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Middle East Economy

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# The Saudi Predicament: Low Oil Prices and Strategic Threats

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The fall in oil prices since 2014 has dramatically reduced the oil revenues of the Gulf Cooperation Council (GCC) member states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates - UAE). The prospects for oil prices have also changed. Until 2014, many forecasted rising prices over the medium term, but since then there has been much more caution. The removal of sanctions on Iran means that there will be more Middle East supply on the market; the United States' oil production is increasing and Chinese demand for oil has slowed. International environmental concerns are also leading to forecasts of lower demand for oil, gas, and coal. President Obama's rejection of the Keystone pipeline project is the latest example of this (See also: *Iqtisadi*, October 2015: "Climate Change Has Happened: The Middle East's Climate Crisis").

Table 1 shows the decline in oil revenues in the four largest GCC states between 2010 and 2014. Using IMF data for Saudi Arabia and OPEC data from January for the other states, plus an extrapolation for 2015, the table suggests that between their peak in 2012 and 2015 oil revenues fell by 33 percent. Saudi Arabian oil revenues fell 4.7 percent in 2013, 11.5 percent in 2014, and will fall by an estimated 35 percent in 2015. In October 2015, the International Monetary Fund (IMF) stated that lower oil prices would lead governments to slow public spending throughout the Gulf. This means that by 2020, when some 10 million people are expected to enter the labor force in the oil exporting countries, cash-strapped governments will have limited room to create public sector jobs.

Table 1

Gulf Oil Revenues, 2010-2015 ($ billions)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Saudi Arabia | 215 | 318 | 338 | 322 | 285 | 184 |
| Kuwait | 62 | 97 | 113 | 109 | 98 | 84 |
| Qatar | 43 | 63 | 65 | 63 | 57 | 36 |
| UAE | 75 | 112 | 120 | 123 | 107 | 48 |
| Total | 395 | 590 | 636 | 617 | 547 | 352 |

Sources: Saudi Arabia: IMF. Other countries: 2010-2014 OPEC and 2015 extrapolation based on EIA

What have been the effects of the fall in oil prices on Saudi Arabia? In January 2015, the succession of King Salman, following the death of King ʿAbdullah, led to a large increase in government spending. Between January and April 2015, bonuses for government employees, students, pensioners, and others were raised by a total of $27 billion, or 4.2 percent of GDP. Traditionally these allocations were made by kings on their accession to power, but what was so significant this time was the scale of the allocations, which were made during a period when revenues fell from 45 percent of GDP in 2012 to an estimated 30 percent in 2015.

Fiscal problems have been exacerbated by very large spending on defense and internal security. These expenditures have risen rapidly in recent years. The nominal amounts allocated and the real amounts (removing the effects of inflation) are provided in Table 2. Between 2000 and 2014, spending in current dollars quadrupled and in real terms it rose almost 2.7-fold.

Table 2

Defense and Security Expenditures, 2000-2014 ($ billions)

| | Current prices | Constant 2011 prices and exchange rates |
|---|---|---|
| 2000 | 20.0 | 27.6 |
| 2005 | 25.4 | 34.8 |
| 2010 | 45.2 | 47.9 |
| 2014 | 80.8 | 73.7 |

Source: Stockholm International Peace Research Institute.

Saudi Arabia spent a higher share of its budget on defense – almost 26 percent in 2014 – than any other country in the Middle East, and the region has the highest defense spending in the world. The share of Saudi national income spent on defense – just over 10 percent in 2014 – was also the highest in the world.

High levels of defense and internal security spending are explained by the threats felt by the leadership. These have been numerous. The outbreak of the Arab Spring at the end of 2010 in Tunisia and then in Egypt, Libya, Bahrain, Yemen, and Syria led to the February 2011 announcement of large-scale benefits for lower and middle income Saudi citizens. These measures included a 15 percent increase in state employee salaries as well as the provision of unemployment benefits and housing loans. In March 2011, the king promised more cash gifts and ordered the construction of 500,000 low-income housing units. Estimates of the total costs of the social welfare programs introduced after the outbreak of the Arab Spring ranged from $93 billion to $130 billion. In that month, March 2011, Saudi Arabia also sent one thousand troops as part of a joint GCC Peninsula Shield force to neighboring Bahrain to put down an uprising against the ruling Sunni Al Khalifa family by the Shiʿi majority.

The intensification of terrorism in Iraq and the emergence of the Islamic State organization pose a threat to the stability of the Middle East. This is in addition to the threats posed by Iran, with or without nuclear weapons. To the south, the Horn of Africa remains unstable and conflicts continued in Syria, Libya, and Sudan. Finally, in 2015, the intensification of the conflict in Yemen led to a Saudi military intervention in support of President ʿAbd Rabbuh Mansur Hadi.

In September 2015, the International Monetary Fund (IMF) noted that real GDP growth in Saudi Arabia is projected to slow to 2.8 percent in 2015 and to 2.4 percent in 2016, as government spending begins to adjust to lower oil prices. This compares with annual average growth between 2010 and 2014 of 5.3 percent. Over the medium-term, growth is expected to be around three percent. The decline in oil prices is resulting in substantially lower export and fiscal revenues. The central government's fiscal balance has deteriorated sharply as a result of falling revenues and rising spending from an annual average surplus of 10.2 of GDP between 2008 and 2012 to 5.8 percent in 2013 and to a projected deficit of 19.5 percent of GDP in 2015. While the deficit will decline slightly in 2016 and beyond as one-off spending ends and large investment projects are completed, it will remain high over the medium-term. The emergence of a budget deficit has already led to increased sales of bonds in the kingdom and will result in the draw-down of foreign currency assets accumulated during the years of high oil prices. This will, in turn, reduce Saudi Arabia's ability to maneuver in the Middle East where it is spending large amounts on the war in Yemen, supplying rebels in Syria, and providing aid to Egypt to support its economy.

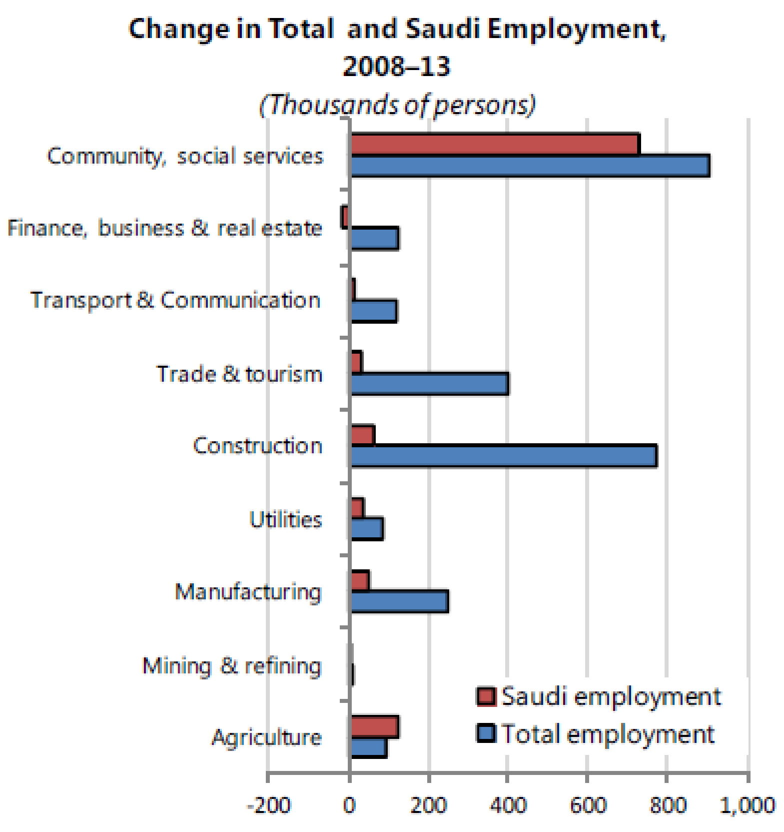
The current account surplus of the balance of payments declined to 10.9 percent of GDP in 2014. It is expected to move into deficit in 2015 but return to surplus between 2016 and 2020. Deposit inflows to banks and private credit growth have slowed in recent months. Nonetheless, the banking system is well positioned to cope with lower oil prices and slower economic growth.

Underlying these financial problems lie deeper structural ones. Although the Saudi government has tried to diversify the economy, in terms of employment it has had little success. Since 2008, over 2.7 million new jobs have been created of which one million were filled by Saudi citizens. In construction, 800,000 new jobs were added, while in the services sector, the number of workers increased by 1.5 million, mainly in social and community services, trade, and tourism. The one million new jobs (37 percent) that went to Saudi nationals were concentrated in the administrative, educational, and health sectors (social and community services), which are largely part of the public sector (See Chart 1 below).

According to the Saudi Central Department of Statistics and Information, in 2014 the total population was estimated at 30.8 million, of whom Saudi citizens constituted 20.7 million. In that year, the total population grew by 2.55 percent a year and the Saudi population by 2.1 percent. The fact that the number of foreign residents increased faster than that of Saudi nationals was an indication that the "Saudization" policy has not worked.

Nearly 50 percent of the population is aged up to 24 years and that group is growing by about five percent or over 500,000 a year. This presents the enormous challenge of creating jobs for young people coming onto the labor market, just to prevent unemployment from rising. Unemployment, especially among the young, was a major factor behind the outbreak of the Arab Spring and represents a continuing threat to stability in Saudi Arabia.

Chart 1

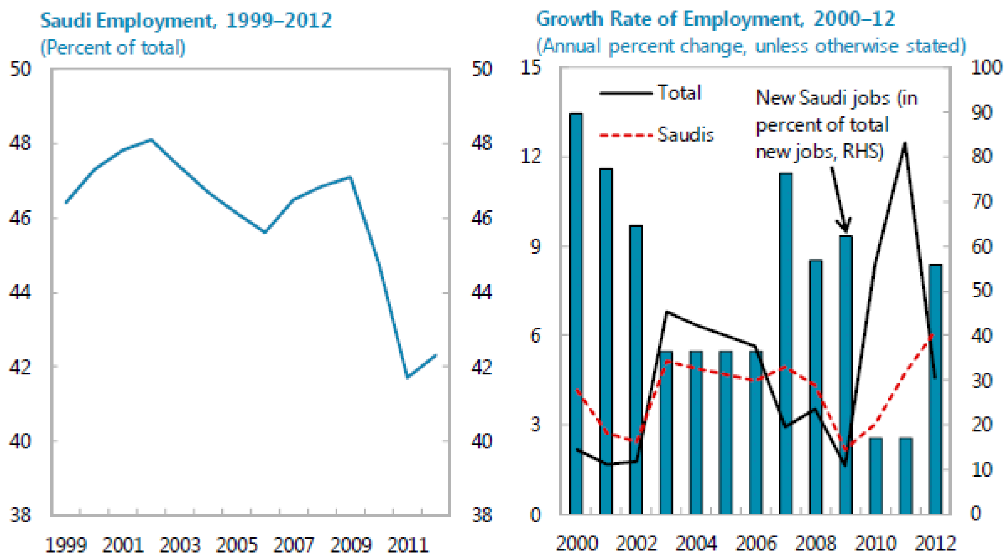


Source: International Monetary Fund (IMF)

In 2014, unemployment was estimated at 11.7 percent. This is almost entirely unemployment of Saudis: foreign workers who lose their jobs leave the country. Unemployment among males was six percent while among females it was 33 percent. High female unemployment persists despite the fact that most Saudi women are not looking for jobs and do not participate in the labor force. The unemployment rate among young people in Saudi Arabia was 40 percent in 2014, which is an extraordinarily high rate and similar to that in Tunisia, a country that has no oil. This is perhaps the most serious socio-economic problem that Saudi Arabia faces.

Chart 2 shows the dynamics of the problem. Between 2000 and 2010, Saudi citizens accounted for a falling share of the labor force. Since then, as a result of changes in policy, more jobs have been created for and taken by Saudis, but this has not increased their share of jobs back to 2000 levels. Even then, Saudis accounted for less than half of total employment. This is due to low participation rates for women, as well as the fact that many Saudi graduates have unsuitable skills and many do not want to work in industry or even in the private sector.

Chart 2




Sources: CDSI; Manpower Research Bulletin; and IMF staff calculations.

The solution is to restructure the growth process. According to the IMF, the short-run the main determinants of economic growth are private domestic investment, openness to trade, public investment, spending on health care and education. Long-term growth relies on private domestic investment, capital expenditures, and spending on health care and human capital. Despite rising public spending over many years, unemployment has remained high. The problem has been the composition of government spending, rather than its volume, and how it could be altered to encourage private-sector-led growth and reduce unemployment. The solutions have been known for years but have either not been implemented or implemented only partially and slowly. Partial and slow implementation against the background of Saudi Arabia's demographic growth has meant that unemployment has increased with socio-economic and political consequences.

Why has diversification not happened? Adeel Malik provides a convincing answer. Although Arab governments have long recognized the need to move away from an excessive reliance on hydrocarbons, they have had little success in doing so. In Saudi Arabia and other Gulf states diversification has been a central, yet largely unrealized, development goal since the 1970s. The reason is that in many Arab countries, good economic policies rarely constitute good politics, especially for the ruling elites. This is because the structural changes demanded by economic diversification—specifically, the production of a greater number and variety of high-value goods through the promotion of manufacturing industry—would enhance the role of business constituencies that, enriched with new income, could potentially challenge the rulers. The Gulf Arab states lack three ingredients that have encouraged economic diversification elsewhere: varied economic constituencies, strong political coalitions, and beneficial neighborhood effects. At independence, they did not inherit economic constituencies that could have gained strong political roles; instead, economic activity remained dominated by royal families and those close to them. The discovery of oil compounded the problem, enabling rulers to co-opt the merchant class with state contracts and other forms of patronage. Pervasive conflict in the region further undermined the prospects of private production by disrupting market linkages among states.

The vested interest in stability is so strong that the government is willing to accept the risks posed by high youth unemployment. As so often in the Middle East, politics dominates economics and longer-term interests are sacrificed to short-term needs.

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