari Al Assaf, Mohammed Al Aiban, Bader Al Bassam, Mohamed Al Yemni, Bader Al Rajhi, Majed Al Anqari, Ahmad and Akram Sab, Fahad Al Tuwaijri, Turki Al Jammaz, Turki Abdulrahman Al Saud, Ahmad Dawood, Faisal Al Al Sheikh, Mishal Al Huwaish, Alaa Dahlawi, Bader Al Nowaiser, Fawaz Al Jomaib, Sultan Al Sultan, Mohamed Al Bawardi, Saad Al Kroud, Fahd Sulaim Al Zamil, Khaled Bin Abdulrahman Al Faisal Al Saud, Khaled Rubaijan, Fawaz Al Tuwaijri, Abdullah Al Gh-monthi, Omar Sulaiman and Mohamed Bin Turki Al Saud. Students such as these inspire confidence in the ability of the Kingdom to meet the challenges of the future.

Over the years I have benefited from various practitioners and experts about the Kingdom and the region in general, and my appreciation is due to Kevin Muehring, John Milne, Michael Field, Sass Ghassanpour, Noel Brehony, Ed O’Sullivan, Guy Gantley, L F T (Tim) Smith, Richard Keck, John Botts, Richard Murphy, Gavin Shreeve, and to many others – too numerous to mention – for their genuine concern about the region, their insightful comments and their sharp wit.

A special word of thanks goes to the Dean of Library Affairs, and to his tireless staff, for meeting my many reference requests. Last, but by no means least, thanks are due to the dedicated efforts of the secretarial and technical staff, Junaid Akhtar and Totty Raborar, and to Sue Katz for the editing. Any shortcomings in the book are entirely my responsibility.

Finally, I would like to acknowledge the financial support provided by KFUPM under Project No. IM/SAUDI ECONOMY/281.

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Abbreviations

ACH  Automated Clearing House
AMF  Arab Monetary Fund
Bear market  falling market prices
BIS  Bank for International Settlement, Basle, Switzerland
BOO  Build Operate Own
BOT  Build Operate Transfer
BOOT  Build Operate Own Transfer
Bull market  Rising market prices
CDS  Central Department of Statistics
Ceteris paribus  Assuming everything else is equal
CPO  Central Planning Organization
CRR  Cash Reserve Ratio
CSCCI  Council of Saudi Chambers of Commerce and Industry
Downstream  processing of gas and oil for final product delivery
Emir  Ruler
EPCCI  Eastern Province Chamber of Commerce and Industry
ESIS  Electronic Share Information System
EU  European Union
FATF  Financial Action Task Force
Fed (The)  Federal Reserve Bank, USA
FRN's  Floating Rate Notes
GAFTA  Greater Arab Free Trade Area
GCC  Gulf Co-operation Council
GDB's  Government Development Bonds
GDP  Gross Domestic Product
GFCF  Gross Fixed Capital Formation
GNP  Gross National Product
GOSI  General Organization for Social Insurance
Hajj  Annual Muslim Pilgrimage to Makkah
Hallal  permissible in Islam
Haram  forbidden in Islam
IDB  Islamic Development Bank
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IOC</td>
<td>International Oil Companies</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<td>Iqama</td>
<td>Saudi residence permit for foreigners</td>
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<td>JIBOR</td>
<td>Jeddah Interbank Offer Rate</td>
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<td>KAAU</td>
<td>King Abdulaziz University</td>
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<tr>
<td>Kafeel</td>
<td>Saudi sponsor of foreign labour</td>
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<td>KFU</td>
<td>King Faisal University</td>
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<td>KFUPM</td>
<td>King Fahd University of Petroleum and Minerals</td>
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<tr>
<td>KSA</td>
<td>Kingdom of Saudi Arabia</td>
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<td>KSU</td>
<td>King Saud University</td>
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<tr>
<td>LIBOR</td>
<td>London Interbank Offer Rate</td>
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<td>Maaden</td>
<td>Saudi Mining Company</td>
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<tr>
<td>Majls Al-Shoura</td>
<td>National Consultative Assembly or Council</td>
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<tr>
<td>mbd</td>
<td>million barrels per day</td>
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<tr>
<td>MENA</td>
<td>Middle East and North Africa</td>
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<tr>
<td>MMBtu</td>
<td>One million British thermal units</td>
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<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<td>MoP</td>
<td>Ministry of Planning</td>
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<tr>
<td>NCB</td>
<td>National Commercial Bank</td>
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<tr>
<td>NCCI</td>
<td>National Company for Cooperative Insurance</td>
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<tr>
<td>NEER</td>
<td>Normal Effective Exchange Rate</td>
</tr>
<tr>
<td>NGL</td>
<td>Natural Gas Liquids (or sometimes NLG)</td>
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<tr>
<td>OBU</td>
<td>Offshore Banking Unit</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<tr>
<td>OIC</td>
<td>Organization of Islamic Conference</td>
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<tr>
<td>OPEC</td>
<td>Organization of Petroleum Exporting Countries</td>
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<td>ORR</td>
<td>Official Repurchase Rate</td>
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<tr>
<td>PIF</td>
<td>Public Investment Fund</td>
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<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
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<tr>
<td>Ramadan</td>
<td>Muslim month of fasting</td>
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<tr>
<td>REDEF</td>
<td>Real Estate Development Fund</td>
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<tr>
<td>REER</td>
<td>Real Effective Exchange Rate</td>
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<tr>
<td>Repo</td>
<td>Repurchase Agreement</td>
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<tr>
<td>Reverse Repo</td>
<td>Reverse Repurchase Agreement</td>
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<tr>
<td>Riba</td>
<td>usury interest</td>
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<td>RPR</td>
<td>Reverse Repurchase Rate</td>
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Abbreviation

SAAB  Saudi Arabian Agricultural Bank
SABIC  Saudi Arabian Basic Industries
SAGIA  Saudi Arabia General Investment Authority
SAMA  Saudi Arabian Monetary Agency
SAMBA  Saudi American Bank (until October 2004)
SARIE  Saudi Riyal Interbank Express System
Saudia  Saudi Arabian Airlines
SCB  Saudi Credit Bank
SCCI  Saudi Chambers of Commerce and Industry
SDR  Special Drawing Right
SEC  Security and Exchange Commission
SEP  Saudi Export Program
SFD  Saudi Fund for Development
Sh.  Sheikh

Shariah  Islamic Law
SIBOR  Saudi Interbank Offer Rate
SIDF  Saudi Industrial Development Fund
SIMAH  Saudi Credit Bureau
SIST  Saudi Individual Stock Traders
SLR  Statutory Liquidity Ratio
SME's  Small and Medium Sized Enterprises
SPAN  Saudi Payment Network
SPRA  Saudi Pension and Retirement Agency
SR  Saudi Riyal
Status quo  Keeping things unchanged
STC  Saudi Telecom Company

Sunnah  Sayings of the Prophet Muhammad (pbuh)
TADAWUL  Electronic share trading and information system
Takaful Ta'awni  Islamic cooperative life insurance product
TASI  Tadawul All Share Index
T-Bills  Treasury Bills
TCF  Trillion Cubic Feet (of gas)
Upstream  production of oil and gas from wells
Wakeel  Saudi commercial agent of foreign companies
Wasta  connection, favour
WTO  World Trade Organization
Chapter 1

OVERVIEW

We judge ourselves by what we feel capable of doing, while others judge us by what we have already done.

*Longfellow*

Introduction

Saudi Arabia has changed dramatically over the past three decades – economically, socially and demographically. This would be a short period in the lifespan of many nations; but for the Kingdom, it has been a long time.

This book examines the key factors leading to the fundamental changes that are shaping the future destiny of the Kingdom, often in directions that cannot be predicted with certainty. However, some indicators are emerging in the Saudi economy that point towards possible outcomes and potential solutions.

There are several distinct but overlapping themes in this book. Readers can focus on chapters with common themes or one can use this book to teach a course that blends theory and current policy issues. The choices are yours. Whichever option is followed, it will become apparent that certain overriding issues prevail in all chapters and themes. The key issues relate to diversifying the economy, managing expectations based on a narrow revenue base, coping with the needs of a young and growing population, empowering the private sector to become the engine of growth through job creation and exports and, finally, ensuring this sector’s willing cooperation in the process of Saudization through replacing foreign workers with Saudis.

The country also has to deal with the consequences of its imminent World Trade Organization (WTO) entry and the challenges and opportunities of globalization. The Kingdom must set up the necessary
regulatory frameworks for an expanded financial and capital market, as well as overseeing the switch from a public sector-driven delivery base to one dominated by the private sector, in line with plans to privatize government corporations.

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 and with a knowledge-based economy. The country also seeks to meet the 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 One and Two. Chapter One 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 large numbers 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 One 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.

Chapter Two assesses the Saudi budgetary framework and the urgent long-term need for a wider revenue base diversification. This will help the Kingdom move away from an inherent fiscal deficit situation and ballooning internal debt – currently standing at around 90% of GDP although the government has signalled its strong intent to reduce this debt in the 2004/2005 budget. 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 twenty 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.
Overview

The financial sector

We explore our second major theme in Chapters Four, Five and Six, as we examine the evolving, and, in some respects, mature financial sector of Saudi Arabia. Chapter Four also analyzes 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, as well as ensuring that today the Saudi banking system 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. Chapter Four explores the growing sophistication of the SAMA’s use of repos and reverse repos as proxy monetary instruments, as well as SAMA’s management of the national debt. It also considers the rationale of SAMA’s fixed exchange rate policy for the Saudi Riyal and the Kingdom’s money supply creation process.

Chapter Five further develops this theme and examines the broader financial markets that have evolved in the Kingdom, especially in the commercial banking sector. This sector is comprised of a mix of wholly-owned “pure” Saudi banks, joint-venture Saudi-ized banks, the newly-approved foreign banks and other financial sector players, such as the money exchangers and 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 Five 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 Six, which analyzes the Saudi Capital Market through a discussion of the evolution of the domestic capital markets, the operating regulatory framework and various obstacles. This is followed by an assessment of the new Capital
Market Law and future prospects for the capital market. We explore the issues of ownership concentration and of 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 analyzes 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. The Saudi government debt market’s structure is closely examined, as well as the future evolution of the Saudi Capital Markets in the face of ongoing liberalization and privatization. We provide some estimates for new company listings on the Saudi capital markets; these estimates indicate that an additional entry of 137 new companies would almost double current market capitalization, to take it to around the SR 890 billion levels.

The heart of the Kingdom: The hydrocarbon sector

The third theme of the book revolves around both 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 Seven 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) is examined, as well as the obstacles they face and how the government is trying to overcome these obstacles (given the importance of the SMEs to Saudi Arabia’s goal of job generation and regional economic diversification). Chapter Seven also explores the role of the Saudi family businesses and their structures, and advocates for some changes to family businesses to enable them to meet the future challenges of globalization and the situation after Saudi entry to the WTO.

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 2004 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.
The chapter further explores the development over time of the complex and evolving business relationship between the Saudi government and the private sector. We look at the government's role as planner, as financing entity, as buyer and seller, as regulator and as 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 that meets market needs at competitive wage levels, and that the government needs to embark on a more aggressive control mechanism of foreign labour supply to the private sector in order to force Saudi employment.

Chapter Eight discusses the oil and gas sectors and explores the opportunities that lay 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 is highlighted. This chapter also thoroughly examines Saudi oil policy and its constraints. The record oil prices experienced during 2004, with oil prices exceeding $50 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 the world's largest natural gas liquid (NGL) exporter.

Chapter Eight also looks at the Saudi petrochemical industry, particularly as it could be the major beneficiary of WTO entry. Today the Saudi Arabian Basic Industry (SABIC) is a significant player in the world's petrochemical markets, planning 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 twenty years' time, literally created out of the desert. Chapter Eight 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 rank Saudi Arabia amongst one of the leading mining countries of the world.

The planned privatization of the Saudi Mining Company (Maaden) will involve the restructure of the company into separate units of 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 Eight presents a new model of mining cooperation with foreign companies that will assist in taking 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 2004.

Foreign trade and technology transfer

Chapters Nine and Ten deal with the next theme, Saudi Arabia’s foreign trade, along with the issue of technology transfer through the use of economic “offset programmes” used to enhance the economy’s base and generate new high technology enterprises.

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 the major trading partner of the future.

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 private capital outflows. Since 2002, Saudi banks have reported some capital repatriation to the Kingdom due to a rising Saudi stock market and a booming real estate sector, in addition to Initial Public Offerings (IPO) and privatization opportunities.

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. Inter-Gulf Cooperation Council (GCC) trade still plays a small part. Saudi Arabia is a net GCC importer, especially from Dubai and Bahrain which re-export to the larger Saudi market.

The transfer of appropriate technology to the Kingdom has always been of major importance, either through Foreign Direct Investment (FDI), joint ventures or through the Saudi Economic Offset Program. Chapter Ten examines the rationale behind the offset programme. When it was initiated in the mid-1980s, it was the first of its kind in the Middle East. Saudi Arabia
sought to obtain benefits from foreign contractors through transferring technology and training local labour. Our analysis reveals mixed success for the current offset programmes, especially in terms of employment generated, but notes that offset companies in general did transfer higher levels of "technology packaging" than did non-offset private sector joint venture companies. Chapter Ten highlights the need for continued reforms of educational institutions in order to produce Saudis with the necessary scientific and technological skills to benefit from such offset ventures. There is also a need to develop a culture of research and development within the private sector.

Meeting future challenges

The final theme involves analyzing 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 transformation 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 to set objectives while minimizing the negative consequences to society at large.

Under this broad theme, Chapter Eleven examines the Kingdom's hopes and aspirations for Foreign Direct Investment the strategic option for liberalization and privatization, and looks at the potential benefits and costs of globalization and WTO entry. 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. Another positive development involves the enhancements of the Foreign Investment Law that offer a number of benefits, including a recent reduction in taxation levels to 20% on foreign companies' profits.

It is the globalization issue that remains unresolved to date. Saudi Arabia's entry to the WTO is only a matter of time, and the Kingdom is using the period before entry to liberalize certain key sectors, especially in finance and insurance, as well as enforcing intellectual property rights. Chapter Eleven closely examines the impact of globalization on Saudi Arabia's financial structure. While it seems clear that this sector of the
economy will withstand any negative globalization issues, the rest of the private sector needs to adjust more rapidly, especially in terms of company structure and internal efficiencies.

The critical issues of the moment – employment, Saudization and the structure and composition of the Saudi labour market – are dealt with in Chapter Twelve. With nationals accounting for just under 11.5% of the total private sector labour force, or around 640,000 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 program.

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 is necessary to change their mind-set and to accept positions previously deemed to be either too menial or socially unacceptable. This might be a prime reason why, according to press reports, some 150,000 Saudis failed to complete job application formalities for guaranteed jobs identified through regional employment offices over the past four years.

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 2003 and 2004, 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. Even within the Middle East, Saudi’s rate is about 6% compared with a 17% average for the rest of the Middle East.

Saudi female participation tends to be higher for those in the older age group, forcing younger Saudi women to prolong their entry to 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 not only a cause of social problems and of increased unemployment-related crimes, but also of potential loss to national output and productivity. Chapter Twelve calculates the cost of such a potential Saudi output gap. Using Okun’s Law, this was estimated at around SR 327 billion for the period 1993-2002, based on fairly high levels of voluntary (or “natural”) rate of unemployment for Saudi society. If this...
natural rate of unemployment were 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 Twelve.

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 Thirteen, 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 2004 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. During the 2004 academic year, the government directed Saudi universities to curtail enrolment in some non-job or market-related subjects.

Once again, one must put Saudi Arabia’s phenomenal transformation into perspective to assess how far the country has travelled in a short period of time. For the whole period of 1927-1960, the country boasted only seven Ph.D graduates from foreign universities. In 2001-2002 alone, there were 185 Saudi Ph.D graduates from foreign universities, of which 22 were women. The total number of Ph.D graduates from Saudi universities was 154, of which 82 were women. It is a proud achievement for any country, but especially for Saudi Arabia where debate in the late 1950s concerned whether to allow female education at all.

Despite massive investment in education over the past three decades, Saudi Arabia’s real per capita income has fallen considerably from around SR 62,000 in 1981 to SR 32,000 levels in 2002/2003. The population has grown faster than its oil revenues, and labour productivity has not kept pace with private sector market forces. In order to compensate for this oil drag, both labour productivity and educational standards will have to rise significantly faster in the next decade.

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 Fourteen explores Saudi Arabia’s multi-faceted relationship with the other five members of the Gulf
Cooperation Council (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.

Chapter Fourteen 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 by 2010. 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 Fourteen 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.

Saudi Arabia’s economy, size and market potential continue to dwarf all the other GCC countries. The Kingdom has sometimes pursued policies for the greater good of all other member states rather than for narrow self-interest. The next test of leadership will be GCC’s management of the transition towards full monetary union and a single currency by 2010, which requires a greater degree of fiscal and monetary policy harmonization than hitherto.

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 Fifteen 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 markers, 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 if they are to succeed. 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.
Chapter 2

ECONOMIC PLANNING: HISTORY, ROLE AND EFFECTIVENESS

The foundation of every state is the education of its youth.

Diogenes

Learning outcomes

By the end of this section, you should understand:

- The need for planning
- The strategic choices faced
- Trends in planning expenditures
- Evolution of the Saudi economy
- Planning and "engines of growth"

Gazing into the future

Domestic challenges of change amid transformation are not particular to the oil-producing nations of the Gulf. Neither is the concept of planning new in substance, although the degree of emphasis and the direction can be new. Saudi Arabia is today facing challenges more pressing than at any other time in its recent history; these range from demographic structures to structural economic imbalances, from the absence of key economic drivers for growth and employment to the critical importance of the role of the private sector as the "engine of growth."

According to observers, Saudi Arabia has some of the most sophisticated development planning processes of any nation in the developing world (Cordesman, 2003). However, good intentions and good plans do not, on their
own, ensure implementation. As will be discussed, Saudi leaders have indeed set what seemed to be the right priorities for the nation, but sometimes events, both domestic and international, have overtaken their planning exercise, throwing good intentions off-balance. It takes foresight and determination to switch directions and persevere to bring about changes over time.

**Why the need to plan?**

It is often said that “the best government is the most invisible government.” This means that “best” governments are those that establish regulatory and legal frameworks and then allow the competitive pressure of free market forces to determine the optimum allocation of resources needed by society. There are those who would argue that this is a utopian luxury that governments in the modern world aspire to, but few achieve in reality. The real world has witnessed a degree of planning and government control, ranging from central planning to what is termed mixed economies, where the government and private sector work together in partnership. Irrespective of which model of planning is adopted, the central goal seems to be the laying of a broad economic foundation for self-sustaining growth with one or more key factors of production (land, labour, capital or managerial efficiency) creating the precondition for self-sustained growth (Rostow, 1960).

Saudi Arabia’s economic development path has sometimes been characterized as one of a classical “rentier” economy (Chaudhry, 1989, 1997, Auty, 2001). In this model, the government seeks to maximize its revenue from a natural resource – oil – and distribute the proceeds amongst various sections of the population. Some distinguish between a “rentier” economy and a re-distributive “welfare state” that derives its income through taxation and other means from one class of society and distributes it to other sections of society (Chaudhry, 1989).

Since Saudi Arabia currently does not impose taxes on its citizens, the term “welfare state” is not technically correct for the Kingdom. The concept of “rentier economy” is a more accurate characterization of the early years of Saudi Arabia’s economic development. According to some observers, an alliance developed between the State and certain business groups in the private sector that aimed to promote the national agenda at the expense of some excluded groups (Wilson, 2004, Champion, 2003).

During the early boom period of the Saudi economy in the 1970s and early 1980s, the large inflows of oil “rents” to the State created a momentum of its own, in which it seemed that the State’s only function was that of a distributive agent and that the government sector became the exclusive motor of the economy (Chaudhry, 1977). The lack of administrative, educational, managerial and physical infrastructure led to absorptive capacity bottlenecks
in those early boom days, with investment decisions being taken that had far-reaching consequences for the future (Mallakh, 1982).

The basic argument against "rentier economies" is that when a state's main source of private revenues is through government expenditures, the society thus supported does not instil a sense of initiative or entrepreneurship amongst its citizens. However, a state that is supported by society through one form of taxation or another will develop a more balanced relationship with its citizens, with both parties responding to the needs of the other (Ehteshami, 2003).

One further effect of the "rentier economy" was the emergence of powerful state bureaucracies which "orchestrated the States' development" (Ehteshami, 2003). The effect was to perpetuate the preference for government jobs in Saudi Arabia, which we shall examine in later chapters, at the expense of the private sector, since bureaucracy viewed the private sector in a subservient relationship instead of as a dominant force. This relationship between the government and private sector affected the "institutional capacity to deliver" (Wilson, 2004). Surveys of attitudes of senior civil servants carried out in Saudi Arabia in the early 1980s showed deficiencies in "psychological drive, flexibility, communication, client relations and impartiality" (Hegelan and Palmer, 1999). According to some observers, there is little evidence that much has changed since those early days (Wilson, 2004).

The above arguments and counter-arguments are easy to discuss in hindsight. The reality of the matter is that Saudi Arabia opted for an operating planning framework to guide the national economy long before higher oil prices propelled Saudi Arabia to the forefront of world economic headlines in 1973/1974. The First Plan covered the period 1970 - 1974. By the time the First Plan period had ended, the Saudi economy was fundamentally transformed, as will become evident later in this chapter when we analyze the structure of the national economy.

**Strategic choices**

In the early 1970s, the Saudi government along with its key planners and consultants grappled with strategic decisions on the direction the economy should be steered. It was not an easy task, given the lack of planning experience, absence of data on the economy and raised expectations of Saudi nationals. Table 2.1 examines some of the strategic development options that were faced by Saudi planners and their potential positive and negative implications.

Each of the options set out in Table 2.1 has appealing positive factors, and these positive factors would have been paramount in the planning discussions – rather than the negative consequences. The country was in a rush to develop rapidly. There were few lengthy discussions or in-depth analysis of potential
negative consequences of one strategic development objective or another (Farsy, 1982), although some commentators did raise early concerns (Bashir, 1977).

Table 2.1 Saudi Arabia: economic development options

<table>
<thead>
<tr>
<th>Development option</th>
<th>Positive Factors</th>
<th>Negative Factors</th>
</tr>
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| Large oil production | • Large foreign investments and surplus financial resources  
• Balance of payment surpluses  
• No incentive to fund crude oil substitutes | • Economic dependency  
• International and domestic inflation  
• Rapid consumption of non-renewable national resources.  
• Rentier economy |
| Oil production based on domestic needs | • Moderate investments abroad leading to paced development and equilibrium between domestic development needs and financial resources.  
• Large oil reserves for future generations | • World oil shortages  
• High international inflation and world recession  
• Strong incentive to find crude oil substitute and suppliers |
| Large scale domestic industrialization and diversification of economic base | • Potential economic independence  
• Skills acquisition and new working habits.  
• Exports potential  
• Technology transfer  
• Education base widened  
• Non-oil economic diversification | • Large imports  
• Need for expatriate labour increased  
• Balance of payments problems with a large element of exported salaries and profits  
• Domestic inflation  
• Institutionalized inefficiency due to subsidy policy (import substitution industry).  
• Mismatch between domestic labour supply output and market requirements. |

From all indications, what has actually transpired from the early 1970s to date is that Saudi Arabia opted for large-scale domestic industrialization and for diversification of the national economic base. The aim was to “transform the economy from overwhelming dependence on the export of crude oil into a diversified industrial economy”, while admitting that dependence on oil revenues will continue for a considerable period of time (Farsy, 1982).
Depending on substantial crude oil production alone was not a long-term strategic choice, for it would have magnified the negative consequences of the "rentier economy" system discussed earlier. It would have meant a more rapid consumption of Saudi Arabia's non-renewable natural resource; the only key decision facing the country would simply have been the rate of oil extraction and the price of oil.

Production of oil based merely on Saudi Arabia's domestic needs would have produced oil shortages, international inflation and world recession, along with a strong incentive to find other suppliers as well as crude oil substitutes. As we will explain in later chapters, Saudi Arabia is cognizant of its key role in world oil supply and has pursued moderating policies in its attempt to ease oil supply shortages. The most recent example was the Kingdom's decision in September, 2004, to increase its production from 8.3 million barrels to over 11 million barrels per day – virtually its full capacity – in order to ease soaring prices of over $50 dollar a barrel, compared with a Organization of Petroleum Exporting Countries (OPEC) price band range of $22 to $28 a barrel.

Adopting the large-scale industrialization and diversification option seemed then, on the surface, to have been the most viable option, with significant discernible advantages. The negative factors that have crept into this strategy over time are now causing the most concern. As will be discussed later, issues of mismatch between domestic labour supply and market needs, the continuing strain on balance of payments due to large expatriate labour remittances, institutionalized inefficiencies and, despite diversification, continuing reliance on oil and oil derivative exports are features of the Saudi economy today. Most of these problems are inherited from the earlier development plans. The section that follows discusses the planning process in more depth.

The history of Saudi planning

Saudi Arabia has undergone a substantial and fundamental transformation over the past three decades since planning was first introduced in 1970. The history of development planning has also seen some radical changes, from directive to indicative planning. Those who were involved in the First Plan admitted that, in essence, the First Plan of 1970 - 1974 was essentially "an exploration, theoretical and empirical", and that the biggest achievement was "the experience gained by Saudis in the field of development planning" (Farsi, 1982). Others are more critical of the whole planning exercise, arguing that the development plans demonstrated good intentions, but did not pave the road to major progress (Cordesman, 2003).

There are those who argue that Saudi Arabian planning has been more "a macroeconomic exercise than a form of detailed microeconomic management" (Wilson, 2004). The argument is that Saudi planning involves designing public expenditure programmes in the light of anticipated revenues and then
executing these expenditures. If revenues are actually achieved, then all is well: projects are implemented and delayed projects restarted. Conversely, if anticipated revenues do not materialize, then the opposite happens: ongoing projects are delayed and new ones suspended.

Planning, however, can be carried out under various models and circumstances, ranging from setting targets for the economy as a whole and providing direction on how resources will be invested, to establishing targets for input resources and the desired output. The Saudi model has not established precise qualitative output targets, but rather quantitative output targets. Planning can also follow an indicative direction on how and where the government wishes the economy to go, providing the necessary rules and regulations to allow the private sector to achieve those directions (Osama, 1987).

Planning exercises do not operate in a vacuum and it is important to analyse the administrative structure under which Saudi planning is carried out. The first planning exercises, in the late 1950s and early 1960s, depended heavily on external bodies and consultants such as the Ford Foundation, the United Nations Team for Social and Economic Planning and the World Bank. In 1961 a Planning Board was established in Saudi Arabia and in 1965 it was incorporated into the Central Planning Organization (CPO), which drafted the Kingdom’s First Five Year Plan in 1969.

In 1975 the CPO became the Ministry of Planning (MOP), reflecting the importance national planning was being assigned, although some argue that the Ministry of Planning in effect took a back seat to the actual implementation policies undertaken by the more powerful spending Ministries such as Commerce, Industry and Electricity (Wilson, 2004). One factor could have been the lack of interaction between the Ministry of Planning and the Saudi public in initiating and formulating plan objectives. It is most likely that in an attempt to try and overcome this gulf between planners and those whose lives are being most affected, the Ministry of Planning function and role was increased when it was given the extra portfolio of “National Economy.” It is now known as the Ministry of Planning and National Economy, following the Saudi Cabinet reshuffle of April, 2003 (Saudi Press Agency, 1 May 2003). The importance of planning had come full circle. The Ministry’s added responsibility underscores the importance of some of the urgent economic tasks that need addressing in the new millennium. A new bolder vision is needed in Saudi Arabia today, one which is comparable to some of the early initiatives taken, raising whole industrial infrastructures out of the desert, to become the world’s most modern petrochemical complexes, as embodied by today’s industrial cities of Jubail and Yanbu.

To reinforce the importance of involving Saudi Arabia’s key decision makers in the planning and implementation process, the Supreme Economic
Council was established in August, 1999, which included Crown Prince Abdullah as Chairman, Second Deputy Premier Prince Sultan as Vice Chairman and the Ministers of Finance, Planning and Economy, Commerce, Labour, Petroleum and Industry as well as the Governor of the Saudi Arabian Monetary Agency (SAMA). The critical role of planning could not have had better support, compared to those earlier days.

Plan achievements

Actual expenditures made by the Saudi government over the whole planning period from 1970 to date have been impressive, standing at around SR 2,613 billion or $697 billion. This is set out in more detail in Table 2.2 for each planning period, organized by broad expenditure categories.

From Table 2.2, it becomes evident how closely government expenditure patterns follow the fortunes of the Kingdom’s oil revenues, with the current Seventh Development Plan (2000 - 2004) not reaching the peak “boom years” of the Third Development Plan period (1980 - 1984).

It is even more important to analyse the different emphases placed during each planning period, reflecting national priorities. This is set out in Table 2.3, which captures key “planning indicators” for each plan. It demonstrates that the planning focus has shifted towards allocative efficiency, human skill upgrading and private sector participation in economic diversification. The principal underlying themes of all plans continue to emphasize raising the standard of living of the people, improving general quality of life and enhancing their skill capabilities.

The importance of safeguarding Islamic values, cultural heritage and traditions continues to be emphasized at the outset of each plan. The intention was to promote economic development, but not “Westernization” - something which other traditional societies undergoing rapid development have found difficult to avoid. The Internet revolution makes maintaining a social status quo even harder, and Saudi society is no exception (Yamani, 1998, 2000, Rasheed, 2002). The recent advances made by Internet and global communication have broken down barriers; the IT revolution is one that few Saudi planners can ignore in the future. The impact of this flow of information has been researched in other Arab societies with social customs and traditions similar to that of Saudi Arabia; IT access has had a profound societal shaping effect (Masmoudi, 1998, Azzam, 2002).