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Saudi Arabia's Plans for Change: Are they feasible?

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In 1970, Saudi oil export revenues came to $2.2 billion and the population was 5.8 million. By 1973, oil revenues had almost doubled, but that was a modest increase compared with what was to follow. In 1974, they reached $35 billion and in 1980, they came to $108 billion! The population continued to grow and when, in 1984, oil revenues plummeted to $26 billion, it had reached 13.4 million. The rapid growth of oil income presented huge opportunities and challenges to the Kingdom, but its freedom of maneuver has declined as both the population and its dependence on oil has increased. The population is now estimated at 32.3 million, increasing by 2.2 percent annually thus adding 1.5 million to the population every two years. Unemployment among young males is over 22 percent and among young females, the rate is almost 56 percent. The United Nations forecasts that by 2030, the population will reach 39 million. This edition of Iqtisadi shows how the recent decline in oil revenue – from $330 billion in 2012 to a forecast $115-130 billion in 2016 – has led to radical policy changes and assesses the prospects for their implementation.

In April 2016, the Deputy Crown Prince of Saudi Arabia and Chairman of the Council for Economic and Development Affairs, Mohammed bin Salman announced plans designed to reduce the country's reliance on oil and diversify the economy. A stake in the state-owned oil company will be floated in an IPO within the next two years. The funds from that and other asset sales up to $2 trillion or more — will be invested in a new sovereign wealth fund to provide the country with a regular investment income from non-oil sources.

The country will be opened up to tourism. Foreigners will be allowed to own property in Saudi Arabia. New small and medium-sized enterprises will be encouraged to the point where they account for 35 percent of economic activity. Subsidies for oil, water, and electricity will be progressively eliminated. Unemployment will be reduced to 7 percent. A range of new industrial sectors will be developed, including petrochemicals, manufacturing, and finance based on foreign investment.

Saudi Arabia, which is highly dependent on oil income, is in danger of instability or even collapse when the world oil price decreases. In 2015, the IMF reported that "Oil revenues account for around 90 percent of central government fiscal revenues and around 85 percent of export revenues, while the oil sector comprises over 40 percent of overall GDP. Further, activity in the non-oil sector is correlated with oil prices through government spending. The importance of oil revenues to the economy has changed little over the past decade. Yet despite its importance in terms of income, exports, and government revenues, the oil sector provides less than five percent of total employment.

This is illustrated in Charts 1 and 2 that show the correlation between oil income and economic growth in the periods 1996-2001 and 2006-2011 respectively.

Chart 1

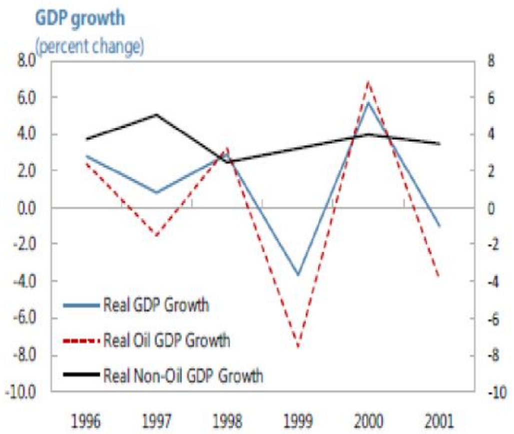
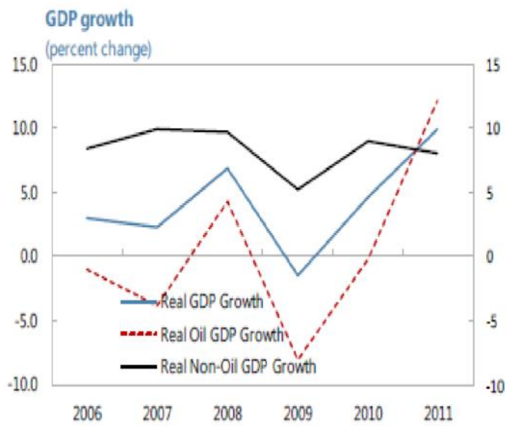


Chart 2



Source: IMF

In May 2016, Moody's Investors Service downgraded the government of Saudi Arabia's long-term issuer ratings to A1 from Aa3 but indicated that the outlook is stable. This reflected Moody's view that lower oil prices have led to a deterioration of the country's credit profile. A combination of lower growth, higher debt levels, and smaller domestic and external buffers leaves the Kingdom less well positioned to cope with future shocks.

While the government has ambitious and comprehensive plans to diversify its economic and fiscal base, these plans are at an early stage of development and their impact remains uncertain.

Along with recent reports by the IMF and others, the McKinsey and Company report, *Saudi Arabia Beyond Oil*, commissioned by the government, argued that the economy could no longer base its growth on oil revenues and public spending. The decrease in the price of oil and demographic changes require that the economy become diversified. The report outlines three pillars that are necessary for the diversification of the non-oil economy: increased labor productivity, a stronger business environment, and sustainable fiscal management. Increased labor market productivity will be achieved through increasing labor market participation (especially of women and youth), improving education and training, improving the flexibility and mobility of the labor market for foreign workers, decreasing the growth in public-sector employment, and increasing the cost of hiring foreign labor. A stronger private sector will develop through the improvement of the business environment, removing limitations to competition, investment in infrastructure, professionalizing management practices, and attracting foreign and local investment. Fiscal management will be transformed by controlling the financing of government deficits, gradually decreasing the role of government investment, increasing non-oil revenues, reforming energy market prices, and improving the returns from state-owned assets.

In 2015, GDP in current prices fell by 13.3 percent, and Moody's forecasts a 5 percent decline in 2016 due to fiscal consolidation in the form of streamlined government spending. Government finances have significantly deteriorated. According to Moody's, the government had a deficit of 14.9 percent of GDP in 2015, following a deficit of 2.3 percent in 2014, and it expects a similarly sized deficit this year. Although the fiscal balance will improve gradually over the coming four years, Moody's expects an average deficit of 9.5 percent of GDP between 2016 and 2020, requiring cumulative financing of $324 billion, which is equal to almost 50 percent of estimated nominal GDP in 2015. It is not clear how this financing need will be met: while Saudi Arabia's had a low levels of government debt (5.8% of GDP in 2015), no medium-term funding strategy has yet been announced.

Saudi Arabia's cash reserves will continue to erode. Following a peak of $731 billion in August 2014, foreign exchange reserves have fell by almost $155 billion to $576 billion in March 2016. The decline in the price of oil has led to a deterioration of Saudi Arabia's balance-of-payment current account balance. This worsened from a surplus of 9.8 percent of GDP in 2014 to a deficit of 8.2 percent of GDP in 2015. Moody's expects the balance-of-payments deficit to reach almost 12 percent of GDP this year, and projects foreign exchange reserves to be approximately $460 billion by 2019.

The new plan includes proposals to sell up to 5 percent of the state-owned oil company, Saudi Aramco and transfer its ownership to the Saudi sovereign-wealth fund, The Public Investment Fund (PIF), so it can increase non-oil investments abroad. The PIF would then dwarf Norway's pension fund, which is currently the world's largest sovereign wealth fund, with assets of nearly $850 billion. Prince Mohammed bin Salman estimated that the Saudi fund could reach nearly $3 trillion and said that the government aims to diversify revenues through privatization in health care and education. He also proposed expanding the country's manufacturing base and investing in alternative energy sources. Taxes on luxury items, such as tobacco and soft drinks will also be introduced. At the end of 2015, fuel, water, and electricity prices were increased and a 5 percent value added tax was announced.

The McKinsey report suggested eight sectors that would contribute to the shift from an oil-based, publicly funded economy to a market based system: mining and metals, petrochemicals, manufacturing, retail and wholesale trade, tourism, healthcare, finance and construction.

Economic growth has decelerated sharply from an average annual rate of 5.5 percent in 2009-2011, to an average of 3.9 percent in 2012-2014. The World Bank projects that in 2016, growth will decline to 2.4 percent. In the face of growing volatility in the oil market, a number of suggestions have been made about how to strengthen and diversify the Saudi economy. An IMF Staff Discussion note, *Economic Diversification in the GCC: Past, Present, and Future,* published in September 2014, outlined policies that have been implemented, or partially implemented, in the GCC with the goal of diversifying the economy in the face of lower oil prices. These include the development of a stronger business climate, achieving greater educational enrollment, increasing trade and foreign direct investment (FDI), supporting a stronger financial sector and a low-inflation environment, and investing in infrastructure and a stronger legal and regulatory structure. Empirically, these attempts have been shown to have some impact, however not all have been successful.

The IMF suggests that the “missing link” lies in the incentive structure for both firms and workers in the GCC. The scale and distribution of public spending has encouraged the production of "non-tradables" (goods and services that are not traded internationally) and workers face a set of incentives that attract them to low-productivity work due to the availability of well-paid public jobs.

Three measures would strengthen the incentives for and ability of workers to enter the private sector. The first is that government employment should be limited by eliminating non-essential positions as they become vacant. Second, there should be an increase in social safety nets that would support the search for private sector employment and guarantee a minimum income level. Finally, the education system should be improved to provide workers with the skills they need for the private sector.

The IMF has also highlighted difficulties in the labor market. Although the current model has contributed to improvements in living standards, it comes at a large cost, and is not sustainable due to the growing working-age population. It therefore recommends creating high-paying private sector jobs for nationals, diversifying the economy to allow for non-oil growth, limiting the growth of the number of public-sector jobs, attracting high-productivity rather than low-skilled foreign workers, improving the quality and the quantity of education.

What are the prospects for implementing the changes envisaged in the government's *National Vision 2030*?

Since 1970, the Saudi government has issued ten national development plans, all of which have called for economic diversification. Despite this, the economy has remained dependent on oil revenues. Among the reasons for the lack of change has been the absence of a plan containing details about how diversification was to be achieved; how the government will support sectors of the economy that are very reliant on oil (such as petrochemicals); and the almost complete dependence of the private sector on the government; and, the lack of specific plans to support the non-oil sectors of the economy.

Some of the steps required to build a diversified economy include: Having an appropriate and measurable development plan that supports the non-oil sectors' contributions to economic development; developing—through regulations and financial support—a strong and independent private sector that does not rely on government spending and projects, and learning from the experiences of similar economies whose national wealth benefited from diversifying their economies. Importantly, since the influence of economic diversification goes beyond sustainable economic growth by fighting corruption, creating jobs, and improving institutional quality, the Saudi government should fully consider economic diversification as a tool for better governance. Finally, additional research can be done on the role of the non-oil sectors (e.g., agriculture, service) that have a competitive advantage in the process of diversifying the economy and creating job opportunities for citizens (Bassam A. Albassam, "Economic diversification in Saudi Arabia: Myth or reality?," *Resources Policy* 44 (2015), 112–117)**.**

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