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Saudi Arabia Enters The 21st Century:

VI. Building True Wealth Versus Over-dependence on Petroleum and the State

Final Review

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If Saudi Arabia is to cope with its political, demographic, and social challenges, it must evolve away from a largely patriarchical, state-driven economy, that is dependent on oil wealth, and create a much more diversified economy that is heavily dependent on its private sector for success. There are no near or mid-term prospects that Saudi Arabia can eliminate a heavy dependence on petroleum or the state sector of its economy, but the time when Saudi Arabia could rely on oil wealth alone is over, and its current over-dependence on the petroleum sector is creating growing economic, political, and military risks. The Kingdom must move to diversify its economy, strengthen its private sector, and encourage foreign and domestic investment as aggressively as possible.

Some Saudis do still act as if the Kingdom's past level of oil wealth should be the eventual norm. In spite of a series of major price shocks since 1986, they still see the oil booms of the mid-1970s and early-1980s as the eventual norm, rather than the "temporary" exception. They regard low to moderate oil prices as an aberration in what they view as a natural long-term movement towards higher prices, and they feel the Kingdom's current economic problems will eventually be solved by the wealth inherent in Saudi Arabia's vast oil reserves. The end result is a view of Saudi economics that assumes that time and oil wealth will eventually solve all problems, that new expenditures will eventually be affordable, and that little discipline is needed to restructure the Saudi economy and Saudi government spending. This view of the future also generally reflects a tacit faith in the state as a planner and manager, although most Saudis who hold this view give lip service to the importance of the private sector and efforts to diversify the economy.

There are other Saudis that have no real vision of the future. They feel the Kingdom should continue to spend largely on the basis of historical momentum, or that maintaining welfare and entitlements spending is more important than economic reform. The impact of this "muddle through" approach to Saudi Arabia's future is reflected in the fact that Saudi Arabia has often maintained higher levels of public spending than its revenues justify. The Kingdom has maintained its spending on domestic and public services, and military forces, at the cost of

budget deficits. It has done so even though the rapid increase in Saudi Arabia's population has meant a steady reduction in its per capita GDP and oil exports, and has imposed growing limits on Saudi Arabia's capacity to spend on subsidies and its social "safety net."

Fortunately, most informed Saudis -- including the Crown Prince and the vast majority of senior princes, technocrats, and businessmen -- understand that Saudi Arabia must make major structural economic reforms. These "modernists" often are as Islamic as every other element of Saudis society, but they are supported by most well educated Saudis and by a generational shift in favor of reform. They realize that Saudi Arabia must cap or reduce its funding of social services and must focus on a pattern of economic development which will ensure that all national groups receive a share of the nation's oil wealth. They recognize that reform must take place within a "safety net" that defuses or reduces social protest. At the same time, they understand that "oil wealth" is as relative as any other form of wealth, and that it is steadily declining in terms of per capita income. They see the need to diversify and privatize the economy, and to create a competitive economic environment dependent on Saudi labor.

The Saudi Economy at the Edge of the 21st Century

There is no way to calculate the precise scale and pace of reform that is needed. As has been discussed in earlier chapters, there are many different estimates of the trends in the Saudi economy and of how they interact with demographic and social pressures, and they differ significantly in portraying the level of the future problems Saudi Arabia faces.[1]

The previous chapters have shown there is no consistency of the trends and pressures within the Saudi economy, even within the US government. For example, the CIA estimates indicate that Saudi Arabia's GDP had a purchasing power equivalent of $173.1 billion in 1994 current dollars, $189.3 billion in 1995, and $205.6 billion in 1996 and $206.5 billion in 1997 and $191 billion in 1999. The CIA estimated per capita income at $10,100 in 1995, $10,600 in 1996, $10,300 in 1997, $9,000 in 1998 and $9,000 in 1999.[2] In contrast, World Bank estimates indicate that Saudi Arabia's GDP had a value of $133 billion in 1995 and $143 billion in 1998, using the Atlas method, and that its per capita income was worth $7,040 in 1995, $7,150 in 1997, and $7,230 in 2000. [3]

Saudi data differ between ministries and have many inconsistencies. There are serious problems in estimating even basic data, like the size of the GNP and per capita income. For example, one Saudi government source reported a GDP of $136 billion for 1996, but did not report a per capita income.[4] The Saudi finance minister used an entirely different definition of GDP in summarizing the Sixth Development Plan. He called for an increase from a GDP of $101.5 billion (380.8 billion Riyals) in 1995 to a GDP of $122.3 billion (458.6 billion Riyals) by 2000.[5] Several years later, the Saudi Finance Ministry reported that Saudi Arabia's GDP totaled $125.1 billion (469 billion Riyals) in 1995, and $136 billion (510 billion Riyals) in 1996 and $145.8 billion (547 billion Riyals) in 1997. [6]

There are also no certainties in forecasting for any country at any time, regardless of the quality of the data. As is the case with most economies, experts, estimates and projections have a long history of being wrong. Data from both Saudi and international institutions, like the World Bank, tend to be over-optimistic in estimating current and future performance. This often gives the impression that problems are actually being solved; when the reality is that the forecaster is picking the most favorable assumptions and trends. At the same time, other outside experts have been predicting critical economic crises for decades, and other international institutions like the IMF have tended to err of the side of pessimism.

Yet, for all of those uncertainties, a number of trends do seem clear. As has been discussed in the previous chapter, the Saudi economy is already under severe demographic pressure. Table 6.1 provides World Bank and Saudi estimates of the trends in the Saudi economy. While virtually every source of such data provides slightly different figures, there is enough consensus between estimates to show that the estimates in Table 6.1 are typical in showing the over-dependence of the Saudi GDP and budget on petroleum revenues, the lack of diversification in the Saudi economy, and the existence of chronic budget deficits.

Virtually all of the data available also indicate that Saudi Arabia still has time in which to act, and the data in Table 6.1 reflect a number of positive trends. The Kingdom has kept inflation low, has limited its budget deficits, has preserved a positive trade balance, and has managed significant capital formation except in years when oil revenues were exceptionally low. As might be expected from the previous chapters, the macroeconomic data in Table 6.1 portray an economy under growing stress, but not one in crisis.

Table 6.1

Recent Trends in the Saudi Economy

(Costs in Billions of Current Saudi Riyals Unless Otherwise Stated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP (Purchaser's Values	392.0	442.0	461.4	443.8	450.0	478.7	529.3	548.4	481.2	535.0	649.3
Real GDP (1994 constant prices)											
(% Change)	9.4	10.3	2.0	-0.4	0.5	0.6	1.3	1.6	1.8	-0.9	4.7
Oil	25.5	21.9	7.1	-3.8	0.2	0.5	2.1	-2.4	3.4	-6.4	9.7
Non-oil Private	3.0	2.9	1.9	0.7	0.7	0.0	1.1	3.8	1.1	1.7	3.1
Government	6.3	13.3	-7.2	2.9	0.5	0.6	0.9	3.4	0.5	2.0	1.5
Total Budget Revenues	154.7	161.9	165.4	141.4	129	146.5	179.1	205.5	141.6	147.5	258.0
Petroleum Revenues	118.1	*118.1	127.1	106.0	95.5	105.7	136.0	160.0	80.0	104.5	214.4
Other Revenues	36.6	*36.6	38.3	35.5	33.5	40.8	43.1	45.5	61.6	43.0	43.6
Total Budget Expenditures	476.8	*476.8	232.5	205.5	163.8	173.9	198.1	221.3	190	183.8	225.3.
Budget Deficit	-160.2	*-160.2	-67.2	-64.1	-34.8	-27.4	-19.0	-15.8	-48.5	-36.3	+22.7
Budget Deficit as % of GDP	19.2%	19.2%	14.6%	14.4%	7.7%	5.7%	3.2%	2.6%	8.4%	5.6%	-6.4
Exports	166.3	178.6	188.3	158.8	159.6	187.4	227.4	227.4	145.4	190.1	295.8
Crude Petroleum	123.3	139.8	148.3	119.9	117.2	133.0	163.3	163.0	97.2	136.3	219.5
Petrol. Products	27.0	23.5	25.9	24.7	25.6	30.1	40.0	36.8	24.7	29.9	51.5
Other	16.1	15.3	14.1	14.1	16.8	24.3	24.2	27.7	23.4	21.9	24.8
Imports	90.1	108.9	124.5	105.6	87.4	105.2	104.0	107.6	112.4	105.0	113.2
Unemployment	-	-	-	-	-	-	-	-	-	-	14%
Current Account											
Receipts	212.1	222.1	228.9	194.3	187.2	219.1	257.0	265.0	184.9	232.0	321.0
Disbursements	227.7	325.6	295.4	259.0	226.5	239.1	254.5	263.8	234.1	230.5	267.3
Balance	-15.5	-103.5	-66.4	-64.7	-39.3	-19.9	2.5	1.1	-49.2	1.5	53.7
As % of GDP	-	-	-	-	-8.83	-4.29	0.45	0.21	-10.18	-	-
Government Domestic											
Debt	-	-	-	-	336	384	422	468	566	-	-
As % of GDP	-	-	-	-	76	83	84	87	116	-	-

* Saudi Arabia changed its annual budget cycle in 1991, and reports 1990 and 1991 as one year.

Adapted by Anthony H. Cordesman from material provided by SAMA, and Ministry of Planning, Kingdom of Saudi Arabia: Achievements of the Development Plans 1390-1418 (1970-1998), Facts and Figures, 16th Issue, Riyadh, 1999, and Kingdom of Saudi Arabia, Ministry of Planning, Achievements of the Development Plans 1970-2001, Facts and Figures, Riyadh, Ministry of Planning, 2001; and Brad Bourland, The Saudi Economy: 2000 Performance;2001 Forecast, Riyadh, Saudi American Bank, February 2001.

The Key Challenges the Economic Reform Must Meet

If the good news is that the Kingdom has both the resources and time in which to react to the demographic and social pressures discussed in Chapter V, the bad news is that Saudi economy faces the following additional challenges.

- A wide range of external forces shape the value of the Kingdom's petroleum revenues in ways that Saudi Arabia cannot control. These include normal market forces, and these forces are global because oil is a global commodity. They also include politics and war. This can lead to massive unpredictable swings in oil revenues, although the value of Saudi petroleum exports dropped in absolute terms from the early 1980s to the late 1980s, and total Saudi exports have experienced only limited peaks and growth since that time. As has been shown in Chapter I, and is discussed in more detail in Chapter VI, oil revenues have been erratic, and real oil revenues have not come close to meeting Saudi Arabia's economic and budget needs.

- Saudi Arabia has faced serious problems in planning its budget and five year plans because it has had no way to predict its cash flow. Its petroleum revenues have been highly erratic and its economy and budget are dependent on these revenues. For example, Saudi Arabia put intense pressure on OPEC in late November, 1997 to increase its production quotas, believing that rising demand would give it major increases in revenue without cutting oil prices. The decision turned out to be disastrous. The Asian economy collapsed shortly thereafter, rises in Atlantic production provided alternative sources of oil, and a mild winter caused by El Nino reduced demand outside Asia. The end result was a massive glut, and an "oil crash" resulting in the lowest oil prices in a quarter of a century. Saudi Arabia was forced to cut production back twice in the spring of 1998, and still had no way to plan its estimated revenue for its budget and five year plan, or its investment in future oil and petrochemical production. Within a little more than a year, however, oil prices had risen to $30 a barrel, Saudi oil revenues had raised sharply, and Saudi Arabia was increasing production to bring oil prices back into balance. The end result was a new set of budgeting problems involving overspending and the inability to predict how long high oil prices would last.

- Structural change has slowed sharply over the last fifteen years, and many of the sectoral changes in the Saudi economy are more productive on paper than they are in practice. Saudi Arabia has expanded its private sector to the point where it now generates a nominal 35% of the GNP, but its diversification efforts have had limited productive impact and have not generated the necessary jobs or "knowledge-based" economy, and have taken place largely in the service and construction sectors. The non- petroleum sector accounted for 76.1% of the economy in 1985, and 64.7% in 1990. It was less than 63% from 1991-1999, with no increase during this period (Table 14). The Kingdom has not always succeeded in diversifying the industrial output of its economy in ways that exceed the investment cost of its diversification attempts, and in making increases in real jobs at anything approaching the rate of its population growth.

- The expansion of the Saudi service sector has often had the net impact of increasing Saudi dependence on imports, and reliance on foreign labor.

- Saudi Arabia's productivity remains low. The Kingdom is not competitive and needs to open up its markets to join the World Trade Organization (WTO), and ensure matching access to foreign markets for its exports. Saudi Arabia became an observer at the WTO in 1998, and is seeking to become a full member in 2002. Membership requires the Saudi private industry to become significantly more competitive, and that Saudi Arabia reduces its tariffs and barriers to foreign investment.[7]

- Saudi educational standards remain too low, and fare too many Saudis received secondary and advanced, education in forms of Islamic studies that do not train them for real-world careers or in programs that do not enforce the proper standards.

- Saudi foreign investment income is about half of what it was in the mid-1980s, and increases in payments mean that net income is about one-third of the former level.[8]

- Total Saudi savings and foreign investments have dropped significantly as a result of the end of the oil boom and the cost of the Gulf War, although estimates differ sharply as to how much.

- Saudi government expenditures have normally exceeded revenues for more than a decade. The budget for 2000 -- a year of peak oil revenues – is the only recent exception. The Saudi government has only repaid its foreign debt by borrowing extensively from its banks, and is still is unable to pay all its domestic debts.

It is to the credit of the Saudi government that it has recognized most of these problems and is seeking to address them. Crown Prince Abdullah has warned that a period of austerity lies ahead, and that the "boom period" for Saudi Arabia and other Gulf oil producing countries is over. The Saudi government has accepted the need to sharply reduce state involvement in the economy and increase the role of the private sector—including foreign investment in the economy. It has taken near-term steps to expedite such changes and has included them in its five years plans.

Nevertheless, the Kingdom is still moving slowly, partly because of the fear of job losses for Saudi citizens, and because of resistance within the Saudi bureaucracy, the traditional sections of society, part of the private sector and by some members of the Saudi royal family. [9] Saudi Arabia has been slow to cut government subsidies, and reduce government expenditures. It has been equally slow to create major new incentives for foreign and domestic investment, increase taxes and reform the financial sector.

Tangible Steps Towards Economic Reform

Any analysis of the Kingdom's future and economic challenges must be made in the context of ongoing Saudi efforts at reform. The reform cabinet appointed in 1995 was much more oriented towards the private sector than its predecessor, many of whose members emphasized state controlled projects and central planning.[10] The Saudi Sixth Development Plan called for the private non-oil sector to grow by an annual average of 4.3%, during the period from 1996-2000, and from a value added of 169.5 billion Riyals in 1995 to 209.3 billion Riyals in 2000 -- a cumulative growth of 23%.[11] Total private sector investment was planned to reach 212.7 billion Riyals, 45% of the total of 472 billion Riyals to be invested during the Sixth Development Plan.

While many of these efforts faltered or were poorly executed through the mid-1990s, the "oil crash" in the late 1990s led the government to become more serious about encouraging the

private sector. Crown Prince Abdullah stated that privatization should be a "strategic choice," began to reform government spending, and introduced a series of reform measures.

The Saudi Seventh Development Plan (2000-2004) clearly recognized the need for fundamental economic reform and diversification, although not without many caveats:[12]

> "Although non-oil revenues have increased over the course of previous development plans, such improvements are not yet sufficient. Because of the multiple and interlinked economic and social dimensions of this issue, careful study is needed to develop the best policies. Hence, the Seventh Plan will develop the following policies:
>
> - To reconsider the existing tax system with the aim of upgrading it and improving collection efficiency while avoiding any adverse social impact.
> - To review the rules and regulations concerning the collection of customs duties with the aim of simplifying them, improving the efficiency of concerned agencies, and increasing government customs revenues without affecting its regional and international commitments.
> - To adjust the current charges and fees for government services to ensure they are commensurate with their costs and to improve the efficiency of agencies responsible for collection.
> - To review foreign labor recruitment fees in order to support Saudisation projects.
> - To move the balance of payments into surplus in the future, while continuing public and private sector efforts to develop non-oil resources.
> - To encourage private investment (both national and foreign) in the exploration and utilization of untapped mineral resources.

Most important, the Saudi government has shown that it is becoming far more serious intaking action. It has instituted a long series of reforms and is contemplating a long list of others. Since the late 1990s on, it has taken the following major steps:[13]

- Corporatization of the Saudi Telecommunications Company (1998);
- Establishment of the Supreme Economic Council (SEC) (August 1999);
- Opening of the stock market to foreign investment in mutual funds, (November 1999);
- Royal decree outlining the restructuring and corporatization of the electricity sector (December 1999);
- Establishment of the Supreme Council for Petroleum and Mineral Affairs (SCPMA) (oil policy decision-making, Gas Initiative negotiations, oversight of Aramco.) (January 2000);
- Foreign Investment Law and creation of the Saudi Arabian General Investment Authority (SAGIA) (April 2000);
- Real Estate Law allowing foreigners to own real estate, except in Mecca and Medina (October 2000);

- Creation of Human Resource Development Fund to train Saudis in job skills (November 2000);
- Creation of the Supreme Tourist Authority for maximizing growth of tourism in Saudi Arabia (November 2000).
- Transfer for responsibility for privatization to the Supreme Economic Council, and requirement that the SEC establish a plan and timetable for privatization (February 2001);
- Guidelines for transparency of economic and fiscal data (May 2001);
- Reductions in tariffs from 12% to 5% (May 2001);
- Establishment of the Saudi Telecommunications Authority as a telecommunications regulator (May 2001);
- Creation of a separate Water Ministry (June, 2001)
- Creation of the Electricity Services Regulatory Authority as an electric power regulator (November 2001); and
- Acceleration of harmonization in GCC tariffs (at 5%) from March 2005 to January 2003 (December 2001.)
- New health services law (June 2002).
- Issuing of a new government privatization strategy (June 2002).
- Creation of a railroad executive program (June 2002).
- Privatization regulations for water desalination. (June 2002).
- First steps in privatizing the post office (June 2002).

Other recent measures include the creation of an Industrial Cities Development Authority, the restructuring of the electrical sector, an anti-dumping law, new social insurance and social security laws, new visa procedures for foreign businessmen, and new incentives for family businesses and small-medium business incubators. The Kingdom has allowed the creation of privately funded colleges as business enterprises, the licensing of water desalination to the private sector, and the creation of labor committees and labor representation on company committees. In areas outside the economy, the Kingdom has issued a new law of governance, and new laws of regions, litigation, criminal procedures, the role of advocates, the authority of the attorney general, and press and publications.

In creating these reforms, Saudi Arabia focused on enlarging its private sector and the eventual creation of a structured system of utilities based on real market prices. It also focused on creating a climate where Saudis would have a major incentive to repatriate their private capital and investment in Saudi Arabia, where a globally competitive economy with high value

("knowledge-based") jobs could develop, and where foreign capital could replace much of the burden on government expenditures to provide the capital need for investment. Such measures were a critical step in increasing government revenues and in releasing capital to fund other development projects. Foreign private investment had only amounted to $4 billion between 1984 and 1997, of which only 20% went to the Saudi private sector.[14]

The Supreme Economic Council

The establishment of the Supreme Economic Council (SEC), or Higher Economic Council, on August 28,1999 is a key example of the steps being taken to strengthen the private sector.[15] The 11-member body has been set up with the goal of devising and implementing the country's economic policy. The Council is chaired by the Crown Prince and first Deputy Premier, Prince Abdullah, with Second Deputy Premier Prince Sultan ibn Abdul Aziz as deputy chairman. Other members include the chairman of the General Committee of the Council of Ministers, and the governor of the Saudi Arabian Monetary Agency (SAMA). It also includes the Ministers of Finance and National Economy, Planning, Labor and Social Affairs, Petroleum and Mineral Resources, and Commerce, and two ministers of state.

The SEC assumes the responsibilities of the Council of Ministers in terms of economic issues. It has a permanent committee called the Economic Consultative Commission which includes a number of ministers, and there is also an advisory committee for economic affairs, The SEC is responsible for studying the general framework of the development plans, financial policies and bases for preparing budget drafts and priorities for expenditure, commercial policies at the domestic and international levels, industrial and agricultural policies, economic and commercial agreements, and relevant economic studies prepared for it by consultative committees.[16] It also reviews reports, monetary policies, and information presented by the Saudi Arabian Monetary Agency (SAMA).

A decision by the Saudi Council of Ministers on February 5, 2001, gave the SEC responsibility for supervising the privatization program, and the implementation and coordination of all related activities with other government ministries. It also charged the SEC with responsibility for formulating a strategic plan and timetable to ensure that such activity took place. The SEC is to decide the scope of the activity of organizations to be privatized and review

and approve the programs proposed by feasibility studies.[17] The Council was reformed on September 23, 2001, and given a revised membership – including leading and highly educated technocrats. It meets regularly under the Chairmanship of the Crown Prince, and covers a wide range of issues from conventional economic policy to the environment.[18]

While the SEC is relatively new, it has already contributed to the approval of a new foreign investment law, drafting the organizational structure of a new General Investment Authority (SAGIA), regulations permitting ownership and investment in real estate by non-Saudis, the establishment of a Human Resources Development Fund, new regulations for employers with expatriate labor, the Seventh Development Plan, and review of the state budget. It has also reviewed new limits on corporate taxes and allowable corporate losses, reduced customs duties, regulations to help privatize Saudi telecommunications, and new standards for transparency and dissemination of economic and financial data. It also reviews educational stipends and some aspects of educational quality.[19]

The Economic Consultative Commission (ECC)

The SEC has a 16-member affiliate body called the Economic Consultative Commission (ECC), which was also formed in September 1999.[20] The ECC is made up of non-governmental experts and provides the chairman of the SEC with advice. It meets at least once a week. [21] Combined with the SEC, the ECC serves as an answer to calls for allowing greater participation of citizens in policy-making, especially in economic issues.

These councils are a response by Crown Prince Abdullah to encourage Saudi businessmen to invest more money into the Saudi economy, rather than keep their capital overseas.[22] The Councils, however, are only beginning to have a significant impact, and the ECC has been criticized for not involving more experienced members of the Saudi business community.[23] According to Dr. Abd al-Aziz Muhammad al-Dukhail, President of the Saudi-based Consulting Center for Finance and Investment, "Privatization is one of the slowest moving areas in Saudi Arabia. Maybe the [newly established] Supreme Economic Council (SEC) can speed it up, but so far it is not taking the role it should and it is not a very active stream of change."[24]

The Supreme Council for Petroleum and Minerals (SPCM)

Saudi Arabia has taken a number of steps to try to improve the management of its petroleum and minerals programs. It first established Supreme Consultative Council in 1992, and then strengthened the new organization in 1996. It announced the creation of an 11-member “Supreme Council for Petroleum and Minerals Affairs" on January 4, 2000. The members include the King as Chairman and Crown Prince as Deputy Chairman, with the Second Vice Premier as Second Deputy Chairman. Its membership includes six ministers and the President of Saudi Aramco.

The creation of the Supreme Council for Petroleum and Minerals (SPCM) created a body in charge of all matters related to petroleum, gas, and other hydrocarbon affairs in onshore and offshore areas. It has the mission of developing and managing a long-term strategy for the development of both petroleum and minerals, and reviews international draft agreements. It is responsible for the general policy of Saudi Aramco, including five years plans, crude oil production and exploration, the five year capital investment program, and the company’s capital position.

While the primary responsibility of the SPCM is the petroleum sector, which is described in Chapter VI, it also is pushing for the development of mining industry. Its mission statement also includes helping to support Saudi Arabia's effort to restructure its economy and accelerate private sector involvement in the country's energy sector.

This Council approved a major initiative in January 2000 to open up part of Saudi Arabia’s gas industry to foreign investment, which led to the new pattern of foreign investment in the gas sector described in the next chapter.[25] It quickly issued invitations to international oil companies (IOC) to resume talks on investment proposals for the energy sector. This move was in order to overcome the resistance of anti-privatization forces, and in response to the rejection by the technical committee, consisting of Saudi Aramco staff, of initial proposals made by IOCs in September 1998. To catalyze the process, Foreign Affairs Minister Prince Saud al-Faisal was appointed to head the ministerial committee to report on the investment proposals. The Council has proved instrumental in rapidly pushing through measures to reform foreign investment laws.[26]

The SPCM has approved a detailed petroleum strategy for the Kingdom, which will be reviewed every two years. Additionally, it has made significant progress in other areas:

- In the Spring of 2000, Prince Saud announced increased opportunities for foreign investment in the gas sector:
- "For areas where Saudi Aramco, the national oil company, is currently producing natural gas, foreign companies would be given opportunities for investment in the in the post-production phases."
- "For areas where gas has been discovered, but not yet exploited, foreign companies will be allowed to contribute in its development as well as participate in post-production."
- "For areas where gas has not yet been discovered, foreign companies will have the chance to invest in exploration, in addition to development, production and post production."[27]
- In November 2000, the Council approved individual foreign company participation in three core upstream gas projects.
- In June 2000, the Kingdom selected three foreign companies for the upstream gas projects, although completion of the actual deals was still pending in October 2002.

A Saudi government press release on an SPCM meeting in August 2000 exaggerates some aspects of how the Council operates, but does give a clearer picture of its functions and the kind of strategic decisions it reviews:

> "Custodian of the Two Holy Mosques King Fahd bin Abdulaziz, who is also President of the Supreme Council for Petroleum and Minerals (SCPM), today chaired a meeting of the council, which reiterated the continuing Saudi policy on oil that aims at realizing a balance in global markets in a way that preserves the interests of petroleum-exporting countries, ensures continued international economic growth, and stabilizes supplies and prices at reasonable levels in line with the June 2000 agreement reached by the member states of the Organization of Petroleum Exporting Countries (OPEC).
>
> "Minister of Petroleum and Mineral Resources Ali bin Ibrahim Al-Naimi was urged to continue to work for realization of these goals through collaboration with OPEC member states for a suitable increase in production in a way that restores balance to the oil market and stabilizes prices. He was also urged to review suitable mechanisms for realizing this stability while continuing coordination with other oil-producing countries, both OPEC and non-OPEC.
>
> "The council welcomed the upcoming Second OPEC Summit in Caracas, Venezuela, and hoped that the conference would culminate in success as regards evaluation of its experiences and readiness to deal with future developments.
>
> "In his report, SPCM Secretary-General Dr. Mutlab Al-Nafeesa said the council had discussed the following topics:
>
> "First: The Kingdom's oil strategy as prepared by the Ministry of Petroleum and Mineral Resources and revised by the ministerial committee. This strategy stems from the strategic goals of the development plans, which have focused on developing human resources, improving the standard of living, diversifying the base of the national economy, enhancing infrastructure, and broadening the role of the private sector.
>
> "The strategy covers the Kingdom's distinguished role in the oil market and its continued cooperation with various countries both inside and outside OPEC for stabilization of that market, guaranteeing oil supplies to consuming countries and building an integrated petroleum industry that contributes positively to the

process of economic development. The strategy aims at safeguarding the share of petroleum in global energy consumption, and at safeguarding the Kingdom's share in the world oil market.

"The strategy, on the other hand, encourages research aimed at diversification of petroleum usage, improvement of its products, and their conformity with environmental standards.

"The strategy appreciates the pioneering role of Saudi Aramco in exploring oil reserves throughout the Kingdom and in developing the sectors of refining and local marketing, and its participation in joint projects in petroleum operations both with the Saudi private sector and with international oil companies. The strategy focuses on enabling the private sector to contribute to the development of services and supporting industries.

"The strategy underscores the importance of cooperation with the concerned state authorities for realization of optimum energy use in addition to continued training and rehabilitation of Saudi cadres in the technologies of the oil industry and its marketing.

"Secondly: The working plan for Saudi Aramco 2000-2004, which includes: Application of a great many new technologies for increasing its productive capacity and reducing its costs; Continued evaluation of the company's selection of suitable grades of oil, whose prices are reflected by market conditions; Increase of supplies of natural gas for boosting industrial development in the Kingdom; Preservation of reasonable levels of productive capacity so as to enable the Kingdom to meet world demand and confront any adverse impact on the situation of the petroleum market; Production and marketing of profitable crude oil, and making lead-free gasoline available in the local market by 2001; Development of security and safety measures and preservation of the environment; Continued development of the skills of Saudi employees so as to enable them to occupy posts at all levels, with the percentage of nationals in the work force expected to reach 87 percent by 2005.

"Thirdly: The Saudi Aramco Annual Report for 1999, which included the following achievements:

- Inauguration of the Al-Shaybah field in the Empty Quarter, by Crown Prince Abdullah bin Abdulaziz, Deputy Prime Minister and Commander of the National Guard;
- Development of Ras-Tanura refinery, and the pipeline for transportation of petroleum products from Dhahran to Riyadh and Qassim;
- Expansion projects for the gas laboratory at Al-Juaymah and for the treatment utilities at the gas laboratories at Al-Othmaniya and Beiri, and commencement of setting up the gas laboratory at Al-Hawiyya.

"Dr. Al-Nafisa went on to say that the council adopted a number of decisions, including the following:

- Approval of the Kingdom's oil strategy;
- Approval of the working plan for Saudi Aramco for 2000 to 2004, and for the work of the preparatory committee to continue with study of comments concerning the plan;
- Approval of the annual report of the company for 1999; and
- Approval of the general budget of the company.

"Formation of a committee comprised of representatives from the Ministries of Petroleum and Mineral Resources, Finance and National Economy, Industry and Electricity, and Agriculture and Water, the executive official of the assigned team for negotiations with international petroleum companies, and a representative from the experts commission at the cabinet for consideration of ways to supervise gas supplies and their prices. The committee will consult the concerned persons and specialists in both government and non-government sectors and then submit its recommendations to the SCPM within a period not exceeding 90 days."

It is obvious that the primary function of the Council is to review and coordinate the plans prepared by Saudi technocrats. However, a review of reports of its meetings through April 2002, reveals that it has continued to focus on energy strategy, major energy investments, OPEC

issues and quotas, and the possible roll of private foreign and domestic firms and capital in developing the energy sector.

This included approval of the eight international firms that the Kingdom announced were selected to invest in the Saudi gas sector on May 18, 2001. A Saudi press release on that date stated that Prince Saud had headed a national team that had been negotiating with the international oil companies, together with Minister of Petroleum and Minerals Ali Al-Naimi, Minister of Industry and Electricity Dr. Hashim Yamani, Minister of Finance and National Economy Dr. Ibrahim Al-Assaf, and Minister of Planning Khalid Al-Qusaibi. It stated that the SCPM had approved the selection of Exxon-Mobil, Royal Dutch Shell, British Petroleum, Phillips, Enron, Occidental, TotalFinaElf and Conoco. Dr Abdulrahman Al Tuwaijri was the Secretary General.[28]

The Saudi Arabian General Investment Authority (SAGIA)

The Council of Ministers established the Saudi Arabian General Investment Authority (SAGIA) on April 10, 2000. The creation of the SAGIA followed several previous steps towards reform:

- In 1998, the government corporatized the telecommunications component of the Ministry of Posts, Telephones, and Telegraphs, and established the Saudi Telecommunications Company (STC).
- In November 1999, the government initiates a program to encourage foreign investment by permitting foreign investors permitted to invest in local shares through established open-ended mutual funds.
- In November 1999, the government announced it would implement the unification of GCC customs tariffs by March 2005.
- In December 1999, Saudi Arabia issued a budget for 2000 that called for only two percent increase in government spending and with conservative assumptions about oil revenues, and a Ministerial Committee approves a new privatization strategy.

The creation of the SAGIA provided a centralized body to create new incentives for foreign investment, and an incentive for the indirect repatriation of part of $600 to $850 billion in Saudi private investment outside Saudi Arabia.[29] The Council of Ministers gave the SAGIA the task of preparing and submitting government policies in development and increasing foreign investment for submission to the SEC, preparing executive plans and rules for investment, making decisions on investment applications and their cancellation, proposing lists of activities to be excluded from foreign investment, preparing studies on investment opportunities and their

promotion, coordinating these activities with other government authorities, establishing suitable domestic and foreign conferences, and creating suitable data bases and statistics.[30]

SAGIA was also charged with establishing a "one-stop-shop" for foreign investors. This had representatives from 16 government agencies. The goal was to reduce red tape by making a single agency responsible for approving and overseeing each foreign investment project. The mission of the SAGIA also included facilitating and shortening government approval procedures, seeking to reduce the time for approval to 30 days, providing information to foreign companies and investors, and creating service centers at the Chambers of Commerce and Industry in Riyadh, Jeddah, and Dammam.[31]

The SAGIA is headed by Prince Abdallah bin Faysal bin Turki -- a younger prince who had worked his way to the leadership of the Royal Commission in Jubail and Yanbu, one of Saudi Arabia's largest single efforts at economic development, and who was highly regarded by both Saudi technocrats and foreign businessmen. Prince Abdullah is a good example of the kind of new leadership needed to make Saudi economic reform work. He was born in 1951, making him part of a new generation of royal technocrats. He studied engineering in Saudi Arabia and the United Kingdom, and had joined the Royal Commission in Jubail and Yanbu in 1975, shortly after its creation. He coordinated many of the development studies for the two cities, and later became responsible for industrial safety. He was made acting Secretary General of the Commission in 1985, and became the permanent Secretary General in 1987. In 1991, he became the chief executive officer and Chairman of the Board of Directors. Upon his appointment to SAGIA, he was given Ministerial rank.

Unlike some aspects of Saudi reform efforts, SAGIA has been aggressive in performing its mission and granting investment licenses, and is now a major force in both reducing the barriers to foreign and domestic investment, and in expediting individual projects. It works closely with US, European, and other potential investors, and Prince Abdallah has become one of Saudi Arabia's most effective spokesmen in promoting the Kingdom.

Nevertheless—as is discussed in more detail in Chapter VII— progress has been slow. The events of September 11, 2001 have had a serious impact on the global economy that has interacted with the collapse of the technology sector and stock boom in the West. Outsider have

been more reluctant to invest in the Kingdom, while Saudis have taken private capital out of the US without repatriating it to the Kingdom or repatriating it in ways that involve productive investment. Regulatory and bureaucratic barriers have proven hard to reduce at the rate required. Lead projects like foreign investment in Saudi Arabia's gas production sector have been delay by politics and disputes over issues like the size of the reserves involved and return on investment. (ROI).

A New Foreign Direct Investment Code and Other Measures

Saudi Arabia has, implemented a new foreign investment code that gave foreign investors the same benefits, incentives, and guarantees offered to Saudi Arabians and companies. The law allows foreigners to own property either independently or with a Saudi partner. It allows investors to remit funds abroad, and reduces taxes by 15% for foreign companies with an annual profit in excess of 100,000 Riyals ($26,700).[32]

The Provisions of the New Foreign Investment Law

Minister for Finance and National Economy Ibrahim al-Assaf announced this new Foreign Direct Investment Code on April 10, 2000. It contained the following changes:[33]

- It calls for rapid decisions and SAGIA must make decisions within 30 days after receiving the required documents. If no decision is otherwise taken, SAGIA should approve the request. It must provide reasons for any rejection and provide a method for appeal.

- A foreign investor may obtain more than one license for various activities, and licensed investments may be both joint ventures or fully owned enterprises. A licensed project enjoys all benefits, incentives, and guarantees enjoyed by a national project.

- A foreign investor may freely transfer the proceeds of a sale of its share, profits, and benefits from liquidation.

- A licensed enterprise may own the necessary premises and real estate.

- Sponsorship of the foreign investor and non-Saudi personnel will be by the licensed enterprise.

- No investment may be sequestered except by a legal award, and a foreign investor may appeal such an award to the Grievance Bureau.

- Amendments to the country's tax rates on foreign business profits to not exceed 30% from the previous ceiling of 45%.

- Changes in legislation allowed foreign companies 100% ownership of projects and property ownership, compared to the previous limit of 49% stake in joint ventures requiring a Saudi sponsor.

- The Saudi Industrial Development Fund (SIDF) is understood to have confirmed that foreign businesses now qualify for SIDF soft loans, even if the corporation is 100% foreign owned.

Reductions in Taxes

The Council of Minister issued a resolution on April 10, 2000 saying the State would bear 15% of taxes on corporate profits over 100,000 Riyals per year. The tax for profits of 100,001 to 500,000 Riyals was reduced from 35% to 20%. It was reduced from 40% to 25% for profits of 5001,000 to 1,000,000 Riyals, and from 45 to 30% for profits above one million Riyals.[34]

In a speech on April 15, 2001, Ibrahim al-Assaf stated that that a new regulation was under consideration by the Supreme Economic Council that would cap the tax rate at 30 percent of the net profits of foreign companies and foreign partners in joint ventures. This move was consistent with efforts to make the system more competitive, and followed the revocation in the New Investment Law of the ten-year and five-year tax exemptions. He explained that the government was assuming liability for 15 percentage points of net profits above SR 100,000 as a transitional measure, which would in effect limit the tax burden to a maximum of 30% of net profits as compared with the current rates. These were 25% up to SR 100,000; 35% from SR 100,000 to SR 500,000; 40% from SR 500,000 to SR 1 million; and 45% over SR 1 million.

In addition, he said that losses would be permitted to be carried over from year to year for an indefinite period of time, instead of being limited to one year. Dr. Al-Assaf further explained that the provisions of this decree, which took effect on April 10, 2000, would apply to all foreign taxpayers in Saudi Arabia. Current investors who enjoy tax exemptions granted under the old investment law will, however, continue to do so until such exemptions expire.[35]

Foreign Ownership of Real Estate

On July 10, 2000, The Council of Ministers amended the real estate laws to allow foreigners to own real estate for their enterprises although investments above 30 million Riyals require approval by the Council of Ministers. Foreigners may own their house of residence with clearance from the Ministry of the Interior. Property in Makkah and Medina is exempted, but non-Saudi Muslims may rent land for up to two years.[36]

Fund for the Development of Human Resources

On July 31, 2000, the Council of Ministers established a Fund for the Development of Human Resources under the chairmanship of the Minister of the Interior. The purpose of the fund was to facilitate the employment and training of Saudi citizens for work in the private sector. This fund can be used to extend subsidies for qualification and training, share in the cost of qualification and training, pay a percentage of salaries for up to two years, support and finance field programs, loan funds for training, and conduct suitable research to set goals for such activities.

"Negative List" of Areas Excluded from Foreign Investment

These were all important steps in improving the climate for foreign investment, but the Supreme Economic Council (SEC) did retain a long "negative list" of areas where foreign investors could not invest in the Kingdom. This list included:

- Oil exploration, drilling and production, except the services related to the mining sector listed in international industrial classification codes.
- Manufacturing of military equipment, devices and uniforms.
- Manufacturing of civilian explosives.
- Catering to military sectors.
- Security and detective services.
- Insurance services.
- Real estate investment in Makkah and Medina.
- Tourist orientation and guidance services related to Hajj and Umrah.
- Recruitment and employment services including local recruitment offices.
- Real estate brokerage.
- Printing and publishing.
- Distribution services, wholesale and retail trade, including medical retail services such as private pharmacies, and commercial agencies, except franchise rights listed by international industrial classifications, with foreign ownership not exceeding (49%), and the granting of one franchise to each area.
- Audiovisual and media services.

- Primary, secondary and adult education.
- Telecommunications services.
- Land and air transportation.
- Transmission and distribution of electrical power.
- Satellite transmission services.
- Pipeline services.
- Services rendered by midwives, nurses, natural therapists and paramedics listed at 93191 by international classification codes.
- Fisheries.
- Blood banks, poison centers and quarantines.

More generally, the foreign community has repeatedly warned the Saudi government that the Investment Law will not have its desired effect until the Saudi courts operate with a more consistent approach to commercial law, and until the government actually enforces the decisions of the courts. This is scarcely an unusual problem in developing countries, where policy-level investment incentive programs and reforms are often paralyzed, in practice, by a combination of bureaucratic and permitting delays, and by the government's failure to develop and enforce anything approaching an effective uniform commercial code. The fact remains, however, that Saudi Arabia only began to solve its many permitting and bureaucratic delay problems by creating SAGIA and still had failed to create a working legal system for steps as basic as debt collection and contract enforcement as of the spring of 2002.

A Saudi proposal to tax the income of foreign workers earning more than $800 (SR 3,500) a month at 2.5%, that was issued in early 2002, also produced some hostile reaction. The tax potentially affects some 1.7 million foreign businessmen, out of roughly six million "legal" foreign workers, many of who already paid some form of tax abroad. On the other hand, the resulting rate was far lower than the level of taxation in many other countries. The Saudis paid a 2.5% religious tax or zakat, and the Saudi government was still earning a little under five percent of non-oil government revenues.[37]

It is hard to put Saudi Arabia's needs and current levels of investment in perspective. Saudi data shows that the average annual growth of private fixed capital formation grew by 4.7%

between 1969 and 2000, but such growth effectively peaked relative to demand in 1985, at 65.1 billion Riyals, as measured in 1994 constant Riyals. Saudi Arabia did not exceed this total until 2000, and the estimate of 67.0 billion Riyals for this year is uncertain. Some growth did take place during the 1990s, but it was erratic between 1992 and 1999, and the figure ranged from 55.5 to 63.3 billion Riyals. This is very limited compared to the types of needs projected in the Saudi Development Plans, although the plan sets no investment goals as specific numbers.[38]

Another way to look at the issue is growth in factory capital and size. Data are not available in constant Riyals, but other Saudi data show substantial growth in operating capital up to 1993, and little real growth after that time:[39]

- Saudi Arabia had 199 factories in 1970, with a total operating capital of 2.8 billion current Saudi Riyals, and total manpower of 13,865.
- Saudi Arabia had 734 factories in 1975, with a total operating capital of 6.3 billion current Saudi Riyals, and total manpower of 27,978.
- Saudi Arabia had 1,196 factories in 1980, with a total operating capital of 21.1 billion current Saudi Riyals, and total manpower of 75,334.
- Saudi Arabia had 1,298 factories in 1985, with a total operating capital of 96.5 billion current Saudi Riyals, and total manpower of 145,299.
- Saudi Arabia had 1,800 factories in 1975, with a total operating capital of 150.1 billion current Saudi Riyals, and total manpower of 183,011.
- Saudi Arabia had 2,647 factories in 1994, with a total operating capital of 215.8 billion current Saudi Riyals, and total manpower of 213,039.
- By the year 2000, however, Saudi Arabia had 3,207 factories in 1975, with a total manpower of 293,971, but total operating capital was still only 231,893.

There has been considerable foreign investment activity in Saudi Arabia in spite of the problems, the Kingdom is trying to solve, and foreign investors do participate in a significant number of joint ventures. The bad news is that the number of foreign companies remains very limited, and the growth of joint ventures lags far behind the levels the Kingdom needs. There is a clear need for reform, if Saudi Arabia is to get the t level of investment it needs, both from outside and inside the Kingdom:[40]

- Saudi Arabia had 923 operating companies in 1972, the first year for which data are available, with a total operating capital of 1.3 billion current Saudi Riyals. Roughly 34 of these companies were foreign with capital investments of 0.13 billion Riyals. There were 108 joint ventures with a capital of 0.26 billion Riyals.

- By 1985, Saudi Arabia had 6,268 operating companies, with a total operating capital of 78.7 billion current Saudi Riyals. Only 14 of these companies were foreign, with capital investments of 0.05 billion Riyals. However, there were 1,260 joint ventures with a capital of 15.3 billion Riyals.

- By 1990, Saudi Arabia had 6,621 operating companies, with a total operating capital of 94.9 billion current Saudi Riyals. Only 21 of these companies were foreign, with capital investments of 0.12 billion Riyals. There were 1,093 joint ventures with a capital of 17.2 billion Riyals.

- By 1995, Saudi Arabia had 8,319 operating companies, with a total operating capital of 142.5 billion current Saudi Riyals. By this timer, 109 of these companies were foreign, with capital investments of 1.0 billion Riyals. There 1,062 joint ventures with a capital of 23.1 billion Riyals

- In 2000, Saudi Arabia had 10,179 operating companies, with a total operating capital of 162.9 billion current Saudi Riyals. A total of 144 of companies were foreign, with capital investments of 1.1 billion Riyals. This was a token increase in foreign companies as a percentage of total companies in 1972, and their capital investments in the Kingdom had experience only limited real growth since 1994. There were 1,219 joint ventures with a capital of 30.4 billion Riyals – still a very limited.

Saudi Efforts to Join the WTO

Saudi Arabia’s efforts to join the World Trade Organization (WTO) are another important attempt at reform. The Kingdom first applied to join the forerunner of the WTO, the General Agreement on Tariffs and Trade (GATT), in 1993. In November 1999, King Fahd stated that "the world is heading for...globalization" and that "it is no longer possible for [Saudi Arabia] to make slow progress."

The Saudi effort to join the WTO is designed to attract foreign investment (up to $200 billion over the next 20 years, according to Foreign Minister Prince Saud. This would include over $100 billion in the power sector alone, plus billions more in petrochemicals and telecommunications). Another goal of Saudi WTO membership is to ensure markets for the country's petrochemical industry, and to create new markets in the future.

As part of Saudi Arabia’s effort to accede to the WTO, the government has indicated that it will take a phased approach to:

- Establishing new trademark and intellectual property laws.

- Removing technical barriers to trade by easing travel visa requirements.

- Signing the Information Technology Agreement and phase-in tariff-free trade in information technology equipment.

- Phasing in the Basic Telecommunications Agreement to allow competition in telecommunications services.

- Changing competition laws to provide anti-trust protections and consumer protection in accordance with WTO rules.

The Kingdom reduced most tariffs from 12% to 5% in May 2001. The GCC Summit meeting then agreed, in December 2001, that tariffs would be harmonized at 5% throughout the GCC in January 2003, two years earlier than originally planned.[41]

Progress again, however, has been slower than the Saudi government hoped. Osama Jaafer al-Faqih, the Saudi Minister of Commerce, noted in an interview in April 2001, that Saudi Arabia was now the only member of the GCC that had not yet joined the WTO, but was the world's 16th largest exporter in 2000 (190 billion Riyals), and the 23rd largest importer (112.5 billion Saudi Riyals.) He noted that Saudi Arabia had been pursuing membership in the WTO for four years because, "Saudi Arabia's accession would help ensure its integration into the multilateral trading system and maintain the momentum for economic development. It would allow greater transparency and more open policies. Membership of the WTO would lock in the ambitious economic reform program that Saudi Arabia is undertaking. It is a reassurance that this process is irreversible. The further opening up of the Saudi market to foreign goods and services will speed up privatization and make Saudi Arabia more attractive for foreign investment." [42]

He blamed the delay in Saudi Arabia's entry on the lack of clear WTO rules, but said that membership was crucial for the Kingdom's economic development. "Since the beginning of this year, substantial progress has been made toward bringing the negotiations to a successful conclusion…The accession of the Kingdom has moved to an advanced stage and strong momentum has been generated…Intensive negotiations are taking place to arrive at a package of rights and obligations which is balanced and beneficial for the current and future economic needs of Saudi Arabia." He said that while the WTO's rules were more balanced than those of the GATT, they did not provide the needed flexibility for developing nations. "The WTO, while priding itself on providing a rule-based system for the conduct of world trade, inter alia the principles of transparency, predictability and mutual advantages, it does not always follow them in practice… In fact, the WTO does not have clear rules and guidance on accession ... the accession process is hampered and prolonged by the absence of such rules and criteria."[43]

Saudi Arabia originally hoped to be admitted to the WTO by the end of 2000, but entry was delayed by a variety of issues, including Saudi willingness to increase market access to its

banking, finance, and upstream oil sectors and the failure to issue new anti-trust regulations. Until 2001, negotiations Saudi officials continued to meet with various negotiators, including those from the European Union.[44] The Kingdom also sought negotiate and finalize the Working Party Report and the Protocol of Accession, and some Saudi officials still hope the Kingdom could be admitted to the WTO by the end of 2002.[45] In practice, however, other nations felt Saudi Arabia sought unrealistic concessions and attempted to disguise it efforts to limit compliance by making claims that such concessions are necessary for cultural and religious regions. As a result no Working Party meetings were held in 2001 or through August 2002.[46]

If Saudi Arabia does enter the WTO, this should help increase Saudi Arabia's volume of trade, but it does present several negotiating, cultural-religious, and economic problems. While Saudi officials tend to blame the WTO for being insensitive to Saudi restrictions on non-Islamic imports, like alcohol, and religious problems in dealing with interest and insurance, WTO negotiators indicate that the Kingdom has not yet been willing to show that it will grant the required access to its banking, finance, and upstream oil sectors. The negotiators called for better copyright laws; tribunals to rule on trade disputes; and new legislation on technical trade barriers, customs evaluation, and food health regulations. Additionally, they called for the Kingdom to limit tariffs to 15%, and to agree to several sectoral initiatives, including an Information Technology Agreement, chemical harmonization, a government procurement agreement, and agreements on textiles, pharmaceuticals, medical and construction equipment, and publishing services.

WTO membership also threatens some local businesses. Some Saudi firms are designed to function in a secure environment protected by high tariffs and monopoly agency agreements. A number of manufacturing enterprises fall under this category, and their managers are deeply worried that having to operate in a WTO environment would put them out of business.[47]Opening up the economy to foreign multinationals and imports will threaten their profit margins and the commercial agencies' monopoly.

The Supreme Commission for Tourism

The Kingdom created a Supreme Commission for Tourism, chaired by Prince Sultan bin Salman, on April 17, 2000. The Supreme Commission for Tourism was given a board of

directors and secretariat, and made responsible for surveying all existing tourist activity by region, promoting tourism, planning regional tourist infrastructure, removing barriers to tourist activities, extending incentives to investors, creation a comprehensive plan to encourage tourism, creating a central information center, and coordinating government and private sector efforts.[48]

As part of the Kingdom's efforts, visas for pilgrims have been extended from 15 to 30 days, and pilgrims are now allowed to visit other parts of the Kingdom besides Makkah and Medina.[49] In addition, Saudia Airlines and other Saudi tourism organizations were allowed to create package tours for non-Muslims, and the government made a deliberate effort to open pre-Islamic sites to foreign tourists.

The potential importance of this Saudi initiative is demonstrated by the fact the government estimated that Saudis spent some $15 billion a year on travel outside the Kingdom, and that internal tourism was one of the most job-intensive single areas where the government could encourage investment. It is far from clear that the government can meet its goal of reducing Saudi tourism spending abroad by 10-25% during the initial phases of its national tourism plan, or come close to raising the tourism sector to 7.3% of the GDP or 6.5% of total employment opportunities – particularly if government subsidized activity related to the Hajjis excluded.

The Supreme Commission for Tourism's estimates that the Kingdom has some 10,000-tourist spots, including places of historic and cultural importance, is also almost certainly exaggerated. Nevertheless, the Kingdom does have many real potential tourist attractions, particularly for Islamic tourists, and can benefit from linkage tourism throughout the Kingdom to the greater and lesser Hajj. Some pre-Islamic sites are of interest to Western tourists, and the Kingdom unquestionably has some of the best scuba diving areas in the world on its Red Sea coast. Tourism revenues may never give the Kingdom the level of revenue it is seeking from this sector, but they did increase from 3.8 billion Saudi riyals in 1992 to 6.1 billion in 1999, and to 6.75 billion in 2000.[50]

Saudi Efforts to Use the GCC to Strengthen the Saudi and Gulf Economies

Saudi Arabia has sought to strengthen regional trade and create a customs union among the Gulf Cooperation Council (GCC) countries. Currently, goods from GCC countries are exempt from all Saudi import duties, as long as 40% of their value has been added within the GCC and the producing company is owned by at least 51% by GCC citizens. The Kingdom acted to establish free trade zones in the ports of Jeddah and Dammam, which were to gradually evolve from being used for re-export and warehousing to become full free trade ports.[51]

In November 1999, King Fahd called for improved regional unity among Gulf States -- economically, politically, and militarily. In December 1999, the Gulf Cooperation Council agreed on a customs union. This customs union is expected to come into force by 2005, adopting a unified import tariff. In May 2001, Saudi Arabia began to move towards the customs union by announcing new regulations to ease the import of goods from other GCC states under preferential tariffs. These regulations dropped a requirement that imports were only eligible if they were made by firms owned by Gulf citizens. Instead, all goods were made eligible with 40% value added in the other GCC states.

These steps moved the Kingdom towards a GCC-wide goal of a tariff union limited to 5.5% to 7.5% tariffs by 2005.[52] They also affected a trade balance that ranged from 8-10 billion Riyals annually in Saudi imports from other GCC states, and around 7 billion Riyals in exports. This represented around 8-10% of total Saudi imports (although many were essentially reexports), and 3-5% of Saudi exports.[53] In addition to improving the potential for trade and private enterprise activity on a GCC-wide bases, they were designed to help move the Kingdom and other GCC states towards a free trade agreement with the European Union and help ease the Kingdom's entry to the WTO.[54] Moreover, in December 2001, the GCC accelerated the date for such a union from March 2005 to January 2003.[55] If such a union actually increases productive intra-GCC trade, and helps reduce dependence on non-GCC labor, the GCC may be able to move on to goals like the creation of a common currency and productive trade agreements with other blocs like the EU.

Future Reforms Now Under Consideration

Useful as some of Saudi Arabia's recent efforts have been, both Saudi and foreign experts agree that the Kingdom still has a long way to go before the government both fully implements the reforms it has already begun and implements other steps that are critical to creating the broader climate needed to restructure and diversify its economy. The government has announced, however, that it does have a number of further reforms in preparation. As of the fall of 2002, these reforms included:[56]

- The effort to accede to the WTO described earlier, plus the drafting of suitable anti-trust regulations;
- Reforming the company law to modernize it and existing regulations. This law is in draft and would modernize the regulations for establishing business entities;
- Improving the capital markets and stock market law by establishing a stock exchange supervisory commission, regulating fixed income markets, and developing a bond market;
- A major gas initiative, allowing foreign companies to develop natural gas production facilities and domestic uses for the gas, and potentially the single largest investment initiative in the Kingdom since the creation of the infrastructure for oil production;
- Privatization at various levels and phases of telecommunications, electric power, the national airline, postal services, railways, port services, and many other smaller state-owned assets;
- Reforming the agency law to reduce the requirements for local agents;
- Reviewing the tax law;
- Developing new laws for e-commerce;
- Creating an arbitration center.
- Changing the sponsorship law to allow companies to be their own sponsors, and liberalize the sponsorship requirements for foreign workers;
- Altering the mining law to make domestic and foreign private sector investment in minerals easier;
- Changing competition laws to provide anti-trust protections and consumer protection in accordance with WTO rules;
- Revising labor law to rationalize employment procedures and increase labor mobility;
- Modernizing the mortgage law.
- Issuing a law allowing toll roads.
- Establishing a new co-operative health insurance law. The current draft of the law will require the 5-6 million expatriate workers to have private health insurance, replacing the existing system where

employers are responsible for the medical costs and expatriates have some access to free medical care. The new law is intended to aid private hospitals to become revenue earners; and

- Increasing market regulation in the insurance sector, as it wants to broaden the coverage of existing private health insurance. (Out of the 80 active local firms. only the state-owned National Company for Co-operative Insurance is licensed to operate.)[57]

- Moving towards a Gulf Cooperation Council customs union 2003 and a common currency in 2010.

There is no question that the Kingdom is making progress, and it is clearly setting many of the right priorities and goals. The practical problem for the Kingdom is the need to match the pace of reform to the pace of demographic need, and to compensate for the underfunding of investment in infrastructure and government services during the 1990s. This is still possible, but the Kingdom's progress continues to lag behind requirement. Like reform in virtually all other countries – including those in the West – the Kingdom also is finding that it is one thing to issue decrees and legislation and another to actually change bureaucratic procedures, see reform translated into action, and remove a host of minor barriers in terms of paper work, permits, and fees.

Putting Current Saudi Efforts in Perspective: Plans and Goals Versus Actions and Achievements

Saudi Arabia has some of the most sophisticated development planning of any nation in the developing world, and certainly in the Middle East. As is the case with its economic reforms, however, good intentions and good plans are never enough. Anyone who studies the past perform of Saudi five year development plans, and the reforms called for in these plans, discovers that that Saudi reform efforts have never before had the necessary continuing support to ensure they are implemented, particularly if the Saudi economy benefits from relatively high world oil prices.

Saudi leaders have often set the right priorities in times of economic pressure, or when the issue was writing a plan versus taking difficult and unpopular action. They have then failed to act or eased the pace of reforms whenever they have created political difficulties or in periods when as petroleum revenues rise and the signs of prosperity return. As is the case with every government in the world, it is all too easy to delay the political and economic cost of reforms when money is available. It takes real courage to persevere consistently over a broad front and over time.

The History of Saudi Planning: The First through Fourth Saudi Development Plans

A review of Saudi development planning provides a clearer picture of the Kingdom's ability to restructure its economy as well as explains the key priorities in its current development plans. Saudi Arabia has a long history of systematic development planning, and has issued seven five-year plans over a period of three decades. Its First Development Plan, or five-year plan was prepared in 1970 (1390/1391), and each of the plans since that time has had a social and institutional dimension as well as an economic dimension.

In broad terms, Saudi Arabia has defined the same major strategic objectives for each of its seven plans:

- To safeguard Islamic values and confirm Allah's Sharia.
- To defend the Faith and the Nation; to uphold security and social stability; and to deepen the values of national loyalty and belonging.

- To improve the standard and quality of life.
- To develop human resources, increase productivity, and replace non-Saudi manpower with qualified Saudis.
- To realize balanced growth throughout all the regions of the Kingdom.
- To diversify the economic base and to reduce dependence on the production and export of crude oil through development of other natural resources and promotion of other economic activities.
- To provide a favorable environment for the activities of the private sector, and to encourage it to play a leading role in the development process.
- To enhance the Kingdom's position within the global economy, promote economic integration among the Gulf Cooperation Council (GCC) countries, and strengthen economic cooperation with other Arab and Islamic countries.

As Table 6.2 shows, the First Development Plan (1970-1974) involved expenditures of 34.1 billion Saudi Riyals and emphasized the Kingdom's rapid transformation into a more advanced nation by focusing on providing a modern infrastructure and basic government services such as water supply and electricity generation, as well as expanding social services and developing human resources. Some 41.4% of total expenditure went to infrastructure versus 27.7% for economic resources, 20.6% for human resources, and 10.3% for social and health development.

The Second Development Plan (1975-1979) came after the explosive rise in oil prices following the oil embargo in 1973, and involved total expenditures of 347.2 billion Saudi Riyals – more than ten times the total expenditures of the first.. Some 49.3% of total expenditure went to infrastructure versus 28.0% for economic resources, 14.7% for human resources, and 8.0% for social and health development. As in the First Plan, the development of an integrate infrastructure was designed to accelerate socio-economic development and was given top priority. The Second Development Plan differed sharply from the First Plan, however, in the fact it could be executed in a period where there were far fewer financial constraints

The Second Development Plan focused on four major directions:

- The first was expansion of transport, electricity, water and housing infrastructure.
- The second was conservation of hydrocarbon resources, encouragement of energy-intensive industries, and export of high value added products. This direction was supported by the establishment of the Royal Commission for Jubail and Yanbu, in order to create the infrastructure for hydrocarbon industries.

- Third, the plan placed "particular emphasis on the development of financial and administrative policies and regulations in conformity with development requirements and the progress of the national economy, as well as facilitating cooperation between the public and private growth sectors in order to realize higher growth rates." As a result, the plan made a number of proposals to give the Kingdom a modern administrative structure.

- The fourth direction concentrated on supporting and encouraging the private sector and established specialized credit funds and policies and measures to support private sector activity.

The Third Development Plan (1980-1984) came during a period when oil revenues continued to increase, and involved total expenditures of 625.2 billion Saudi Riyals – nearly twice the total in the Second Plan. Some 41.1% of total expenditure still went to infrastructure versus 30.7% for economic resources, 18.4% for human resources, and 9.8% for social and health development. The preparation of the Third Development Plan occurred during a period when Saudi Arabia had become the largest oil exporter in the world and a major financial power. It also covered a period when the infrastructure and development expenditures of the earlier plans were beginning to have a substantial effect, and it was clear that the Kingdom had to make more efficient use of foreign labor. As a result, it focused on making structural changes in the economy by defining oil and gas production levels in ways that would maintain national resources, continuing to build hydrocarbon industries, and completing infrastructure projects. The plan also sought to expand growth and development in all regions of the Kingdom, along with efforts to improve administrative organization and government procedures and enhance economic and management efficiency.

The Fourth Development Plan (1985-1989) involved major changes in both the focus and methodology of the plan. The focus shifted away from new investment in infrastructure to operations and maintenance, restructuring the economy to allow the private sector to play a substantial role in the development process and diversifying the production base. The was necessary in part because a major reduction in oil revenues forced total spending in the Fourth Plan to be cut to 348.9 billion Saudi Riyals, a little more than half the total for the Third Plan. At the same time, population growth, a maturing infrastructure base, and the need to deal with a steady rise in the number of Saudi youths shifted spending so that 33.0% of the Fourth Plan was spent on human resources development versus 18.4% in the Third Plan, and spend on social and health development rose from 9.8% to 17.7%. Capital investment-heavy activity like infrastructure dropped from 41.1% of total spending to 28.9% and economic resources development dropped from 30.7% to 20.4%. As part of the focus on strengthening the private

sector, the methodology of the plan shifted from a central planning and projects-based approach to a program planning method that also gave government agencies more flexibility.

Table 6.2

Expenditures During the Saudi Development Plans

	Economic Resources Development		Human Resources Development		Social and Health Development		Infrastructure Development		Total	
	SR Billion	(%)	SR Billion	(%)	SR Billion	(%)	SR Billion	(%)	SR Billion	(%)
Actual Expenditures										
First Development Plan: 1970-1974 Actual	9.5	27.7	7.0	20.6	3.5	10.3	14.1	41.4	34.1	100
Second Development Plan: 1975-1979 Actual	97.3	28.0	51.0	14.7	27.6	8.0	171.3	49.3	347.2	100
Third Development Plan: 1980-1984 -Actual	192.2	30.7	115.0	18.4	61.2	9.8	256.8	41.1	635.2	100
Fourth Development Plan: 1985-1989 Actual	71.2	20.4	115.1	33.0	61.9	17.7	100.7	28.9	348.9	100
Fifth Development Plan: 1990-1994 Actual	34.1	10.0	164.6	48.0	68.0	20.0	74.2	22.0	340.9	100
Sixth Development Plan: 1995-1999 Actual	48.2	11.5	216.6	51.5	87.5	20.8	68.1	16.2	420.4	100.0
Seventh Development Plan: 2000-2004 Planned	41.7	8.5	276.9	56.7	95.8	19.6	73.8	15.2	488.2	100.0

Source: Saudi Ministry of Planning, September 2002.

The Saudi Fifth Development Plan and the Gulf War

The Fifth Development Plan (1990-1994) was heavily influenced by the Gulf War and by an increasing understanding that the world oil market was highly volatile and the Kingdom could not count on high oil revenues. It did even more to encourage the private sector to participate in development, and sought to encourage the private sector to provide services in areas where the government had traditionally provided services. It placed a high priority on increasing the technology base. In practice, however, low oil revenues forced a number of downward adjustments in government spending and the government had to give priority to human services and against shift resources away from development and infrastructure.

The total value of expenditures under the plan was 340.9 billion Saudi Riyals in current Riyals, and human resources development rose to 48.0% of the total and social and health development rose to 20.0%. Capital investment-heavy activity like infrastructure dropped to 22% (about half the percentage in the First Plan) and economic resources development dropped to only 10%. While roughly 70% of the First Plan was capital-intensive investment in development, the percentage for the Fifth Plan was closer to 30%.

The Fifth Development Plan is also a case example of good intentions and weak implementation. It was a well structured plan that set many of the right priorities for development, expansion of the private sector, diversification, and Saudisation. In practice, however, the high cost of Saudi expenditures on the Gulf War during 1990-1991 made the content Fifth Plan largely moot and had a powerful impact on the Sixth Development Plan that followed. It also left the country with an estimated $55 billion debt.

The average rate of annual real growth (in constant 1989 prices) in the government petroleum sector during 1990-1994 was sharply affected by a boom in oil revenues during the peak of the Gulf War followed by nearly zero growth during the later part of the plan: It was 25.2% in 1990, 20.4% in 1991, 6.3% in 1992, -3.8% in 1993, and 0.2% in 1994. The Gulf War was so expensive, however, that it more than offset any benefits the Kingdom obtained from high oil revenues. Saudi Arabia sustained large current account deficits in the early 1990s, and official reserves fell from $23 billion in 1987 to only $7.4 billion in December 1994. Saudi Arabia's deficit on account totaled $27.6 billion during the peak war year of 1991, and was still

$8.7 billion in 1995. The Kingdom had a surplus of $200 million in 1996, but the deficit totaled more than $3.4 billion in 1997.

Annual average real growth in the non-petroleum government sector consisted largely of defense expenditures for the Gulf War, followed by growth rates of 0.8% from 1992-1994. Growth in the private sector averaged only 1.3% over the entire period of the Fifth Plan. The shifts in both private and public capital expenditure fluctuated sharply by year, depending largely on oil revenues. Gross fixed capital formation had to be war oriented in many areas, although the average increase in expenditures in the petroleum sector was relatively high except in 1991.[58]

Even so, real economic growth was higher during the Fifth Plan than during the Sixth Development Plan that followed. The total private and government non-oil sectors grew from 220.5 billion Saudi Riyals in 1990 to 237.0 billion in 1994 (+7.5%), measured in constant 1989 prices. The oil sector grew from 113.6 billion to 140.5 billion (+24%), and the entire GDP in purchaser's values grew from 341.0 billion to 377.4 billion (+11%)[59]

Studies by the World Bank indicate that Saudi Arabia's GDP per capita dropped by an average of 3.3% per year in current dollars during the time period from 1980-1992.[60] The World Bank also estimates that Saudi Arabia's GDP experienced an average annual decline of 1.9% from 1985-1995, and rose by only 1.9% from 1996-1997, when oil prices were relatively high. Even then, demographic pressures cut the Saudi GNP per capita by 1.4%.[61] Furthermore, Saudi Arabia experienced budget deficits in every year but two of the last twenty years.[62]

GDP is an uncertain measure of economic performance in Saudi Arabia, since increases in services subsidized activity, welfare payments and government deficit spending are included, regardless of the fact they scarcely benefit the economy. Even if these problems are ignored, however, Saudi Arabia's performance was not particularly impressive. The Saudi Arabia Monetary Agency (SAMA) reports that the total GDP rose by 1.4% during 1994, 4.3% during 1995, 8.6% during 1996, and 7.1% in 1997, but these figures are much more optimistic than the estimates of the International Monetary Fund (IMF). Like the CIA, the IMF estimates that no real growth took place in 1995, while 1996 saw a growth of 2.5%, and 2.0% in 1997.[63] In contrast the EIU estimates .5% growth in 1995, 5 % in 1996 and 2.5% in 1997.

The Saudi Sixth Development Plan

The Saudi Sixth Development Plan eventually involved total expenditures of 420.4 billion Saudi Riyals, nearly 80 billion Riyals more than the Fifth Plan. Like the Fifth Plan, however, the Sixth Development Plan emphasized human resources and services over investment in development and infrastructure. Human resources development rose to 51.5% of the total and social and health development rose to 20.8%. Capital investment-heavy activity like infrastructure dropped to 16.2% and economic resources development only totaled 11.5%.

The Saudi Sixth Development Plan, or Development Plan,[64] adopted the following macroeconomic strategy: [65]

- "Real" average growth of 3.9% in the non-oil sector's contribution to the GDP, compared to 3.2% growth during the period of the Fifth Plan. [66]
- Total investment growth of 8.5% per year, amounting to more than 18% of the GDP.
- An average annual growth of non-oil exports of 12% in current prices.
- Increased domestic non-oil revenues for the government.
- Progressive elimination of the budget deficit and balance of payments deficit on current account.
- Balanced government budget by the end of the Sixth Development Plan, and rationalization of government expenditure.
- Shift in government expenditures from consumption and current operating expenditures to investment.
- Steady increase in opportunities for the private sector through the gradual and selective use of alternative financing and privatization initiatives.
- Mobilization of the private sectors financial assets by broadening the domestic capital market.
- Reductions in the number of low-skilled foreign workers and increased capability of the Saudi work force in order to improve productivity.

The Sixth Development Plan sought to increase the Saudi GDP from 380.8 billion Saudi Riyals in 1995 to 458.6 billion Riyals in 2000, while maintaining an average annual growth rate of 3.8%. Additionally, it called for the non-oil sector to grow from 235.9 billion Saudi Riyals in 1995 to 285.1 billion Riyals in 2000, and while maintaining an average annual growth rate of 3.9%.

The private sector portion of the non-oil sector was planned to grow from 169.5 billion Saudi Riyals to 209.3 billion, with an average annual growth rate of 4.3%. The oil sector was planned to grow from 142.8 billion Saudi Riyals to 172.5 billion, and by an average annual growth rate of 3.8%. In contrast, the government services portion of the non-oil sector was only planned to grow from 66.4 billion Saudi Riyals to 75.8 billion, an average annual growth rate of 2.7%.[67] It called for the oil and gas sector to increase from 27% of the GDP in 1990, and 32.9% in 1995, to 33.8% in 2000. [68]

The Sixth Development Plan also called for an average level of 4.2% growth in the producing sectors and 4.4% growth in the service sectors. Meeting these goals required a 3.4% annual increase in private sector investment, and a 5.5% annual growth in government investment. Annual private investment was to rise from 126.5 billion Saudi Riyals in 1995 to 176.9 billion in 2000; government investment was to rise from 273.5 billion Saudi Riyals in 1995 to 335.5 billion in 2000.[69] The government services share of total investment was planned to rise from 18.1% in 1995 to 25.0% in 2000, with much of the producing sector investment in manufacturing to go to government-run petroleum refining and petrochemical activity. Even if it had been successful, this shift in investment scarcely represented rapid "privatization" and was highly dependent on improved oil revenues. It did not meet the plan's stated goal of increasing the role of the private non-oil sector, which remains at almost exactly the same 10% share of the economy today as it had in 1990. [70]

If one looks at the achievements of the Sixth Development Plan, however, the planned level of real growth and reform did not take place in either the government or private sector. If one accepts Saudi figures, Saudi Arabia calculates that the average rate of annual real growth (in constant 1989 prices) was 0.6% in the government petroleum sector during 1995-1999, 1.8% in the non-petroleum government sector, and 1.3% in the private sector. The shifts in both private and public capital expenditure fluctuated sharply by year, depending largely on oil revenues. The annual rate of government gross fixed capital formation varied from –5.8% to +14.1%. The rate in the oil sector varied from –43/4% to +6.5%, and the rate in the private sector varied from –10.4% to +26.2%.[71]

The total value of private and government non-oil sectors grew from 237.9 billion Saudi Riyals in 1995 to 255.7 billion in 1999 (+7.5%), measured in constant 1989 prices. The oil sector

grew from 140.5 billion to 144.5 billion (+2.8%), and the entire GDP in purchaser's values grew from 387.3 billion to 409.4 billion (+5.7%)[72] Total growth over the period of the Sixth Development Plan was only about half the rate achieved during the Fifth Plan, and well under one-third the rate of population growth.

There were other areas where the Sixth Development Plan failed to set a meaningful course for the nation's future. It called for reductions in the past level of subsidies to water-intensive agriculture, but still called for a 3.1% increase in output and for agriculture to increase from 36.9% of the non-oil GDP in 1990, and 38.3% in 1995, to 40.2% in 2000. It is difficult to see how this growth could ever have been achieved without the massive subsidies, in terms of water and fuel that are sold far below cost and market prices. The planned growth in the service sector was also highly dependent on import-related income and left the share of government services in 2000 (24.0%) at a level very close to that in 1990 (25.8%).[73] In practice, however, oil revenues and budget problems made many of these issues moot.

In any case, progress fell far short of Saudi goals and the government failed to make most of the reforms necessary for the plan to work. As has been noted, the Gulf War and limited oil revenues still had a lingering impact in the mid-1990s. The crash in oil prices that began in late 1997 then led to a new deficit of US$ 12.9 billion in 1998 and US$ 9.1 billion in 1999.[74] Once again, the Sixth Development Plan demonstrated that good intentions did not pave the road to major progress.

Looking at the Future: The Saudi Seventh Development Plan

The goals and policies of the Seventh Development Plan (2000-2004), which was released in August 1999, again set all of the right priorities and its expenditure and implementation plans again present the same basic problems. The plan calls for total expenditures of 488.2 billion in current Saudi Riyals. This is a nearly 60 billion Riyal increase over actual expenditures in the Sixth Development Plan, but still means that the Kingdom will spend roughly 60% of the peak expenditures it made in the Third Plan as measured in constant Riyals.

As was the case in the Fifth and Sixth Plans, the Seventh Development Plan also emphasizes the need to solve the Kingdom's increasingly urgent human resources problems over investment in development and infrastructure. Human resources development is planned to rise to 56.7% of the total and social and health development is nearly constant at 19.6%. Capital investment-heavy activity like infrastructure is planned to drop to 15.2% -- in spite of expanding demand and underinvestment in the maintenance of some key systems like water -- and economic resources development is only planned to total 8.5%.[75]

The Macroeconomic Implications of the Seventh Development Plan

Some aspects of the Seventh Development Plan have already been discussed in the previous chapter, but its major macroeconomic goals are:

- Achieve an annual GDP growth of 3.16%, with annual growth in the private sector of 5.04%. Achieve average annual growth rate of 3.44% in services sector, 3.05% in agriculture, 8.34% in non-mining, and 5.14% in industrial sector.
- Diversify the economy by attaining a non-oil sector growth of 4.01% per year, expanding the role of the non-oil sector from 68.4% to 71.6% by 2004. Much of this growth should be targeted towards the manufacturing sector, rather than in the service sector
- Achieve an average annual growth rate of 8.29% in petrochemicals, and 7.16% in other manufacturing.
- Increase gas production to develop reserves and domestic use, in order to serve development objectives and contribute to the diversification of income sources.
- Enhance the private sector's participation in petroleum industries.
- Consolidate efficiency in production, refining, and distribution.
- Achieve average annual real growth rate of 6.85% in investment; increase investment from 22.7% of GDP in 2000 to 25.4% in 2004, with 71.2 % of the total investment in the economy coming from private sector sources.
- Reduce the State budget deficit as a percentage of GDP, from –10.8% in 1999 to zero percent by 2004, through measures such as increasing government non-oil revenues, and rationalizing government expenditures.
- Improve the current account balance, and go from a deficit equal to 3% of GDP in 1999 to a surplus of 6.9% in 2004.
- Increase the role that the Saudi Credit Bank plays in investing in small business.
- Increase the size of the electricity, gas, and water sector by an average annual rate of 4.62%, and increase construction on related projects by 6.17%.

- Increase the share of national manpower in total employment from 44.2% to 53.2%, and replace 488,600 foreign workers with Saudi nationals.

- Develop human resources and the value of Saudi nationals through programs that expand higher and vocational education, with an increased emphasis on on-the-job training, by increasing technical school enrollment from 33,000 to 55,000.

- Develop a national manpower database to match individuals with appropriate jobs for their level of qualifications.

- Increase the effectiveness of the Saudi health care system, achieving a 95% immunization rate for children, adding 4630 beds to hospitals, including the construction of 44 new hospitals, each with 50 bed capacities.

- Increase the amount of transportation infrastructure including roads, highways and water networks.

The broad macroeconomic goals of the Seventh Development Plan are summarized in Table 6.3, in constant (1994) Saudi Riyals. The plan calls for an average annual GDP growth of 3.16%, and even if this goal was achieved it would lag Saudi population growth. The Plan only calls for annual average growth in the oil and gas sector of 1.21%. It leaves the burden of growth to the non-oil sectors that must grow at an average annual rate of 4.10%, so that the non-oil sectors of the GDP must grow from 68.4% in 1999 to 71.6% in 2004. It is important to note that oil refining and petrochemicals are defined as parts of the non-oil sector. Even if they are added to the oil and gas sector, however, they still only account for 35.5% of the GDP in 1999 and 32.7% in 2004.[76]

The other producing sectors must grow at an annual average rate of 5.04%, and the service sector, which must grow at 3.44%. The bulk of growth must occur in the private sector -- with the non-government service sector growing at 5.03% versus 1.21% for the government services sector. Non-oil (private sector) mining is planned to grow by an average of 8.29%, petrochemicals by 8.29%, other non-oil manufacturing by 7.16%, and finance and business services by 7.68%. In broader macroeconomic terms, the growth in other manufacturing (less refining and petrochemicals), construction, non-government services, non-oil trade, real estate, and finance business services is planned to make up for a lack of growth in all petroleum related activity and a decline in government services as a share of GDP (17.8% to 16.3%).

Table 6.4 provides an additional perspective by showing the Seventh Development Plan's estimate of capital formation and investment. It shows that gross capital formation is expected to reach 671.73 billion Saudi Riyals during the life of the plan in constant 1994 Riyals, and that the non-oil private sector is expected to implement 478.48 billion Riyals of this total or 71.2%. The

non-oil producing sectors are projected to account for 32.2% of planned investments, and the finance, insurance, real estate, and business sectors to account for 11.8%. The non-oil government services sector will account for 33.41%

Like previous plans, the Seventh Development Plan stresses the importance of a continued drive towards privatization, with the goal of achieving "lower costs, improved [economic] performance, and providing jobs for citizens."[77] Tables 6.3 and 6.4 show, however, that the Seventh Development Plan differs from other plans in the government's sharply growing need for a level of private sector and foreign investment that can alleviate many of its capital, budget deficit. It is also clear from the plan that this be accomplished largely by reforms that remove the barriers to foreign and private investment, rather than by direct financial incentives or government-funded programs to encourage investment. At the same time, all of the expenditures and investment proposals in the Seventh Development Plan are increasingly evaluated in terms of their potential effect on the job market, and the need to emphasis social and entitlement expenditures, and operations and maintenance -- even at the cost of necessary government investment.

Saudi Arabia will continue to make progress under the Seventh Development Plan. In fact the data in the previous tables and charts show it already has done so. It is doubtful, however, that the Kingdom will meet its goals in replacing government with private and foreign investment, lead to the required growth in the private sector, create the necessary jobs, and make the Seventh Development Plan any more successful than the Fifth or Sixth.

As has been noted earlier, the Saudi investment climate has been sharply affected by the instability in the region, the regional turmoil coming from the Second Intifada, the backlash from the events of "9/11," and the uncertainties regarding a US and British attack on Iraq. At the same time, many key elements of government's plans for economic reform legislation already lag by one-two years, and the government cannot now come close to meeting many of its goals for privatization and foreign investment in areas like gas. The growth of the producing sectors still calls for excessive growth and investment in agriculture. The other producing sectors are lagging with the exception of construction, and many activities in the services sector continue to expand demand for imports, rather than produce balanced growth.

Table 6.3

Macroeconomic Goals of the Seventh Development Plan
in 1414/1415 (1994) Millions of Saudi Riyals

Sector	Value Added (SR Million)		Share in GDP (%)		Average Annual Growth Rate (%)
	1999	2004	1999	2004	
Crude Oil and Natural Gas	147791	156934	31.0	28.2	1.21
Non-Oil Sectors	325393	397728	68.4	71.6	4.10
Producing sectors	130505	166901	27.4	30.0	5.04
Agriculture	34666	40282	7.3	7.2	3.05
Non-Oil Mining	2207	3295	0.5	0.6	8.35
Industry	45313	58206	9.5	10.5.	5.14
Oil refining	17146	18064	3.6	3.3	1.05
Petrochemicals	4475	6665	0.9	1.2	8.29
Other manufacturing	23692	33479	5.0	6.0	7.16
Electricity, Gas, and Water	765	959	0.2	0.2	4.62
Construction	47553	64158	10.0	11.6	6.17
Services Sector					
Non-Government Services	110366	141070	23.2	25.4	5.03
Trade	35899	44117	7.5	7.9	4.21
Transport and Communications	32473	39029	6.8	7.0	3.75
Finance and Real Estate Services	29054	42053	6.1	7.5	7.68
Real-Estate Services	7728	9633	1.6	1.7	4.51
Finance & Business Services	21326	32420	4.5	5.8	8.74
Community and Personal Services	12940	32420	4.5	5.8	8.74
Government Services	84522	89758	17.8	16.3	1.21
Import Duties Less Imputed Bank Services Charge	2489	1038	0.6	0.2	-16.00
Total GDP	475673	555701	100.0	100.0	3.16

Source: English language version of the Seventh Development Plan 1420/21-1424/25 AH (2000-2004 AD), Riyadh, Ministry of Planning, 2001, p. 131

Table 6.4

Structure of Investment in the Seventh Development Plan in 1414/1415 (1994) Millions of Saudi Riyals

Sector	Values in Billions of SR	Share in Total (%)
Crude Oil and Natural Gas	33.41	5.0
Non-Oil Sectors	638.32	95.0
Producing sectors	222.69	33.2
Agriculture	17.5	2.6
Non-Oil Mining	3.51	0.5
Industry	104.82	15.6
Oil refining	4.93	0.7
Petrochemicals	35.00	5.2
Other manufacturing	64.89	9.7
Electricity, Gas, and Water	79.00	11.8
Construction	17.86	2.7
Services Sector	169.11	25.2
Trade	36.24	5.4
Transport and Communications	33.99	5.1
Finance and Real Estate Services	78.81	11.8
Real-Estate Services	38.81	5.8
Finance & Business Services	40.03	6.0
Community and Personal Services	20.07	3.0
Total Non-Oil Private Sector	478.48	71.2
Government Services	159.83	23.8
Total Investment	671.73	100.0

Source: English language version of the Seventh Development Plan 1420/21-1424/25 AH (2000-2004 AD), Riyadh, Ministry of Planning, 2001, p. 140

The Labor Force Implications of the Seventh Development Plan

All of these factors interact with the fact Seventh Development Plan reflects all of the demographic, job creation, and educational problems discussed in the pervious chapter and which were summarized in Table 5.2. The planned rate of job creation in the Seventh Development Plan, however, raises truly serious issues. The average annual rate of job creation in 0.9% versus a population growth rate that has averaged well over 3.0% and over 3.5% in recent years. The Plan Organization puts the average annual growth rate in the working population at 3.9% (and says the rate below working age has dropped to 2.6% which seems unrealistically low). It can only guess at employment for women, but estimates that in will increase from 32.8% of the labor force in1999 to 34,1% by 2004.

As has been discussed in the previous chapter, job creation is far easier to call for than achieve. Foreign Minister Saud al-Faisal has suggested that each billion dollars invested in new energy projects should produce 10,000-16,000 jobs. The Saudi American Bank estimates that $5,000 million has been invested over the last 25 years in foreign direct investments and has created 54,000 jobs while joint venture projects by the Kingdom created a further 21,000. As a result, only after a major restructuring of the Saudi labor force, to eliminate foreign labor from existing jobs, can significant improvements be made. It is also clear that the government still lacks a viable national manpower strategy that can actually achieve the goal of replacing 60% of the foreign labor force with Saudi nationals.[78] Saudi Arabia's declining real per capita income, persistent budget deficits, and over-dependency on oil revenues will not be easy to change.

The Challenge of Dependence on Petroleum Exports and Revenues

All of Saudi Arabia's economic reform efforts, and development plans, center around the fact that Saudi Arabia remains an oil-driven economy and the resulting strengths and weaknesses. The Saudi petroleum sector accounted for over 39% of the Saudi GDP in 2000, by Saudi estimates. The Energy Information Agency (EIA) of the US Department of Energy (DOE) estimates that petroleum and petroleum related exports accounted for around 90-95% of total Saudi export earnings in 2000, and for 70% of state revenues, and 35-40% of the country's gross domestic product (GDP).[79] More than 55% of Saudi capital investment still goes to oil and petrochemicals.

Chart 6.1 shows a Saudi estimate of the Kingdom's dependence on the main elements of the petroleum sector in constant prices. As has been discussed in chapter III, it is clear that Saudi Arabia is less dependent on the petroleum sector than it was at the start of the oil boom or in the early 1990s, but its dependence did not vary in the 1990s except according to the forces exerted by world demand for petroleum and the resulting revenues.

SAMA data show that the total value of crude oil, natural gas, and petroleum refining was $51.7 billion in 1992, out of a GDP of $123.0 billion (42%). It was $48.2 billion out of $127.6 billion in 1995 (39.0%), $39.1 billion out of $128.76 billion in 1995 (30%), and $77.6 billion out of $173.1 billion in 2000 (44.8%). Saudi Arabia did not diversify, it simply won or lost at a global economic lottery.

Chart 6.2 illustrates the continuing importance of the petroleum sector to the Saudi economy in simpler terms. It shows that that in 2000, an average annual change of even $1 in the price of a barrel of oil can cut or raise the Saudi GDP by $2.5 billion.[80]

Chart 6.3 shows that the rate of diversification in the Saudi economy slowed sharply in the 1990s, and that much of the decline in the relative size of the petroleum sector has been the product of massive government spending, rather than an increase productive activity. It shows that a combination of state-owned petroleum activity and other government activity accounts for over 60% of the total economy, and that there has been no meaningful change in the relative importance of petroleum, other government, and private sectors on the Saudi economy for a decade.

In fact, the total value of all non-petroleum sectors in constant 1994 prices declined from a peak of 80.8%% of the total GDP in 1985 (a year of extremely low oil revenues), and 72.5% in 1989, to levels well below 70% through all of the 1990s. there was no meaningful no growth in share through 2000, when the non-petroleum sector totaled 66.2% of the GDP. The situation was more impress in terms of absolute growth. The private sector did add 11% in terms of value in constant 1994 Riyals between 1994 and 2000, but this is less than 2% per year. Expenditures in the government sector also increased by 9.2%, or virtually the same amount. The growth outside the petroleum sector is even less impressive in reality because the way in which the Saudi government measures the value of petroleum sector understates Saudi Arabia's true dependence

on oil and gas. Saudi data normally includes most petroleum related construction as construction activity in the other government and private sectors, and the Saudi data only counts refining activity under the petroleum sector and not activities like the manufacturing of petrochemicals and fertilizers.[81]

The data in these charts also shows the limited impact the Saudi down stream activity has so far had on the economy. While some reporting on individual ventures emphasizes Saudi efforts to expand downstream operations like refining, most of the growth in the value of refining activity in the petroleum sector took place from the mid-1980s to 1990. Measured in constant 1994 Saudi Riyals, refining activity rose from 5.8 billion in 1970 to 10.9 billion in 1985, and then to 12.5 billion in 1990, and 16.3 billion in 1991. It dropped below 16 billion Riyals annually in 1993-1996, Since that time, the value of refining activity has ranged between 16 and 17 billion Riyals, peaking at 16.97 billion Riyals in 2002 – a year of very high oil privates..[82] (The value of refining in current dollars was $5.0 billion in 1992, $5.3 billion in a year of solid oil earnings like 1997, $3.9 billion in a year of low oil earnings like 1997, and $5.8 billion in a year of high oil earnings like 2000.) [83]

Chart 6.4 shows how the Saudi economy has shifted by activity, as measured in both producers' values in constant 1989 prices and in current dollars, using two different Saudi sources. This analysis again illustrates the dangers of relying too much on any single source, or the precision of the data now available. Econometrics is at best an art form, and one where the analysis of multiple sources, their origin, and their definition is critical to making even broad judgments. Nevertheless, both sets of data show the same over-dependence on oil as analysis by sector, and a lack of serious momentum behind diversification.

If anything, both sets of data understate Saudi dependence on the petroleum sector because it is impossible to breakout petroleum-related construction, government activity, and manufacturing – such as plastics – with any consistency. Nevertheless, some recent trends seem fairly clear:

- The Saudi construction sector is one of the few areas outside the petroleum and government sectors that has long had a major impact on the Saudi economy. This sector, however, has scarcely been an engine for recent growth and diversification. It accounted for around 11% of the GDP in 1985, but was 8.5% in 1992, 8.4% in 1995, 9.9% in 1998, and 7.9% in 2000. It too has grown relatively slowly since the end of the Gulf War, and at an average real rate of less than 1% since 1992. [84]

- The data in Part Two do reflect a significant sales sector in wholesale, retail, and restaurant activity, which has grown from around $8 billion in 1992 to $10 billion in 2000. This activity, however, consists largely of the marketing of imported goods, and growth is virtually inevitable given Saudi demographics.

- The growth of the transportation and communication sector has been significant, but the value of the sector still declined from 8.7% of the GDP in 1985 to 6.4% in 1990. The growth of the finance, insurance, real estate, and business services sector was also relatively static, and it shrank from 7.4% of the economy in 1985 to around 5.0% in the late 1990s. It was only 4.9% in 2000, although its share was inevitably higher in years with low oil revenues. [85]

- The total share of government services in the economy has been relatively static and has not declined over time. It was 16% of the GDP in 1992, 18% in 1995, 18% in 1997, and 17% in 2000. The community, social, and personal services sector, and the electricity and water sector have grown more steadily, but have still lagged population growth and have not grown in ways that have contributed more to the economy than they have consumed.[86]

- While agriculture accounts for over 6% of the GDP, it only does so because of government subsidies, the waste of irreplaceable "fossil" well water, and the underpricing of desalinated water [87] Even with such subsidies, agriculture averaged less than 2% real growth during the 1990s, and it might well have shown no growth, or a decline, without subsidies.[88] The trade sector shrank from 10.2% of the GDP in 1985, to 7.7% in 1990, 6.4% in 1995, and then rose to around 7% in the late 1990s.[89] The average rate of annual growth was less than 1% after 1992, however, and employment per dollar shrunk slightly while the ratio of imports per trade dollar increased slightly.[90]

- The two sectors where there has been positive growth that actually have benefited the economy have been mining and quarrying, and manufacturing. Mining and quarrying had a low real growth rate of less than 2.0% during most of the 1990s, but this rose to around 3% during 1997-1999. This at least approached the population growth rate. Unfortunately, mining and quarrying remains a sharply undeveloped aspect of the Kingdom's economic activity in spite of substantial resources, and accounted for only about 0.5% of the GDP in 2000. SAMA estimates the net value of the non-petroleum related mining and quarrying sector only rose from $0.5 billion in current dollars in 1992 to $0.7 billion in 2000, while the total GDP rose from $123.0 to 173.1 billion.

- Non-petroleum related manufacturing had a low real growth rate of less than 2.0% during most of the 1990s, but this rose to around 5% during 1997-1999. Its value rose from $5.5 billion in 1992 to $9.9 billion in 2000. Manufacturing accounted for around 4-6% of the GDP in 2000, but this was roughly the same share of the Saudi GDP as in the mid-1980s. As a result, the absolute expansion in the value of non-petroleum related manufacturing between 1992 and 2000 had little effect in further diversifying the composition of the Saudi GDP over the last decade.[91]

The Other Impacts of Petroleum Dependence

While most estimates indicate that some 35% to 40% of the Saudi GDP now comes from the private sector, much of this output comes from activity that consists of selling imports and services funded through oil exports. This contributes to Saudi Arabia's heavy trade deficit in services, which has consistently averaged around $15 billion a year since the end of the massive service payments made for the Gulf War.[92] In other words, the apparent growing diversity of the Saudi economy is often more a function of how Saudi Arabia reports its statistics rather than the

kind of restructuring and growth that makes the Kingdom less dependent on oil revenues and exports.

Chart 6.5 reinforces this point. It shows that Saudi government expenditures have been financed largely by oil exports and that the Saudi government share of the GDP has been funded largely by oil. The figures in Chart 6.5 do, however, actually understate the importance of the petroleum sector because they do not include revenues from areas like plastics and petrochemicals in "oil revenues." At the same time, it is clear from Chart 6.5 that the Saudi government has not succeeded in making major reductions in its dependence on the petroleum sector since the mid-1980s. The fluctuations in the share of petroleum revenues in Chart 6.6 from the mid-1985s onwards is more a matter of oil prices and the volume of oil sales in any given year than the result of the structural diversification of government revenues.

Chart 6.7 shows that virtually all of Saudi Arabia's exports are petroleum related and that Saudi Arabia is only making moderate progress in moving into downstream operations. This is particularly important because Saudi Arabia has few natural resources other than oil and gas, and once again the Kingdom has not made significant improvements in the diversification of its exports for more than a decade. Chart 6.7 illustrates the resulting problem in a critical recent case. Non-oil exports did virtually nothing to ease the impact of the massive "crash" in oil prices that began in late 1997.

More recent data on Saudi exports indicate that Saudi Arabia's non-oil exports increased by only 2.4 percent to SR25.4 billion in 2001 compared to SR24.8 billion in 2000, although this occurred in spite of a global economic slowdown. They were estimated to account for about 11 percent of total exports and 3.8 percent of nominal GDP. However, non-oil exports financed through commercial banks constituted only 46 percent of total non-oil exports last year compared to 53 percent in 2000 and 48 percent in 1999. The value of non-oil private sector exports financed through commercial banks fell substantially by 11.4 percent to SR11.63 billion in 2001 compared to a six-year peak of SR13.13 billion the year before.

"Non-oil exports" are also a misleading title because they have a very large component of petroleum-related content, most of which comes from very capital intensive

and low labor-intensive industry. The petroleum market-driven Saudi Basic Industries Corporation (SABIC), which does not obtain funds through commercial loans, accounts for one-third of all industrial production in Saudi Arabia and around 70 percent of its total production is destined for the export market. Its net profits fell by more than 50 percent to SR1.78 billion in 2001 compared to SR3.63 billion in 2000. In contrast, the Saudi cement industry increased its exports by 3.7 percent to 2.88 million tons in 2001, mostly to countries in the region, including Jordan, Syria and Egypt.

The Saudi Arabian Monetary Agency (SAMA) classifies those "non-oil exports" which are financed through local banks into three major categories: Chemicals and plastics, agriculture and animal products, and other products. "Chemicals and plastics" exports are also closely tied to the conditions in the petroleum market, and financing of chemicals and plastics dropped sharply by 16.7 percent in 2001, to SR3.19 billion compared to SR3.83 billion in 2000. However, chemicals and plastics exports still accounted for 27.4 percent of Saudi commercial bank's financing in 2001, compared to 29.2 percent in the previous year.

Agriculture and animal products, the smallest category of non-oil exports financing accounted for only 1.2 percent of total banks' financing and its value was nearly halved to SR136 million in 2001 over a year ago. This continued decline reflects the non-competitive nature of the Kingdom's agricultural industry where most products are backed by direct and indirect subsidies.

The third major component of Saudi no-oil exports and export financing is "other industrial goods." It includes numerous manufacturing goods such as base metals, building materials, paper products, textiles, machinery and electrical appliances and represents a substantial 71.4 percent of total bank financing. Export financing of this category decreased by 8.1 percent to SR8.31 billion last year, after reaching a six-year peak of SR9.04 billion in 2000. Again, the fall of this category was largely attributed to lower demand for Saudi industrial products on the international market, due to the US-led global recession. The decrease of total export financing was also reflected by falling international commodity prices. According to the International Monetary Fund (IMF), the market price indices for metals and agricultural raw materials dropped by 9.5 percent and 7.2 percent, respectively, in 2001.

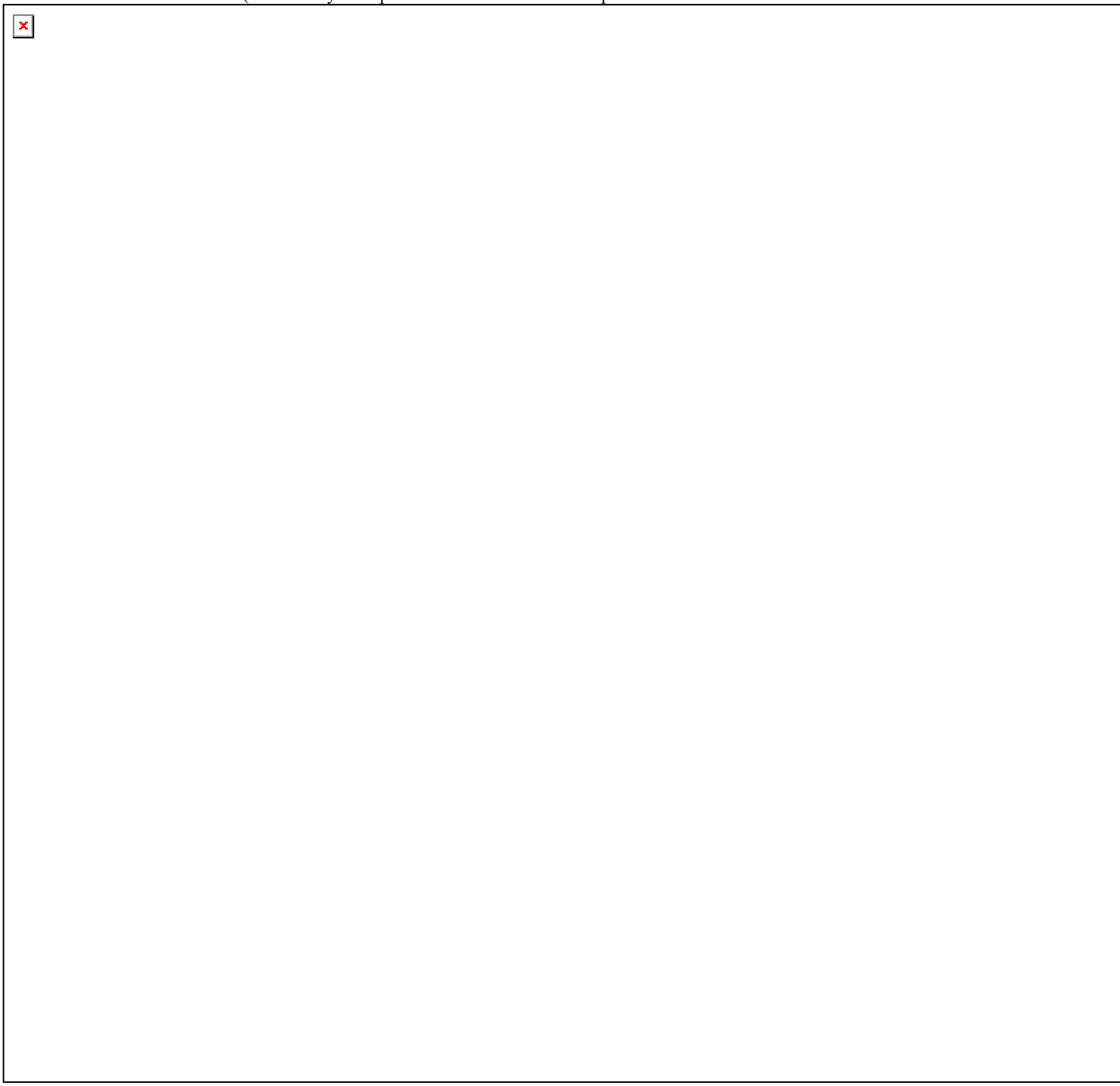
One positive trend that has occurred in recent years is a growth in regional trade, although this does not affect the level of diversification in the Saudi economy or as yet generate added growth. The Gulf Cooperation Council (GCC) share of bank-financed Saudi non-oil exports has risen because of the favorable custom treatment among GCC countries affecting domestically produced goods with at least 40 percent local value added and 51 percent GCC ownership. They are exempted from tariffs, and export financing of Saudi products through local banks' to GCC countries amounted to SR5.0 billion last year, up 1.3 percent from SR4.93 billion in 2000. Other Arab countries constituted the second largest market for Saudi exports financed through local banks with a 15.5 percent share, but remained relatively flat. Elsewhere, the shares of such Saudi exports financed by local banks to Western Europe and the United States remained small at 5.5 percent (SR637 million) and 4.6 percent (SR537 million), respectively.[93]

Once again, it must be stressed that there are no macroeconomic rules about economic dependence on petroleum, or that determine the level of diversification required. Nevertheless, Charts 6.8 and 6.9 put Saudi dependence on the oil sector in a broader perspective, and one that is often ignored in discussions of the Gulf. They show that the oil economies in the Middle East have shown relatively slow sustained growth since the oil boom following the fall of the Shah in 1979, and the first two years of the Iran-Iraq War in 1980-1981. In contrast, diversified economies have had higher average growth over time than oil economies in the Middle East, and much higher growth in the developing world as a whole.

Chart 6.1

Oil and Petroleum as a Share of the Saudi GDP: 1970-2000

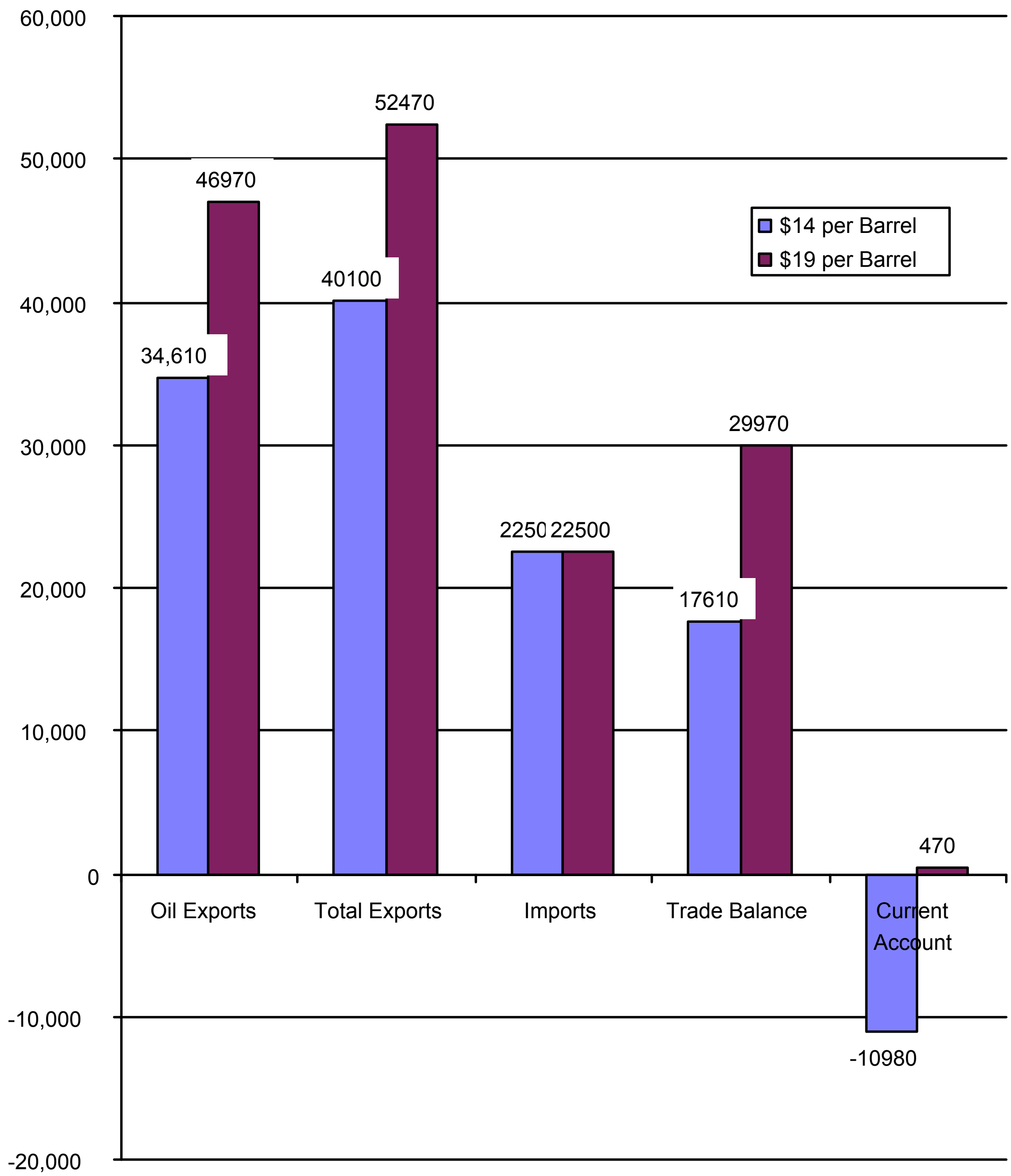
(Million Riyals at producers' values at constant prices: 1970=100



Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, Thirty-Sixth Annual Report (2000), SAMA, Research and Statistics Department, 2000, pp. 346-348; Thirty-Seventh Annual Report (2001), SAMA, Research and Statistics Department, 2001, pp. 356-358.

Chart 6.2

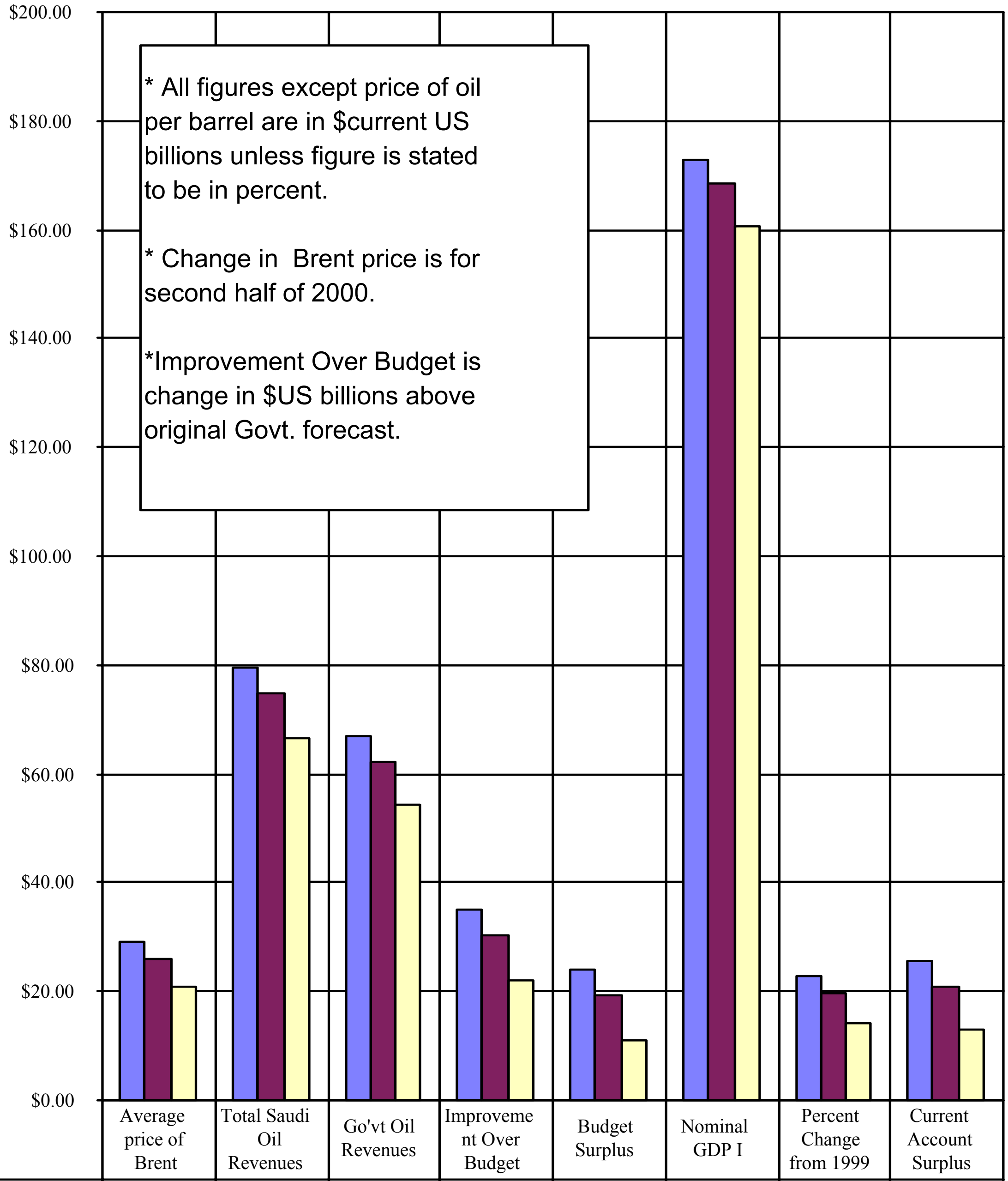
The Impact of Oil Prices on the Saudi Economy – Part One
(In Current $US in Thousands)



Source: Adapted from Middle East Economic Digest, September 27, 1996, p. 5

Chart 6.2

The Impact of Oil Prices on the Saudi Economy – Part Two
(In Current $US in Thousands)

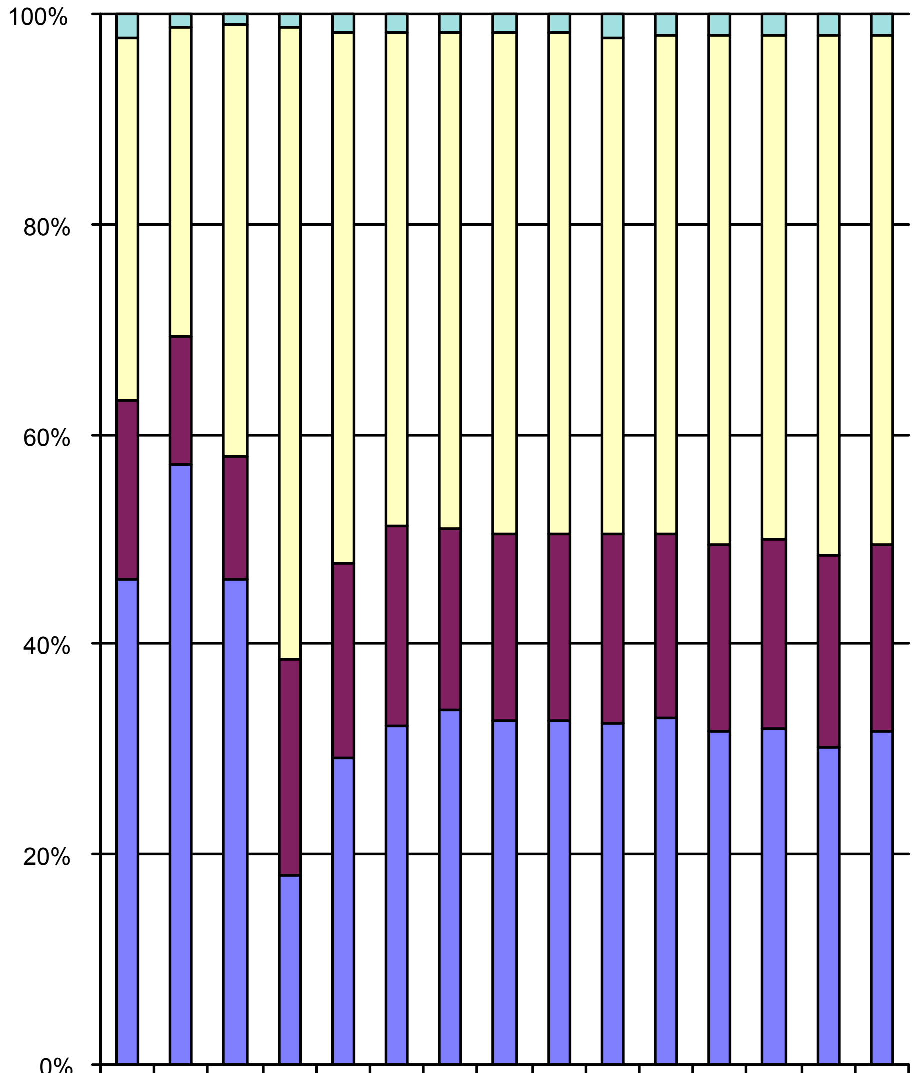


	Average price of Brent	Total Saudi Oil Revenues	Go'vt Oil Revenues	Improvement Over Budget	Budget Surplus	Nominal GDP I	Percent Change from 1999	Current Account Surplus
High Case	$29.00	79.5	67	35	24	173	22.7	25.6
Base Case	$26.00	74.7	62.2	30.2	19.2	168.7	19.6	21
Low Case	$21.00	66.7	54.2	22.2	11.2	160.7	14	13

Source: Adapted from Brad C. Bourland, The Saudi Economy: Mid-2000 Update, Riyadh, Saudi American Bank, August, 2000. Pp. 4-8.

Chart 6.3

Saudi Oil Production, Government Expenditures, and Other Economic Activity as a Percent of GDP at Constant 1994 Purchaser's Prices



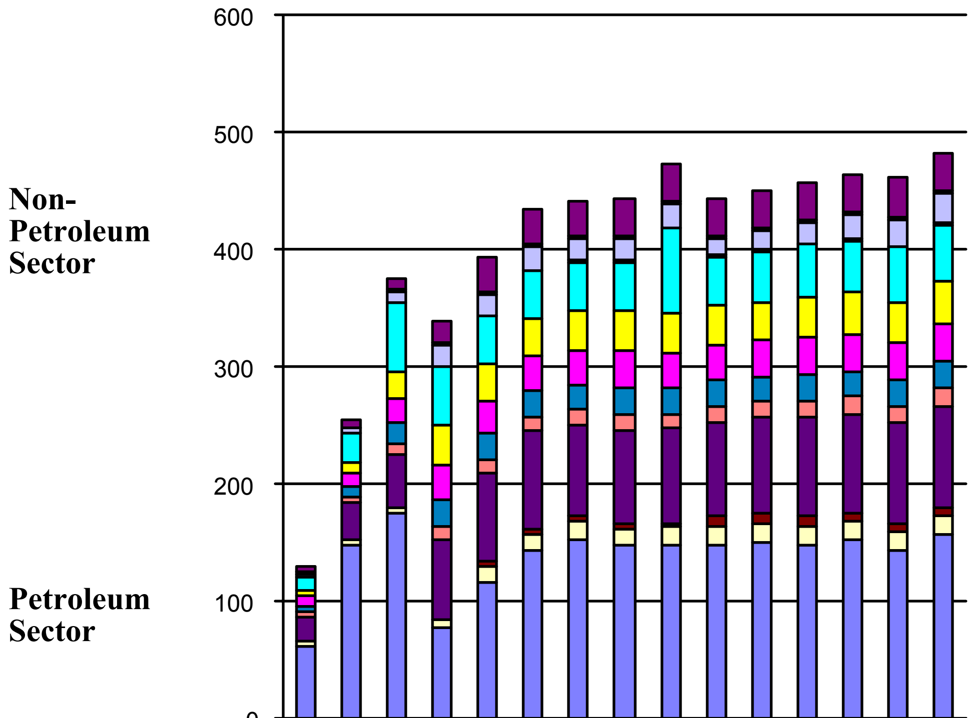
	70	74	80	85	90	91	92	93	94	95	96	97	98	99	2000
Import Duties	2.3	1.3	1	1.3	1.9	1.7	1.9	1.9	1.8	2.2	2.1	2.1	2.1	2.1	2
Private Sector	34.4	29.4	41.2	60.1	50.5	47.1	47.1	47.6	47.7	47.4	47.3	48.3	48	49.3	48.5
Government	17	12.1	11.7	20.6	18.4	18.9	17.2	17.8	17.8	17.8	17.7	18	17.8	18.3	17.8
Petroleum Sector	46.3	57.2	46.2	18.1	29.2	32.3	33.9	32.7	32.7	32.6	32.9	31.6	32.1	30.3	31.7

Source: Adapted by Anthony H. Cordesman from Ministry of Planning, Achievements of the Development Plans, 1390-1420 (1970-2001), Facts and Figures, Ministry of Planning, 19th Edition, 2002, Tables 9 and 10.

Chart 6.4

The Composition of the Saudi Economy by Sector –Part One

(In Billions of Constant 1994 Riyals in Producers Values)

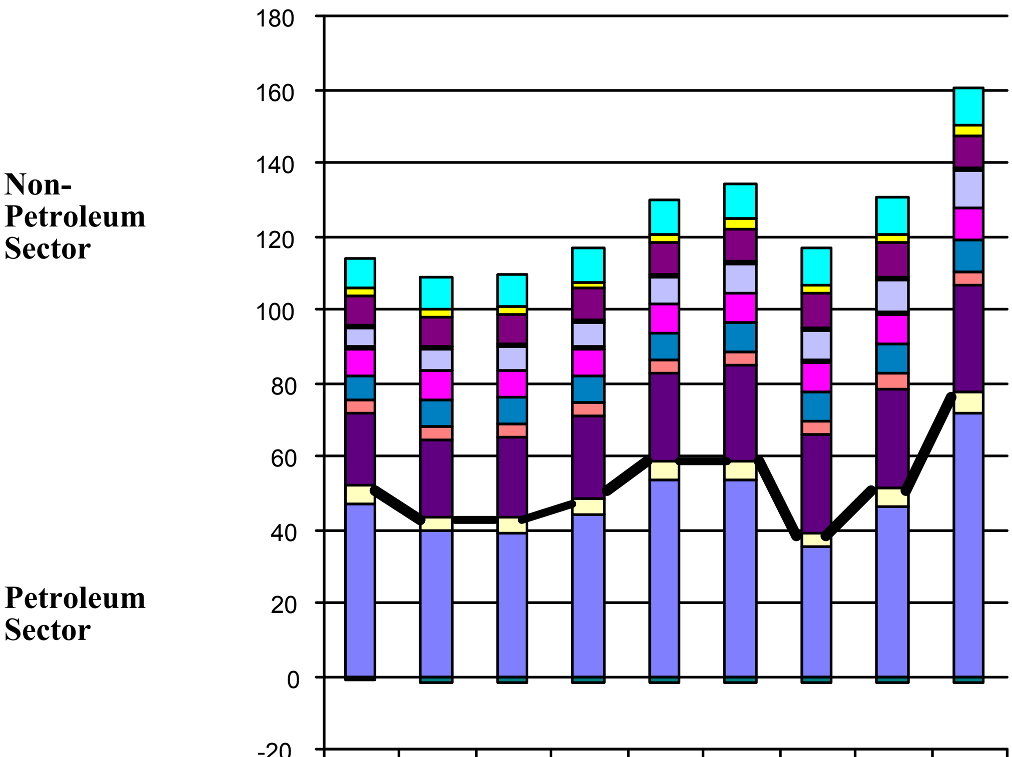


	70	74	80	85	90	91	92	93	94	95	96	97	98	99	2000
Agriculture & Fishing	5.6	6.7	9.3	18	30	30	31	31	31	31	32	32	33	33	34
Mining & Quarrying	0.6	1	1.5	2	2	2	2.1	2.1	2.1	2.1	2.1	2.2	2.3	2.3	2.4
Other Manufacturing	2.8	4.8	9.7	19	17	19	19	20	20	15	16	18	21	23	25
Electricity, Gas, Water	0.1	0.2	0.3	0.5	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.9	0.9
Construction	12	25	60	49	40	41	42	42	73	43	43	45	45	46	48
Trade	4.2	7.6	21	34	32	32	33	33	33	33	33	34	35	35	36
Transport & Communications	8	12	20	30	29	30	30	33	31	31	31	32	32	33	33
Finance & Real Estate	5.4	9.3	20	23	21	21	22	22	22	21	21	22	22	22	23
Community & Social Services	3.5	5	8.7	11	13	13	13	13	13	13	14	14	14	15	15
Government Services	23	31	44	67	74	84	78	80	80	81	81	84	85	86	88
Petroleum Construction	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Petrochemicals	-	-	-	1.3	5	3.7	3.7	3.8	3.9	9.4	8.5	8.6	6.3	5.9	5.6
Refining	3.4	4.3	5.4	7	13	15	16	16	16	16	16	17	17	17	17
Crude Oil & Gas	62	148	175	76	117	142	153	147	147	148	151	147	152	143	156

Source: Adapted by Anthony H. Cordesman from Ministry of Planning, Achievements of the Development Plans, 1390-1421 (1970-2001), Facts and Figures, Ministry of Planning, 19th Edition, 2002, Tables 11 and 12.

Chart 6.4

The Composition of the Saudi Economy by Sector –Part Two
In Current $US Billions

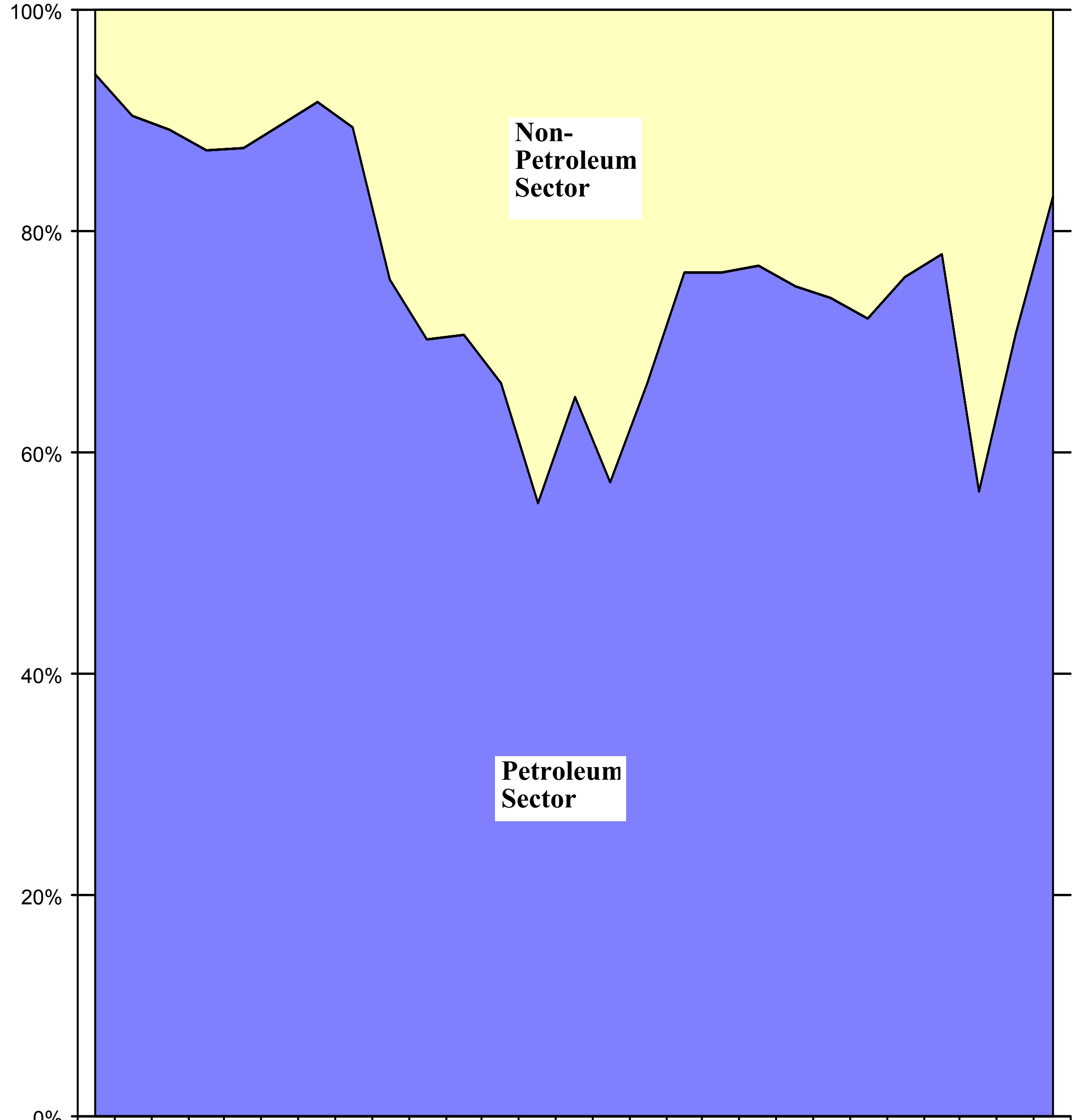


	92	93	94	95	96	97	98	99	2000
Total	*123.0	*118.4	*120.0	*127.6	*141.1	*146.3	*126.7	*142.6	*173.1
Bank Service Charges	-1.3	-1.5	-1.6	-1.6	-1.6	-1.6	-1.7	-1.9	-2.1
Wholesale/Retail/Restaurants	8.3	8.6	8.8	9.2	9.5	9.9	9.9	10	10.4
Import Duties	2.4	2.5	2.2	2	2.4	2.4	2.7	2.6	2.6
Agriculture & Fishing	7.7	8.1	8.3	8.4	8.6	8.9	9	9.2	9.3
Mining & Quarrying	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.7	0.7
Manufacturing	5.5	5.9	6.3	6.9	7.5	8.2	8.6	9.2	9.9
Electricity, Gas, Water	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Transport & Communications	7.5	7.9	7.4	7.3	7.5	7.8	8	8.2	8.5
Finance & Real Estate	6.9	7.1	7.4	7.3	7.5	7.8	8	8.2	8.5
Community & Social Services	3.4	3.5	3.6	3.6	3.7	3.8	3.9	4	4.2
Government Services	19.9	21	21.4	23	24.1	25.9	26.7	27.4	28.6
Refining	5	4.2	4.2	4.5	5	5.3	3.9	4.8	5.8
Crude Oil & Gas	46.7	39.4	39.2	43.7	53.4	53.6	35.2	46.2	71.8

Source: Adapted by Anthony H. Cordesman SAMA, Annual Report, 37th Edition, November 2001, and Brad Bourland, The Saudi Economy in 2002, Saudi American Bank, Riyadh, February 2002, p. 34.

Chart 6.5

Saudi Oil Exports as a Percent of Total Government Revenues: 1974-1999
(In Current Billions of Riyals)

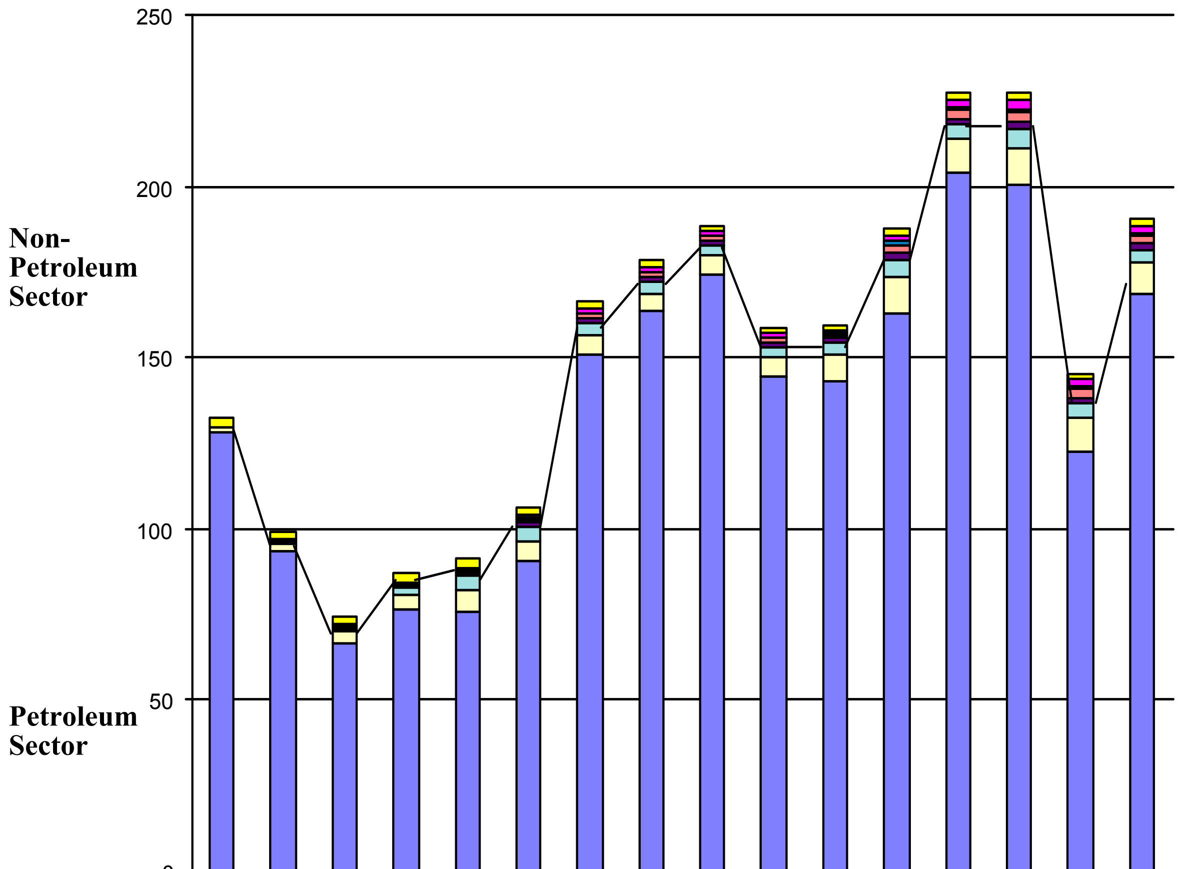


	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	2000
Other Revenues	5.9	9.9	15	17	16	22	29	39	60	61	50	45	34	36	36	39	37	37	38	36	34	41	43	46	62	43	44
Petroleum Revenu	94	94	121	114	115	189	319	329	186	145	121	88	42	67	48	76	118	118	127	106	96	106	136	160	80	105	214

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2000, pp. 360-361; 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 372-373, and Ministry of Planning, Achievements of the Development Plans, 1390-1421 (1970-2001), Facts and Figures, Ministry of Planning, 19th Edition, 2002, Tables 1 and 4.

Chart 6.6

Saudi Petroleum Exports Relative to Total Exports
(In Current Billions of Riyals)



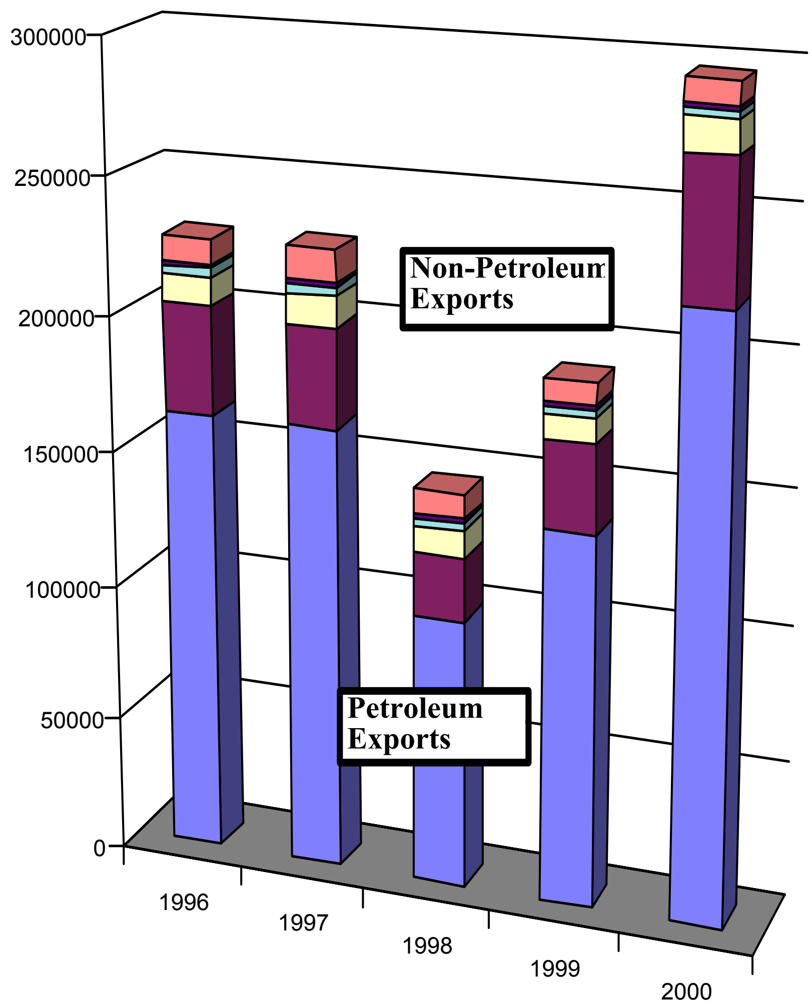
	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99
Reexports	2.5	2.1	2.2	2.3	2.4	2.3	2.4	2.3	1.5	1.5	1.3	1.8	2.3	2.5	1.8	1.9
Other Exports	0.1	0.1	0.1	0.4	0.6	0.7	0.9	1.2	1.1	1.3	1.3	1.9	1.8	2.3	2.1	2.4
Machines & Tools	-	-	-	-	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.9	1.1	1.1	1	0.9
Base Metals & Produc	0.2	0.4	0.4	0.7	0.8	1	1.2	1	0.9	0.9	0.9	2.6	2.4	3	2.2	2.2
Foodstuffs	0.2	0.3	0.5	0.8	1.2	1.4	1.2	1.4	1.6	1.7	1.4	1.6	1.3	1.7	1.7	1.8
Plastics	0.02	0.5	1.1	2.3	3.8	4.2	3.8	3.4	2.8	2.5	3.4	5.5	4.3	5.7	4.2	3.5
Chemical Products	1.5	2.2	2.9	3.8	6.3	5.6	5.7	5.5	5.7	5.8	7.9	10.2	10.4	11	10	9.2
Crude Oil & Gas	127.9	93.6	66.9	76.6	76	90.8	150.9	163.3	174.2	144.6	142.8	163.1	203.7	200.2	122.5	168.7

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 360-361.

Chart 6.7

Saudi Non-Oil Exports Had Almost No "Smoothing" Impact During the "Oil Crash" in 1996-2000

(Value in Millions of Riyals)

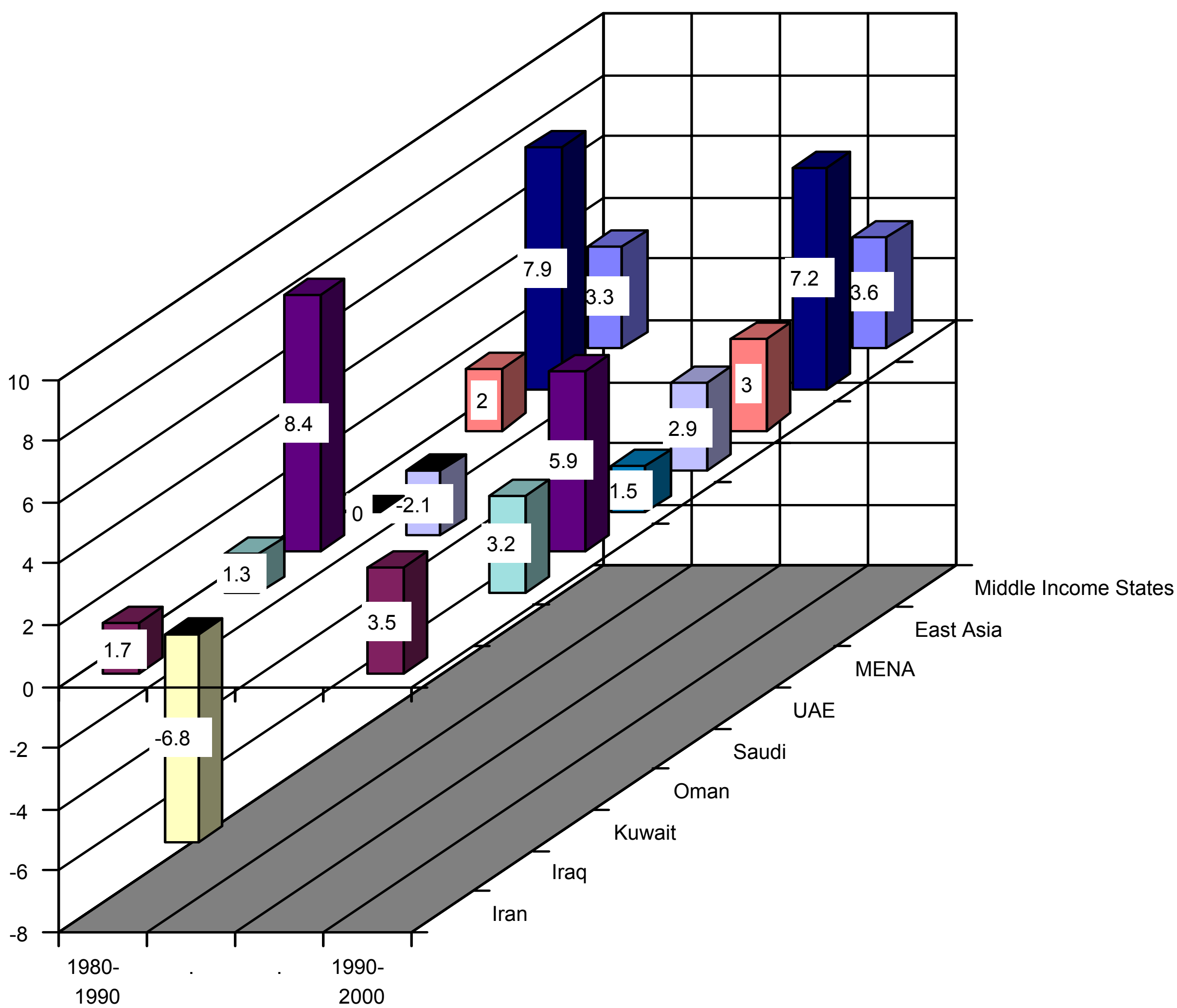


	1996	1997	1998	1999	2000
Others	9443	11385	9055	8099	8268
Agriculture/Food	1339	1660	1663	1768	1700
Construction Materia	2964	3593	2737	2808	2712
Petrochemicals	10435	11036	9961	9189	12125
Refined	39965	36755	23133	31977	51480
Crude Oil	163282	163016	98839	136321	219470

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2000, pp. 360-361; and 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 157-158.

Chart 6.8

GDP Growth of Saudi Arabia Lagged Behind the Other Gulf and MENA States, as Well as East Asia and Middle Income States, During the 1980s and 1990s
(Percent of Real Annual Change during 1980-2000)

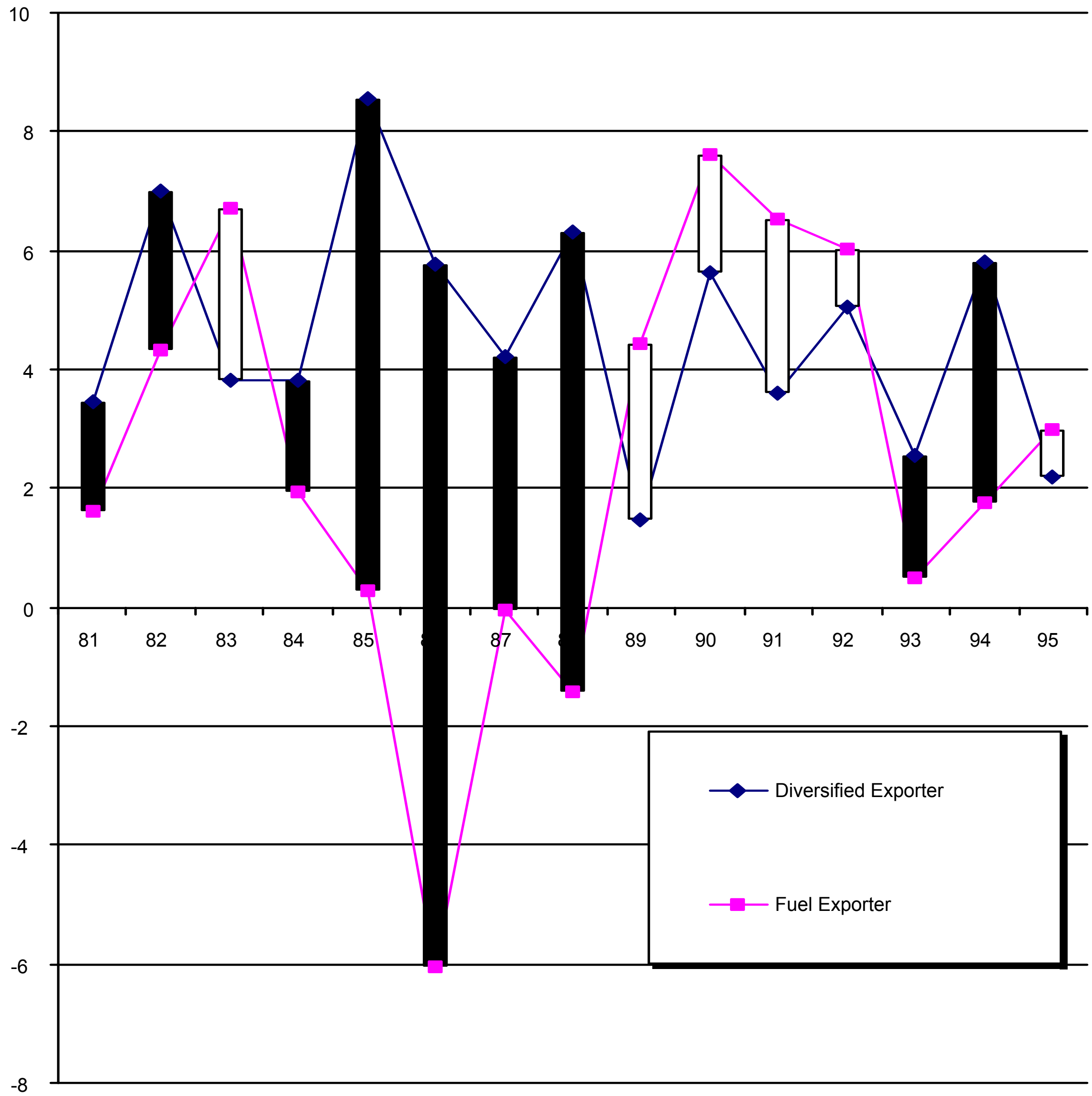


Adapted by Anthony H. Cordesman from World Bank, World Development Indicators, 2002, pp. 204-206.

Chart 6.9

GDP Growth of the MENA Oil Exporters Lagged Behind that of the Diversified Exporters and Was Far More Vulnerable to Oil Prices

(Percent of GDP Growth)



Diversified exporter = Egypt, Israel, Jordan, Morocco, Syria, and Tunisia.
Fuel exporter = Algeria, Bahrain, Iran, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.
Adapted by Anthony H. Cordesman from IMF, World Economic Outlook, Washington, IMF, May, 1996, pp. 98-105.

Political and Military Risks of Saudi Over-Dependence on Petroleum

The risks inherent in Saudi Arabia's structural dependence on the petroleum and petroleum-related industries and exports are increased by a number of exogenous factors. Petroleum is a global economy commodity whose price is dictated by factors outside Saudi Arabia's control. These include weather, the health of the economies of importing states, and the taxes, regulations, and environmental policies of importing states. External events can also lead to major fluctuations in the price of oil, and these include war and political crises. The Arab-Israeli conflict in 1973, the fall of the Shah in 1979, the outbreak of the Iran-Iraq War in 1980, the Iranian hostage crisis and US sanctions against Iran, the bombing of Pan Am 103 and UN sanctions against Libya, and Iraq's invasion of Kuwait, the Gulf War, and more than a decade of UN sanctions against Iraq, are all examples of such political and military events.

Charts 6.10, 6.11, and 6.12 show the combined impacts of market forces and military and political events on oil prices, the total oil revenues, or OPEC, and Saudi oil revenues in particular. These swings are particularly great if they are measures in constant dollars, which reflects their real economic impact. As Chart 6.12 shows, Saudi Arabia earned $223.2 billion from crude oil exports in 1980, measured in constant 2000 dollars. It earned only $66 billion in 2000, a year with exceptionally high oil revenues by the standards of the 1990s.

If one looks at the swings in current dollars, which are far smaller than the differences in constant dollars, the Saudi oil revenues in Chart 6.11, the revenues reached a peak of $133 billion a year in 1981, and dropped to $46 billion in 1983. As Chart 6.11 shows, the swings in Saudi oil revenues were particularly acute at the end of the 1980s. Saudi oil revenues only averaged around $19 billion to $25 billion from 1984-1988, about one fifth of their 1981 level, and Saudi financial reserves dropped to as little as one-third of their 1981 level of $190 billion. Oil revenues were under $24 billion in 1988.[94]

The Gulf War changed this situation as prices firmed and Saudi oil production rose to compensate for the embargo of Iraq. Total Saudi merchandise exports from $28.3 billion in 1989 to $44.4 billion in 1990, and then to $47.8 billion in 1991, and $50.3 billion in 1992. This new burst of oil wealth was, however, more than consumed by the cost of the Gulf War and aid to the US and other Saudi allies. Further, oil prices and oil revenues dropped sharply in 1993 and

remained low in 1994 and total merchandise exports dropped to $42.4 billion and $42.6 billion respectively.

Rises in oil prices again increased the value of Saudi exports in 1995. Total merchandise exports rose to $49.90 billion, $60.6 billion in 1996 and $60.6 billion 1997.[95] As a result of low oil prices, they dropped to $38.8 billion in 1998 and were still only $50.5 billion in 1999. They rose with oil prices to $80.7 billion in 2002. This total, however, scarcely have the economic impact of a of about $111 billion in real dollars from roughly nine MMBD of exports in 1981, and $73 billion from exports of only 5.6 MMBD in 1992. The Saudi economy also showed now growth even in current dollars in other exports during 1992-2000. Such exports fluctuated from $5.8 billion to $7.4 billion during the 1990s, but they were $6.5 billion in 1992 and were still only $6.6 billion in 2000.[96]

Moreover, Saudi Arabia received less from its foreign investments, in part because it had to pay for the Gulf War. During the late 1980s, Saudi Arabia received a net balance of well over $9 billion a year from investment income. This income dropped to less than $7 billion in 1991, reached a low of $1.4 billion in 1994, and averaged from $2.8 to $3.8 billion a year during the mid 1990s.[97] Saudi official foreign assets did begin to rise again in the late 1990s. They rose from $67.9 billion in 1995 to $78.0 billion in 1996, and $86.0 billion in 1997. However, the drastic cut in oil revenues that began that year forced Saudi Arabia to cut them to $78.3 billion in 1998, and 68.34 billion in 1999. They rose back to $73.5 billion in 2000, as a result of the shift from "oil bust" to "oil boom," and to $82.6 billion in 2001.[98] They are expected to reach $78.5 billion in 2002. These shifts are measured in current dollars, however, and too small to have much macroeconomic impact. In any case, the days in which the Kingdom could accumulate official assets approaching $200 billion in constant 2001 dollars seem to be long over.

These swings in oil prices and oil revenues have an inevitable impact on the Kingdom's trade balances. During the late 1980s the Kingdom's deficits on current account ranged from $4.1 billion to $9.8 billion. This figure increased dramatically from $4.2 billion in 1990 to $27.6 billion in 1991. Since that time, the deficit has dropped to $17.8 billion in 1992, $17.3 billion in 1993, $9.1 billion in 1994, and $5.3 billion in 1995. There was a positive balance of $0.7 billion in 1996, and $0.3 billion in 1997, but the "oil crash" in 1998 led to a deficit of $13.8 billion, which could only be financed through capital payments provided by the oil and private sectors.[99]

The rise in oil revenue during 1999, changed current account balance to a positive $0.4 billion in 1999, produced a surplus of $15.6 billion in 2000, and is expected to produce surplus of $3 billion in 2001.[100] It obvious from these figures that the Kingdom wins as well as loses, but it is equally obvious that in cannot shape the outcome of such trends, predict them, and plan for them as long as it is so dependent on the petroleum sector.

Chart 6.10

Politics, War, and the Trends in the Price of Saudi Arabia Light Crude: 1970-1999

($US Current and $US 1997 Constant)

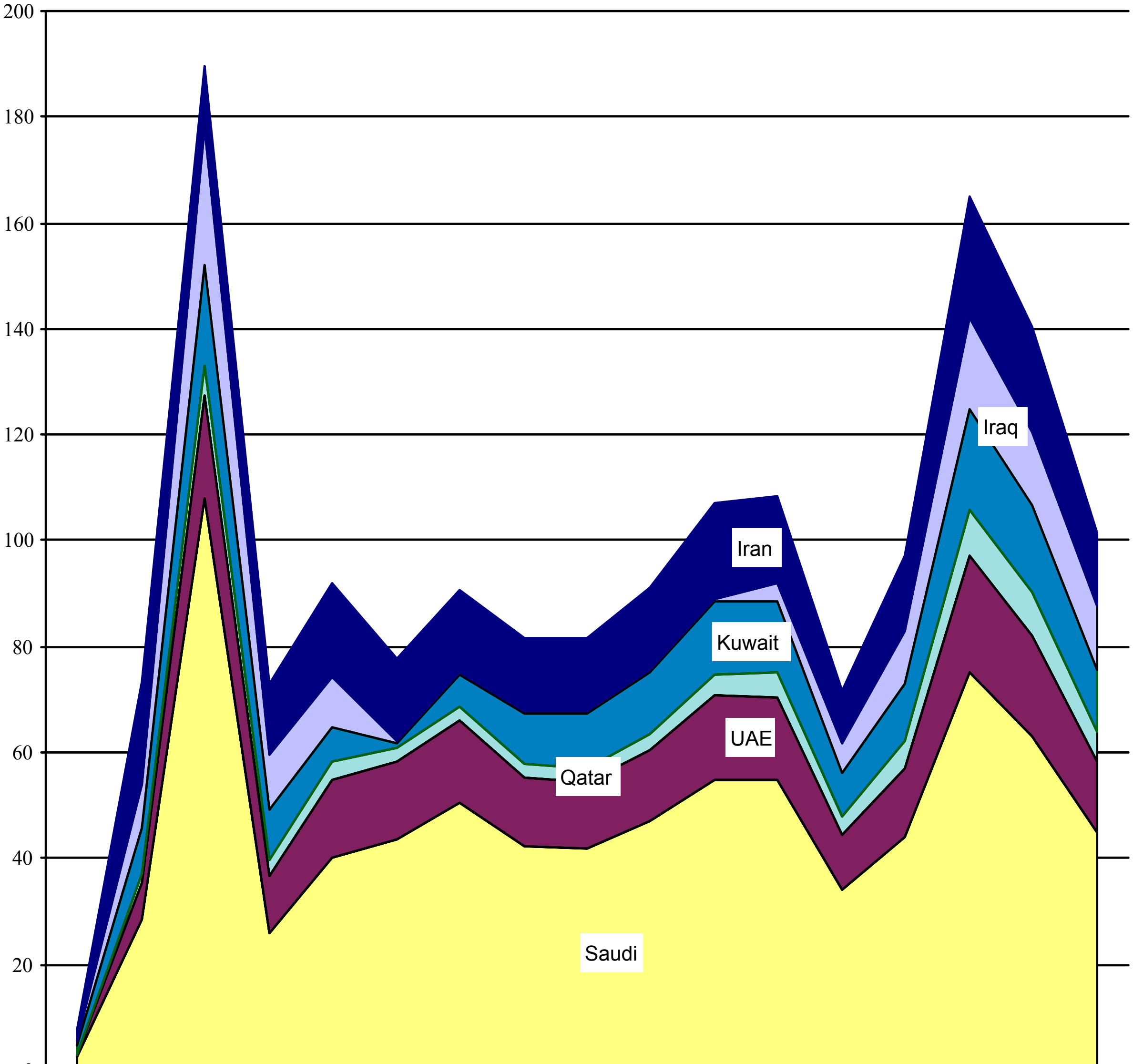
Total ME												
OPEC	13/31	18/87	17/91	9/53	15/19	14.77	15.99	16.75	16.84	16.99	17.18	18.3o
Total ME	13.95	19.57	18.40	10.25	16.49	16.19	17.43	18.34	18.59	18.84	19.08	20.16

Adapted by Anthony H. Cordesman from Cambridge Energy Associates, World Oil Trends, 1998, Cambridge, Mass., 1998, pp. 26-27.

Chart 6.11

The Combined Impact of War, Politics, and Global Market Forces has been Massive Swings in Gulf Oil Revenues: 1970-2000

($Current Billions)

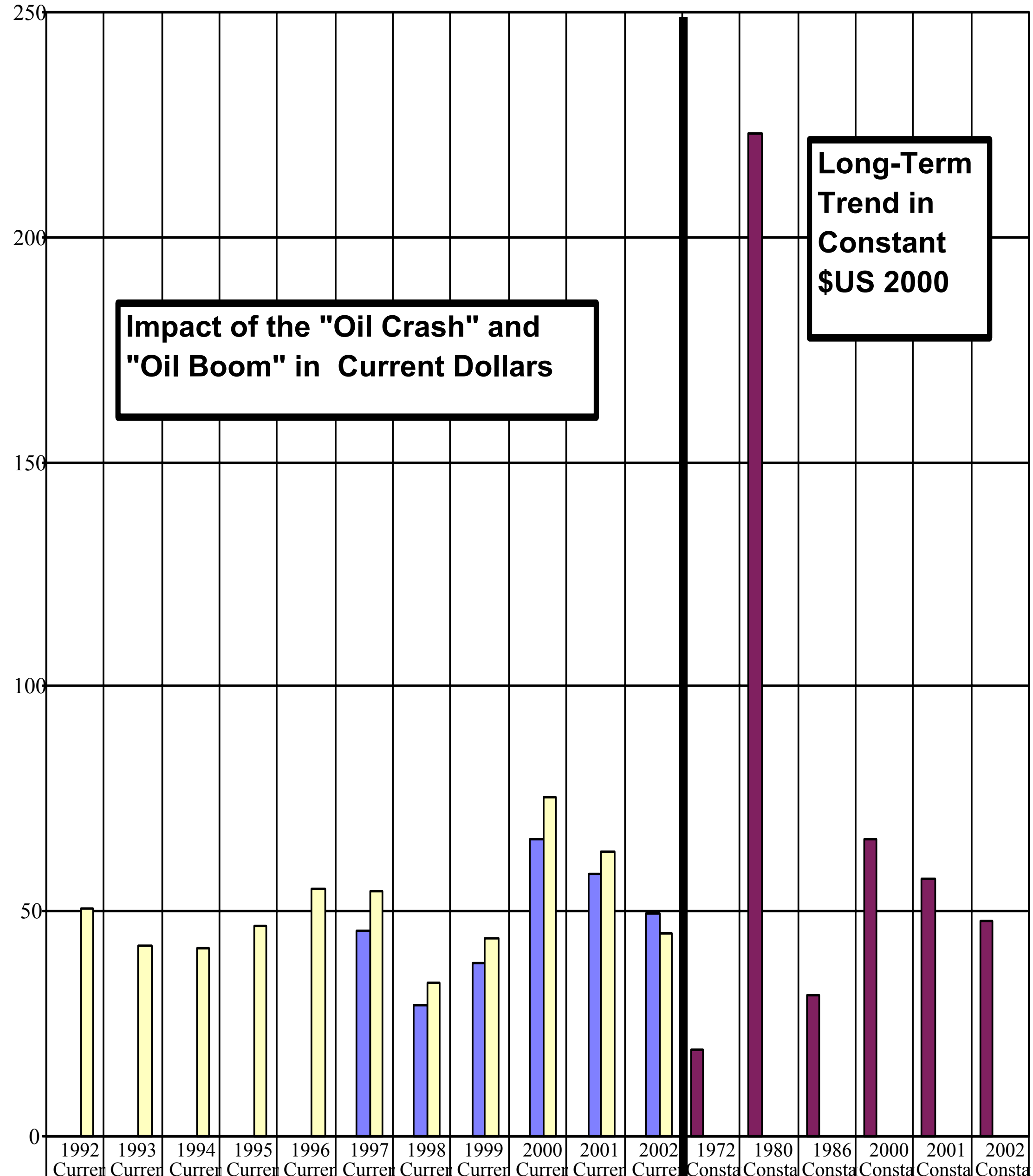


	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002e
Iran	2.4	19.6	11.7	13.7	17.9	15.8	15.5	14	13.8	15.4	18	16.3	10.1	13.9	23	19.9	13.6
Iraq	0.79	8.2	26.1	10.1	9.6	0.35	0.48	0.43	0.44	0.5	0.68	3.5	5.6	9.9	17.2	13.9	12.3
Kuwait	1.6	8.6	18.9	9.5	6.4	0.87	5.9	9.4	10.3	11.7	13.5	13.3	8.2	10.9	18.9	16.6	11.5
Qatar	0.23	1.8	5.4	3.1	3.3	2.8	2.9	2.7	2.7	3.2	3.9	4.8	3.4	5.1	8.7	8.1	5.8
UAE	0.52	6.8	19.4	10.9	14.8	14.4	15.2	12.7	12.6	13.5	16.1	15.8	10.2	13.3	21.9	18.9	13.4
Saudi	2.4	28.5	108.2	25.9	40.1	43.7	50.7	42.5	41.9	46.9	54.9	54.7	34.2	43.9	75.3	63.1	44.9

Adapted by Anthony H. Cordesman from Cambridge Energy Associates, World Oil Trends, 1998, Cambridge, Mass., 1998, pp. 26-27; Cambridge Energy Research Associates, OPEC Tilts to Market Share, World Oil Watch, Winter 2002, p. 28; and from projections by Energy Information Agency based on various editions of the "OPEC Revenues Fact Sheet," www.eia.doe.gov/emeu/cabs/opecrev2.ntml.

Chart 6.12

The Swings in Saudi Oil Export Revenues 1972-2001:
Even the Boom in 2000 Was No Boom By Past Standards
(In $US Current and 2000 Constant Billions)



	1992 Curren	1993 Curren	1994 Curren	1995 Curren	1996 Curren	1997 Curren	1998 Curren	1999 Curren	2000 Curren	2001 Curren	2002 Curre	1972 Consta	1980 Consta	1986 Consta	2000 Consta	2001 Consta	2002 Consta
DOE/EIA Constant												19.3	223.2	31.2	66	57.3	48
DOE/EIA Cur						45.5	29.4	38.3	66	58.2	49.6						
CERA Curren	50.7	42.5	41.9	46.9	54.9	54.7	34.2	43.9	75.3	63.1	44.9						

Source: Adapted by Anthony H. Cordesman from data provided by the EIA as of March 2001 and December 2001 (www.eia.gov/emeu/cabs/opecrev2.html.) and in Cambridge Energy Research Associates, OPEC Tilts to Market Share, World Oil Watch, Winter 2002, p. 28.

"Oil Bust" and "Oil Boom": The Interaction Between OPEC and Market Forces

Saudi Arabia must also cope with the interaction between market forces and the politics of OPEC. Saudi Arabia has often acted independently of OPEC and in ways that have greatly benefited the global economy by stabilizing the world's oil supplies and keeping prices relatively moderate. At the same time, the politics of OPEC can impose limits on the Kingdom's production, and Saudi Arabia does come under political pressure from other OPEC states to reduce its production in times or low oil prices or when other states feel this may serve Arab political causes. For example, the Kingdom came under such pressure in April 2002, when Iraq cut off oil exports to countries that supported Israel against the Palestinians as a result of the Second Intifada and when Iran also called for a boycott. Instead, the Kingdom raised production to compensate for Iraq's cuts and stated that it would not use oil as a weapon, but would rather push forward with Crown Prince Abdullah's peace initiative.[101]

As is discussed in depth in the next chapter, Saudi Arabia's vast oil reserves give it a strong long-term strategic interest in maintaining an increasing level of oil exports at comparatively moderate prices. For all of Saudi Arabia's short-term economic problems, it must think ahead to the market conditions of 2010 and beyond and it is under far less pressure to maximize oil revenues than states like Iran, Iraq, Algeria, and Nigeria. As a result, Saudi Arabia is also often under pressure to reduce its exports more sharply than those of other OPEC states. Nevertheless, Chart 6.13 shows that the interaction between OPEC and market forces does add another set of uncertainties to Saudi oil revenues, and creates another reason that Saudi Arabia must seek to diversify and reform its economy.

OPEC, Mild Winter, and Asian Recession: The "Oil Crash" of 1997

These risks, and the massive swings in oil revenues that can result, are illustrated by both the sudden "oil crash" that took place the late 1990s and the "boom" that followed. In late 1997, Saudi Arabia pushed OPEC into giving the Kingdom its highest oil output quota in more than 15 years. The Kingdom secured a new quota of 8.76 million barrels per day (bpd) at OPEC's ministerial meeting in Jakarta. This quota was 760,000 bpd higher than the quota it had held over the last four years, although Saudi Arabia had been pumping between 8.2 million bpd and 8.3 million bpd in the months leading up to the agreement.

Saudi Arabia took this action despite the fact that OPEC's overall production ceiling rose from 25.03 million bpd to 27.5 million bpd, and the concern of other states in the 11-member group that oil prices would fall because of increased supplies. Saudi experts felt that demand and prices were firm enough so that the benchmark price of Brent crude would average $20 a barrel even with the new OPEC ceilings. Brent was then trading at $19 a barrel, equivalent to around $17.50 for a typical Saudi export barrel.

The Saudi motives in seeking higher production were clear. Saudi officials stated that the rise in quota was necessary to increase the Kingdom's cash flow and funding for its 1998 budget and five-year plan, and reduce or eradicate its $4.5 billion budget deficit. The Saudis also sought to clear contractual debt**,** some of which stretched back to 1991**,** and eliminate any difficulties in marking loan repayments such as the $4.3 billion loan Saudi Arabia took out in November, 1997 to pay for new aircraft for the country's national airline Saudia. Finally Saudi Arabia sought funding to pay for new infrastructure projects and military equipment, such as replacements for some 100 aging US F-5 warplanes.

The end result was an "oil crash" that led to a major cut in oil prices and revenues; the impacts of which still cannot be estimated. An estimate of this decline in Saudi and other Gulf oil revenues is shown in Charts 6.12 and 6.14. Chart 6.13 shows the EIA estimate of the value of crude oil exports while Chart 6.15 shows the trend in total petroleum related exports.[102]

Several factors helped cause this "oil crash." Asia was Saudi's largest crude export market, accounting for 60 percent of sales, with its main buyers in Japan and South Korea. ($1=3.75 Riyals). Asia was already in an economic downturn and slid into a major recession even before the new quota went into effect on January 1, 1998. A mild winter and low demand for heating fuel and uncertainty over the volume of Iraqi crude exports under the United Nations "oil-for-food" deal then made things much worse.

Rises in Iraqi production also had an impact. While OPEC output fell by nearly 1 million bpd, Iraqi output rose by more than 400,000 bpd, thus effectively reducing the OPEC cutback to only 500,000 bpd.[103] Iraq also stepped up its verbal attacks against the Kingdom and its oil policy. Iraq accused Saudi Arabia of flooding oil markets with its production, "pursuing a US policy aimed to reduce oil prices to suit its interest in the Middle East and in Iraq in

particular."[104] Iraqi oil minister Amir Muhammad Rasheed blamed Saudi Arabia for the deterioration in world oil prices, saying Arab countries had lost $929 billion between 1997 and 1998 because of the Saudi oil policy.[105]

Oil prices dropped sharply from around $23 a barrel in October 1997, and reached a nine-year low of $12.80 a barrel on the New York Mercantile Exchange in March 1998 and $14.61 for the most active futures contracts. Prices rose briefly to $16.50 a barrel when Saudi Arabia, Mexico and Venezuela agreed to a joint cutback of 1.325 million barrels per day (MMBD). Nevertheless, prices then dropped again. The OPEC "basket" price (a weighted average of Algeria's Saharan Blend, Indonesia's Minas, Nigeria's Bonny Light, Saudi Arabia's Arabian Light, Dubai, Venezuela's Tia Juana, and Mexico's Isthmus) fell to a low of under $10 per barrel in December 1998.

Prior to the OPEC meeting of June 1998, Saudi Arabia, Venezuela, and Mexico agreed to cut production by 450,000 barrels per day as of July 1st. This cut failed, and even further OPEC cuts of 2.6 MMBD during 1998 only helped to halt a further fall in oil prices, and did not produce a recovery.[106] Real world oil prices during 1998 and early 1999 were at the lowest levels since 1973, prior to the Arab Oil Embargo late that year, and since 1986, following the oil price collapse of late 1985/early 1986.

OPEC revenue had peaked in 1980, at $439 billion in constant 1990 US dollars. In contrast, 1998 was OPEC's worst revenue year in constant dollar terms since the early 1970s ($77 billion in 1972), when revenues reached only $80 billion (in constant $1990). The previous low revenue year had been 1986 ($83 billion in earnings), which followed the oil price collapse of late 1985/early 1986.[107] As a result, the Saudi domestic debt rose from 336 billion Riyals in 1994 to 612 billion Riyals in 1999, and from 76 to 115% of the GDP. The government could only stabilize its budget through domestic borrowing as an alternative to foreign borrowing, and by making a steady increase in the percent of net expenditure on operating expenses and entitlements at the cost of investment. [108]

In March 1999, major OPEC members reached a preliminary agreement to cut world oil production by more than 2 MMBD beginning on April 1st. Special emphasis was placed on resolving the dispute over Iran's adherence to this and previous output cut agreements. Iran had

maintained that its 300,000-BPD reduction should be taken from a baseline of 3.9 MMBD, whereas other OPEC states said it should have been 3.6 MMBD. The issue was resolved when Saudi Arabia, Kuwait, and the UAE agreed to absorb the missing Iranian cut and Iran accepted the benchmark of 3.6 million bpd for all future cutbacks in return. All other OPEC states accepted production cuts below the July 1998 quotas, and all OPEC members except Iraq then agreed to the cuts. The agreement of March 1999 brought Saudi Arabia's production to 7.438 MMBD, substantially below the level of 8 MMBD, that it had tried to defend for the past several years.[109]

The Wheel Turns: The "Oil Crash" Turns into an "Oil Boom"

In the late spring of 1999, this situation reversed itself. An unexpectedly rapid Asian recovery and high economic growth in the developed world began to drive demand back up. As a result oil prices rebounded following OPEC's March 23, 1999 agreement to cut oil production by 1.7 MMBD and West Texas Intermediate and other major crude prices approximately tripled in less than a year.

The increase in oil prices was caused by several other factors: OPEC's March 1999, 1.7-million bbl/d quota cut agreement, in addition to over 2.5 million bbl/d in two output cutbacks agreed to earlier; high levels of OPEC compliance to its quota agreement; and strong world oil demand, including the rebounding Asian economies and the surging US economy. As a result, the US Energy Information Administration's (EIA's) data and forecast information indicated that OPEC oil export revenues for 2000 were 59% higher than 1999, and 113% higher than it 1998.

Saudi oil prices increased sharply following OPEC's March 23, 1999 cutback agreement. They reached a 10 year high of $30 per barrel in early March 2000, and averaged $25-$30 per barrel during late 1999 and early 2000. The Hague and Amsterdam production agreements successfully cut global production by 420,000 barrels in June 1999. Total production averaged 76.48 million barrels a day and Brent crude prices edge above $31 in the first quarter of 2000. The average price of Brent in 1999 averaged $17.90 a barrel up from $12.70 a barrel in 1998. As a result, Saudi revenues from crude oil exports, rose to $38 billion in 1999.[110]

Oil prices continued to rise in 2000 reaching prices not seen since the Gulf War reaching a new 10 year high of $37 a barrel in the third quarter of 2000. This rise in oil prices led to an

improvement in Saudi finances and the Kingdom's economic situation, as oil prices continued to rise to the point where they were 52% higher in early 2000 than in 1999. By Saudi calculations, the value of oil exports, which had dropped from $52.2 billion in 1997 to $32.5 billion in 1998, rose back to $44.7 billion in 1999, and then leaped to $72.1 billion in 2000.

The Saudi budget deficit, which had increase from 2.9% in 1997 to 9.6% in 1998, dropped to 6.4% in 1999 and there was a budget surplus of 3.5% in 2000. The Saudi deficit on current account went from +0.21% of the GDP in 1997 to –10.21% in 1998, but rose to +0.28% in 1999 and +9.01% in 2000. The government domestic debt as a percentage of GDP, which had averaged 76-87% in 1994-1997, risen to 116-119% in 1998 and 1999, dropped to 95% in 2000.[111]

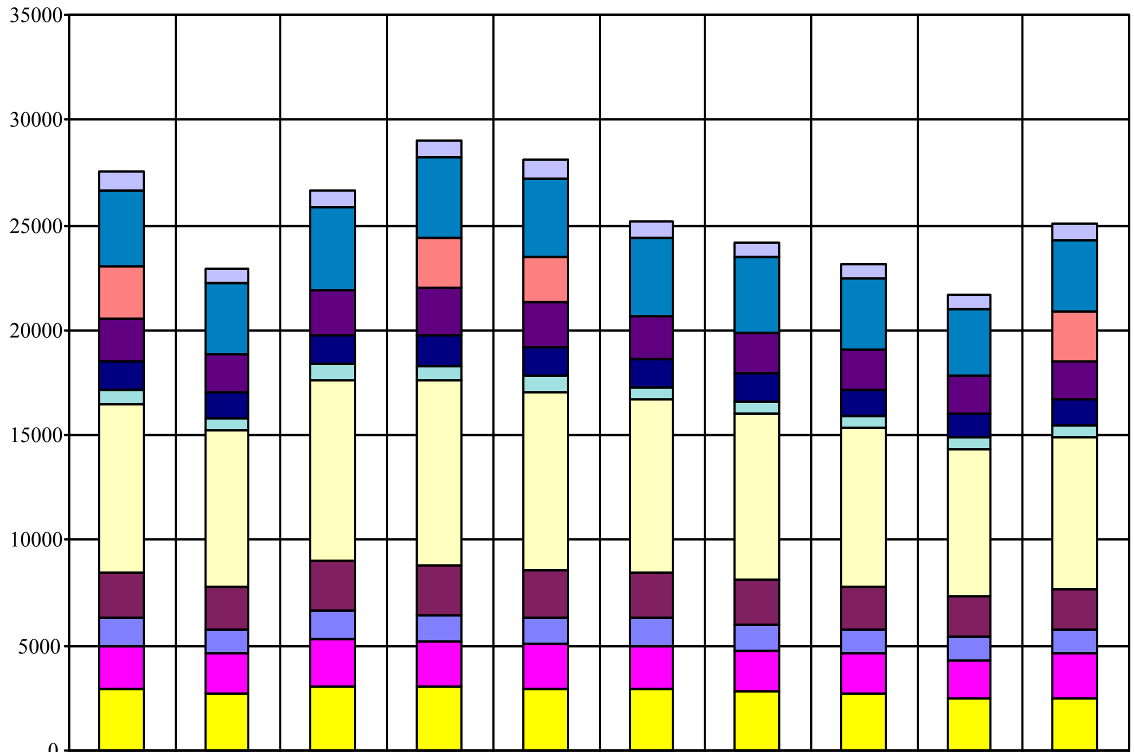
This one year of "oil boom" helped to improve the overall financial stability of the Kingdom, but this scarcely solved any of the Kingdom's structural problems. Even in a year like 2000, the real growth in the GDP at most only marginally exceeded population growth The oil boom of 2000 also did not allow the government to make major increases in its official foreign assets, even though it allocated some of its year 2000 budget surplus to such spending. These had climbed back from levels near or below $60 billion during the Gulf War to a peak of around $86 billion in 1997. The "oil crash" forced the Kingdom to cut them to $74 billion by the beginning of 2000, and they were still around $79.0 billion in early 2001.[112]

Moreover, petroleum revenues dropped again in 2001. The average price of Saudi crude dropped from $27.00 in 2000 to $21.80. The real value of the oil sector of the Saudi GDP, which had increased by 8.5% in 2000, it dropped by 3.6% in 2001. GDP growth was at most well under half the population growth.[113] The budget surplus, which was 3.5% of the GDP in 2000, dropped to a deficit equal to 3.9% of the GDP in 2001. In short, Saudi Arabia certainly benefited from the increases in oil revenues in 1999-2001. It has no way to plan as if it could them in the future, however, and the fact such "booms" follow on "busts" without warning means it cannot even plan how to use such unexpected windfalls efficiently.

Chart 6.13

The OPEC Game Adds Another Uncertainty: Saudi and Other OPEC Member Production Targets and Actual Output: 1999-2002

(In MMBD)



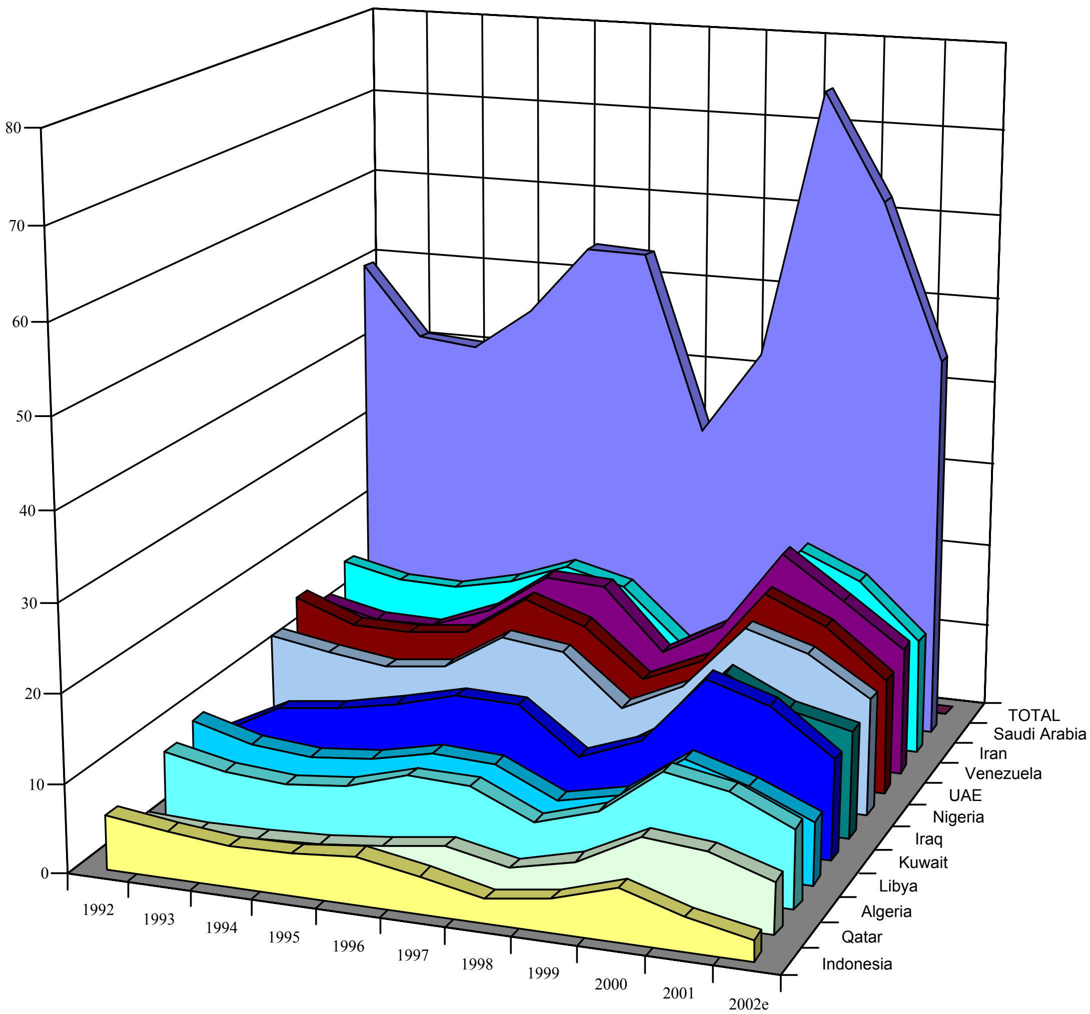
	Actual: Feb 99	3/1/99 Quota	11/1/00 Quota	4Q 2000 Actual	1Q 2001 Actual	2/1/01 Quota	4/1/2001 Quota	9/1/01 Quota	1/1/02 Quota	2Q 2002 Actual
Algeria	810	730	853	842	830	805	773	741	693	770
Iran	3620	3356	3917	3822	3779	3698	3552	3406	3186	3367
Iraq	2560	NA	NA	2382	2072	NA	NA	NA	NA	2404
Kuwait	1990	1836	2141	2212	2154	2021	1941	1861	1741	1780
Libya	1350	1227	1431	1442	1430	1350	1296	1242	1162	1260
Qatar	660	593	692	728	714	653	627	601	562	640
Saudi Arabia	8080	7438	8674	8833	8464	8189	7865	7541	7053	7216
UAE	2160	2000	2333	2335	2278	2201	2113	2025	1894	1930
Indonesia	1330	1187	1385	1275	1260	1307	1255	1203	1125	1130
Nigeria	2040	1885	2198	2135	2124	2075	1993	1911	1787	2050
Venezuela	2900	2720	3077	3010	2958	2902	2786	2670	2497	2530

Source: Adapted from EIA, "OPEC," www.eia.doe.gov/emeu/cabs/opec2.html, various editions; Middle East Economic Digest, March 26, 1999, p. 5; EIA, Monthly Energy Review, various editions, and www.eia.doe.gov/emeu/cabs/opec2.html.

Chart 6.14

"Oil Crash" to "Oil Boom" in 1996-2001: The Cumulative Impact on Saudi and OPEC Revenues

(In US Current Billions)



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002e
Indonesia	6.1	5.2	4.6	4.8	5.4	4.2	2.7	3.7	5.9	3.8	2.3
Qatar	2.9	2.7	2.7	3.2	3.9	4.8	3.4	5.1	8.7	8.1	5.8
Algeria	8.4	7	6.4	7.1	9.2	8.9	5.9	7.9	13.4	12	8.9
Libya	9.6	7.7	7.1	7.7	9.3	8.9	5.7	7.3	12.3	10.1	7.1
Kuwait	5.9	9.4	10.3	11.7	13.5	13.3	8.2	10.9	18.9	16.6	11.5
Iraq	0.5	0.4	0.4	0.5	0.7	3.5	5.6	9.9	17.2	13.9	12.3
Nigeria	12.7	11.5	10.6	11.5	15.7	14.8	9.1	12.4	20.1	18	13.5
UAE	15.2	12.7	12.6	13.5	18.1	15.8	10.2	13.3	21.9	18.9	13.4
Venezuela	12.8	11.2	11.2	14	18.7	18.3	11.1	15	24.5	19.8	14.8
Iran	15.5	14	13.8	15.4	18	16.3	10.1	13.9	23	19.9	13.6
Saudi Arabia	50.7	42.5	41.9	46.9	54.9	54.7	34.2	43.9	75.3	63.1	44.9
TOTAL	*140.4	*124.3	*121.4	*136.3	*165.5	*163.5	*106.2	*143.2	*241.2	*204.2	*148.1

Source: Adapted by Anthony H. Cordesman from projections by the EIA in various editions of its "OPEC Revenues Sheet," and from Cambridge Energy Associates (CERA), "OPEC Tilts to Market Share," World Oil Watch, Winter 2002, p. 28.

Oil Wealth and Demographics: Understanding the Future Limits

There is no way to accurately model any aspect of Saudi Arabia's economic future, In fact, virtually every part of the preceding economic analysis has documented major unpredictable swings in some aspect of Saudi Arabia's economy. At the same time, no discussion of the limits of oil wealth can be complete without examining possible future trends.

History has shown that this is anything but easy. Oil prices are anything but stable, and the average price of a barrel of Saudi light crude oil went from $18.80 in 1997 to $12.24 in 1998 (-45%), only to rise to $17.40 in 1999 (+42%), $26.81 in 2000 (+54%), and $24.70 in 2001 (-8%). Put differently, the price of oil nearly more than doubled between 1999 and 2000, although it fell back in the first half of 2001.[114]

The broader economic impact of these changes is illustrated by the fact the Saudi per capita income in current US dollars fell from $7,313 in 1997 to $6,208 in 1998 (-15%), only to rise to $7,863 in 2000 (+27%). The fact that the previous charts reflect similar massive swings occurred in oil revenues and the Saudi economy in 1973-1975, 1979-1982, 1986, and 1991-1992, is a warning that any effort to predict future trends borders on hubris.[115]

There are, however, practical limits to how far Saudi Arabia's oil revenues can swing as long as the world remains dependent on oil for much of its energy. This is a dependence that would require a massive shift in energy technology, and both the International Energy Agency (IEA) and the Energy Information Agency (EIA) of the United States Department of Energy (DOE) currently project a steady increase in world demand for oil through at least 2020 -- even under the scenarios which make the most favorable assumptions about increases in alternative energy resources.

Demand is scarcely likely to be stable, but world economic growth is virtually certain to steadily increase demand over time.[116] Some things simply do not happen. Oil prices do not reach sustained levels that cause the global economy to collapse. Oil prices do not drop to sustained levels below the cost of production. A nation like Saudi Arabia, -- with more than some 80 years of proven reserves even at export levels in excess of eight million barrels of oil

does -- not run out of oil. Beyond these limits, however, any estimate must be more illustrative than predictive.

Even so, it is interesting to examine what happens when relatively favorable assumptions are made about the increase in world demand and oil prices, and the resulting Saudi oil revenues, and then look at how these would affect Saudi Arabia's future per capita income. The data in Charts 6.15 to 6.22 portray a complex set of numbers, but they also portray a relatively straightforward way of illustrating the best real-world case that Saudi Arabia is likely to encounter in terms of oil revenues and oil wealth over the coming two decades:

- Chart 6.15 illustrates the EIA's projection of the increase in Saudi and other Gulf state oil production capacity through 2020. These estimates are based on the EIA's reference case, which sees Saudi Arabia as the key swing state in increasing world oil supply. It should be noted that Saudi production capacity is estimates to rise from 9.4 million barrels per day (MMBD) in 2000 to 22.1 MMBD in 2020. This is an increase of well over 100%, and senior Saudi officials seriously doubt that the Kingdom will actually reach 20.0 MMBD by 2020. As such, it makes very optimistic assumptions about Saudi production capacity.

- Chart 6.16 provides a similar EIA projection of total actual Gulf exports. This projection does not break out the level of actual Gulf production by country, but it too indicates an increase in production of more than 100% by 2020. At the same time, it shows that total exports are projected to be much lower than total production capacity – both because of increases in domestic demand and diversion to the production of petroleum products. The EIA projects that total Gulf production capacity in 2020 will be 42.9 MMBD, but that actual exports will only be 33.5 MMBD, or 78% percent of total capacity.

- Chart 6.17 examines the possible revenues Saudi Arabia can earn from its oil production under a wide range of prices in constant $2000 dollars. The first set of figures show the EIA estimate of total production capacity under different market conditions. The second set of figures show the average landed cost of an imported barrel of oil to the US. These price estimates are significantly higher than price estimates based on average refiner acquisition cost or Brent crude prices which are, in turn, are higher than the average price of Saudi crude The chart then examines three set of r scenarios for Saudi oil revenues. The first set of revenue calculations is based on the total potential value of all oil sales if Saudi Arabia produced and exported at 100% of capacity under the low, reference, and high demand cases. The second set of revenue estimates is more realistic in that it assumes that Saudi Arabia can export a stable average of about 80% of its total production capacity. This too seems to be a favorable assumption for Saudi Arabia.

- The estimates in Chart 6.17 project a major increase in real Saudi oil revenues between 2000 and 2020, and show that Saudi oil revenues could increase from some $66 billion in 2000 to $145.55 to $161.26 billion by 2020. At the same time, it is important to note that even under the most favorable case, Saudi Arabia would only earn 78% of its peak real oil earnings in 1980, and would only earn 68% in the reference case. Put simply, these figures warn that Saudi Arabia is unlikely to ever earn the same real oil export revenues it earned in 1980.

- Charts 6.18 and 6.19 add another parameter to the model. They show the range of per capita Saudi oil earnings using the population growth estimates made by the World Bank and Census Bureau. As has been discussed in Chapter IV, such estimates have much the same range of uncertainty as oil production and oil revenue, but the results are striking. Population growth has already had a massive impact on Saudi oil wealth. Oil wealth per capita peaked in 1980 at $22,596 per person. Population

growth and drops in oil revenue had driven it down to $3,041 in 2000, even though this was a very favorable year for oil revenues.

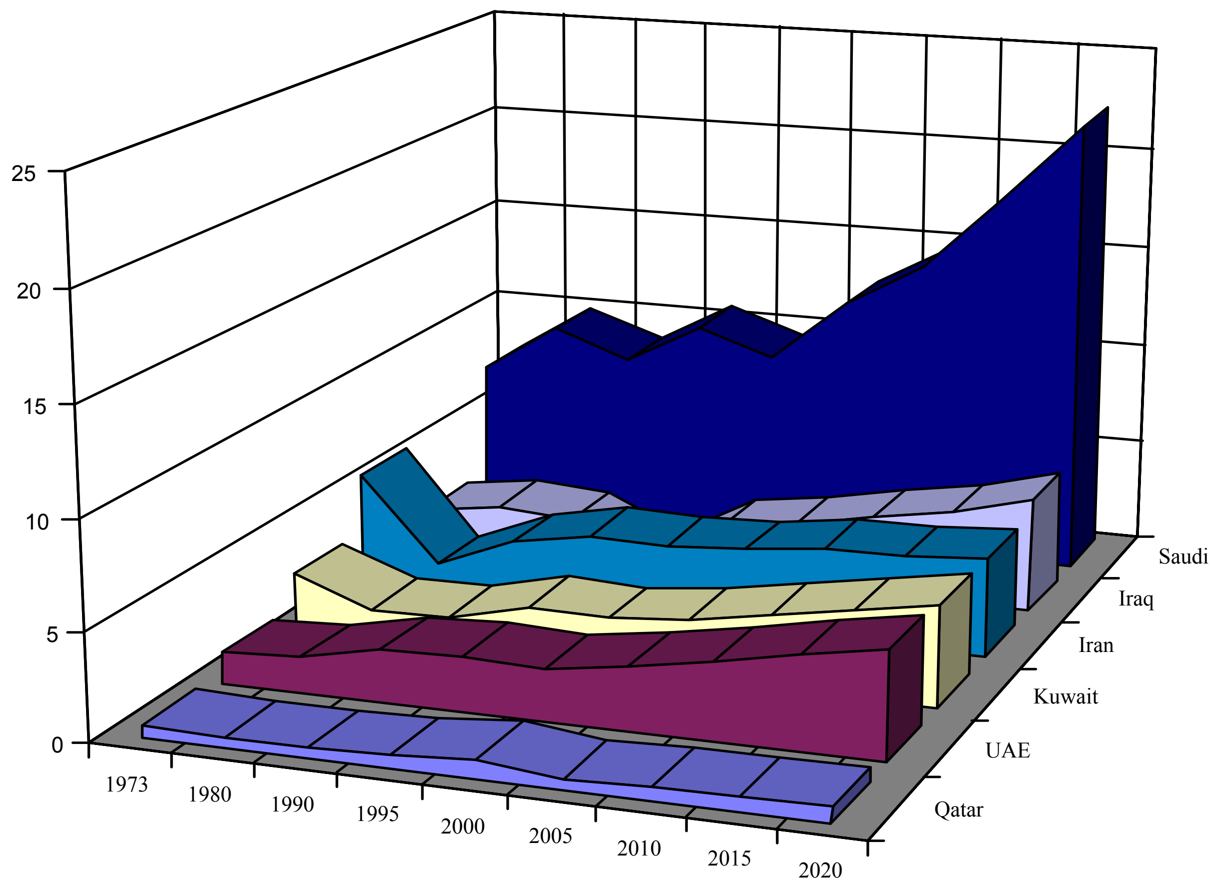
- Chart 6.20 simply portrays the range of the per capita oil export income figures shown in Charts 6.18 and 6.19 in a form that shows the range of uncertainty involved. It shows that oil revenues per capita in 2020 can range from $3,199 to $4,266. It should again be stressed, however, that these estimates are made under very favorable assumptions for Saudi Arabia, and that in the real world, it is very unlikely that actual per capita oil revenues will significantly exceed $3,000.

Uncertain as such a modeling effort is, it does show that even very favorable assumptions still indicate that Saudi Arabia cannot rely on oil wealth in the future, and that the historical problems over-dependence on oil has created for Saudi Arabia will be just as valid in the future even if Saudi Arabia is able to more than double its gross real oil exports over the next two decades. This is not a warning that Saudi Arabia will be poor, nor does it mean that oil will not be of immense value to the Kingdom. It is, however, a clear indication that Saudi Arabia's emphasis on economic reform, diversification, and expanding its private sector is absolutely critical to both Saudi Arabia's welfare as a nation and its future stability.

Chart 6.15

The US Projects Massive Increases in Saudi Oil Production Capacity and in Implied Oil Export Earnings

(EIA Reference Case in MMBD)



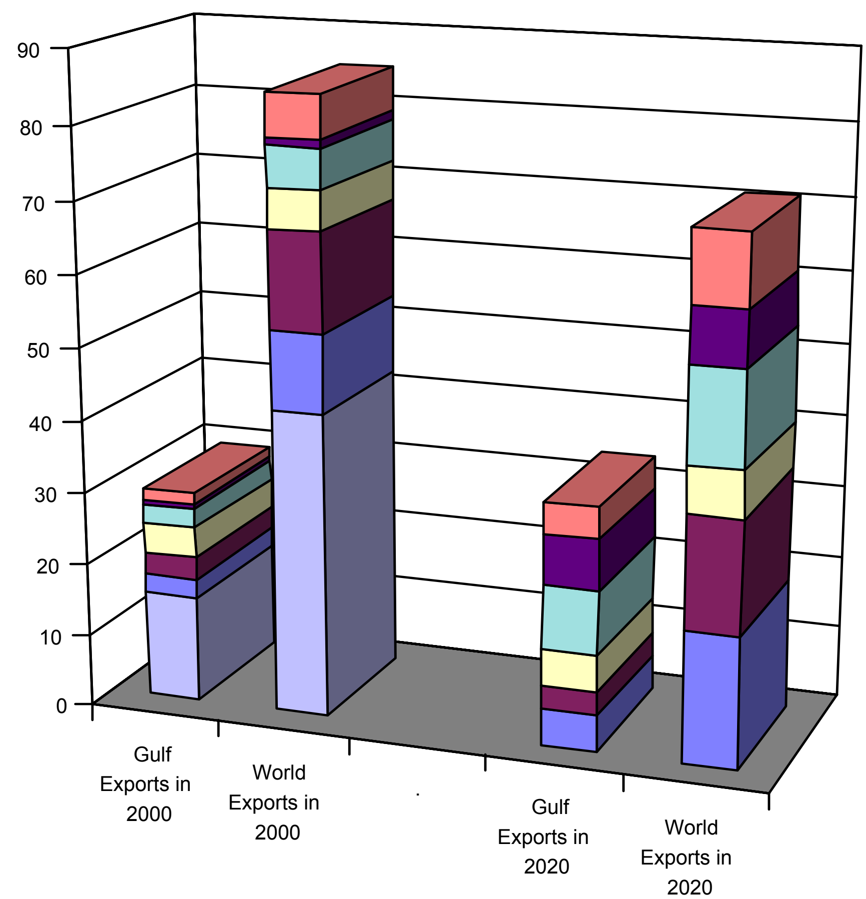
	1973	1980	1990	1995	2000	2005	2010	2015	2020
Qatar	0.57	0.472	0.5	0.6	0.9	0.5	0.6	0.7	0.7
UAE	1.533	1.709	2.5	2.6	2.5	3	3.7	4.4	5.1
Kuwait	3.02	1.656	1.7	2.6	2.5	2.8	3.5	4.1	4.8
Iran	5.8	1.662	3.2	3.9	3.8	4	4.4	4.5	4.7
Iraq	2.018	2.514	2.2	0.6	2.6	3.1	3.9	4.5	5.5
Saudi	7.596	9.9	8.6	10.6	9.4	12.5	14.6	18.2	22.1

Total Gulf	-	18.7	-	21.7	25.9	30.7	36.4	42.9
Saudi Arabia as % of Total	-	*45.95*	-	*43.35*	*48.2*	*47.6*	*50.0*	*51.53*
Total OPEC	-	27.2	-	31.4	38.4	44.8	52.0	60.2
Total World	-	69.4	-	77.4	88.0	98.4	109.8	121.3
Saudi Arabia as % of Total	-	*12.4*	-	*12.1*	*14.25*	*14.8*	*16.6*	*18.21*

Source: Adapted by Anthony H. Cordesman from EIA, International Energy Outlook, 1997, DOE/EIA-0484 (97), April 1997, pp. 157-160, and EIA, International Energy Outlook, 2002, DOE/EIA-0484 (2002), March 2002, Table D1.

Chart 6.16

The Same is True of US Projections of Actual Saudi Exports: 2000 versus 2020
(In Millions of Barrels Per Day)



	Gulf Exports in 2000	World Exports in 2000	.	Gulf Exports in 2020	World Exports in 2020
Rest of World	1.5	5.9		4.3	9.9
China	0.7	1.1		7.1	7.6
Pacific Rim	2.7	5.6		8.7	13.1
Industrial Asia	4.1	5.4		5	6.5
Western Europe	3.2	13.7		3.5	15.6
North America	2.6	10.7		4.9	18.2
TOTAL	14.8	42.4		*33.5	*70.9

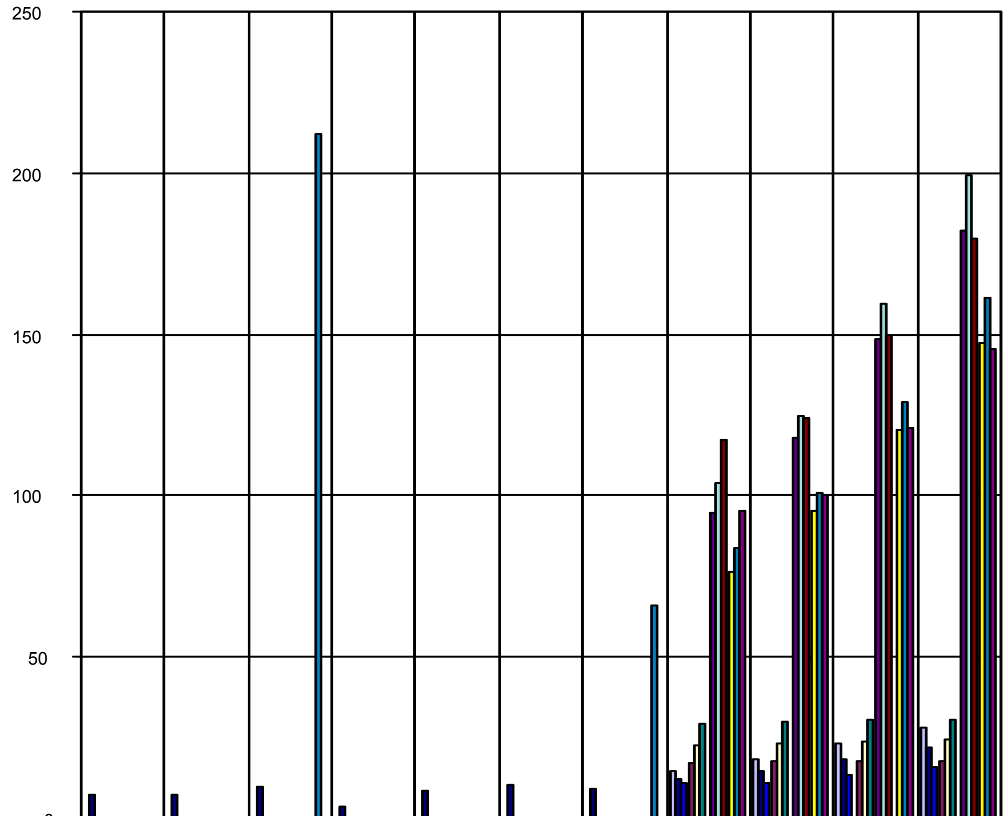
Gulf as % of World 34.9% 47.2%

Source: Adapted by Anthony H. Cordesman from US Department of Energy, International Energy Outlook, 2002, Washington, Energy Information Agency, March 2002, Table 13, p. 38.

Chart 6.17

Even Extremely Favorable Estimates of Future Saudi Oil Revenues Do Not Bring Them Back to the 1980 Peak

(EIA Cases. Revenues Equal Daily MMBD X 365 X oil price. Export Revenues equal 0.81 X Total Revenues. Prices in Constant $US2000)



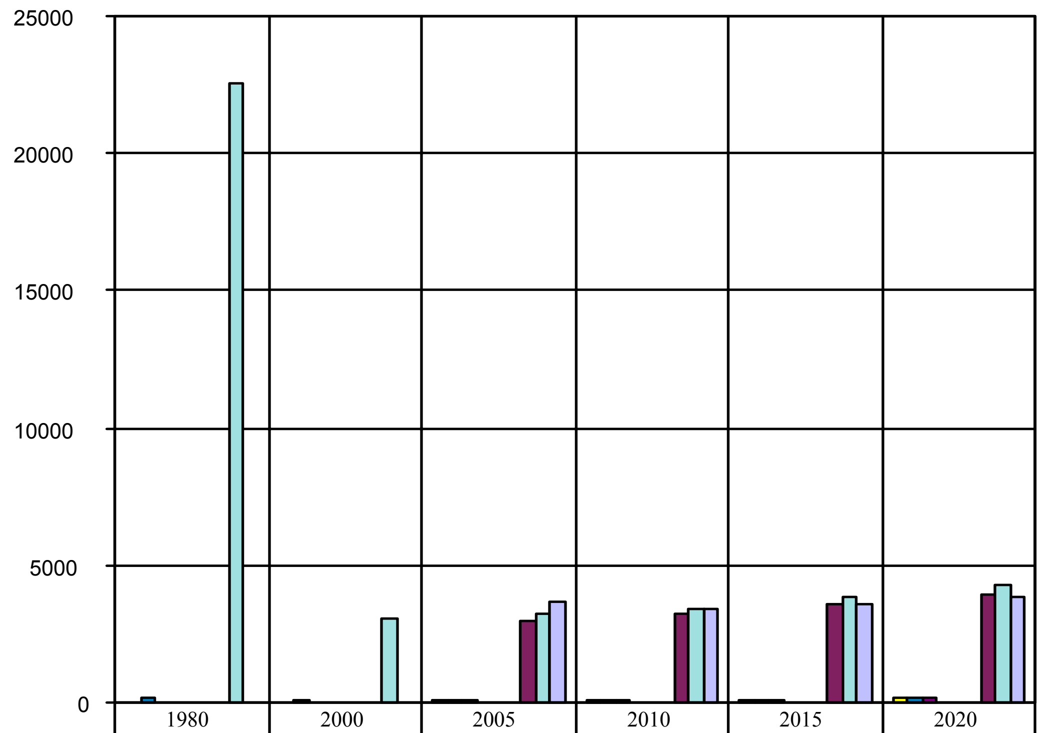
	1973	1975	1980	1985	1990	1995	2000	2005	2010	2015	2020
MMBD at Low Oil Price								14.9	$18.30	23.1	28.3
MMBD Ref Case	7.596	7.075	9.9	3.388	8.5	10.6	9.4	12.5	$14.60	18.2	22.1
MMBD at Hi Oil Price								10.9	$11.30	13.5	16.1
.											
Low Oil Price								$17.41	$17.64	$17.64	$17.64
Ref Oil Price								$22.73	$23.36	$24.00	$24.68
Hi Oil Price								$29.56	$30.01	$30.40	$30.58
.											
Low Oil Revenues $B								$94.68	$117.83	$148.73	$182.21
Ref Oil Revenues $B								$103.71	$124.48	$159.32	$199.08
Hi Oil Revenuse $B								$117.60	$123.78	$149.79	$179.70
.											
Low Export Revenues $B								$76.69	$95.44	$120.47	$147.59
Ref Export Revenues $B			$212.40				$66.00	$84.01	$100.83	$129.14	$161.26
Hi Oil Export Revenues ($B)								$95.26	$100.26	$121.33	$145.55

Source: Adapted by Anthony H. Cordesman from US Department of Energy, International Energy Outlook, 2002, Washington, Energy Information Agency, March 2002, Table 12, p. 39 and Appendix D, pp. 239-241.

Chart 6.18

Rough Estimates of Future Saudi Oil Revenues, Population, and Exports Per Capita: World Bank Population Data

(EIA Cases. Revenues Equal Daily MMBD X 365 X oil price. Export Revenues equal 0.81 X Total Revenues. Prices in Constant $US2000. Revenues per capita are Total export Revenues Divided by Population)



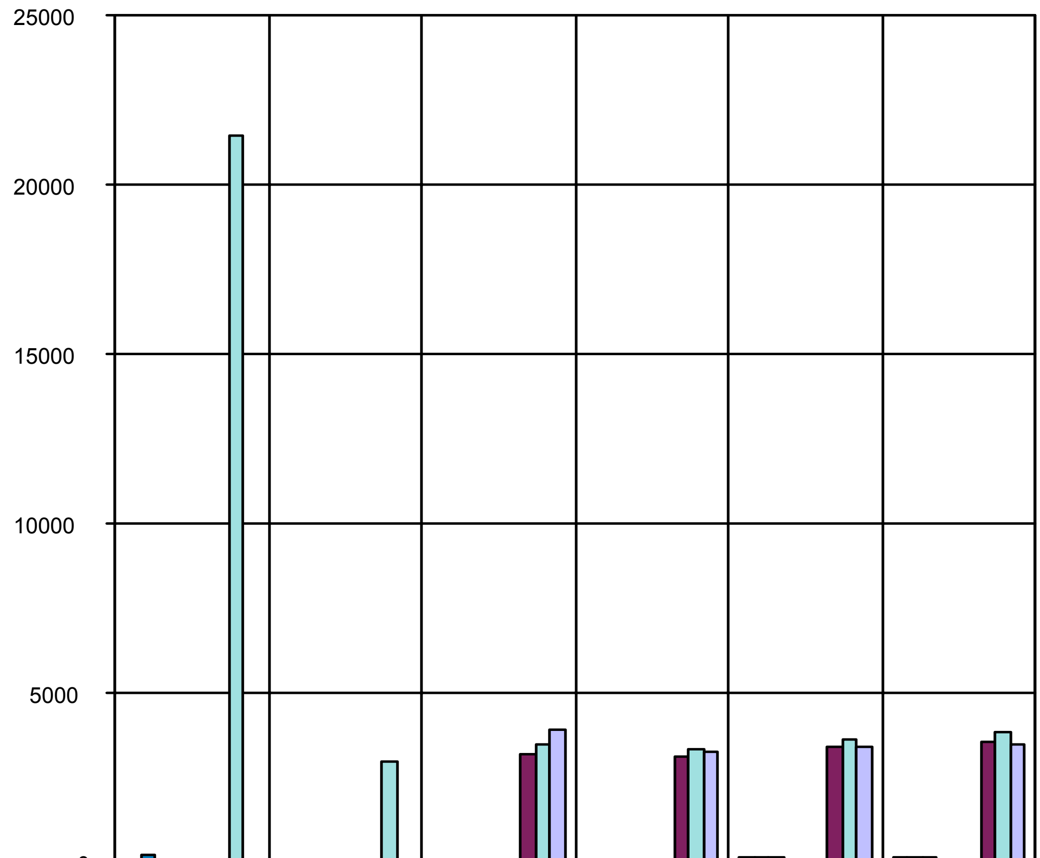
	1980	2000	2005	2010	2015	2020
Low Export Revenues ($B)			$76.69	$95.44	$120.47	$147.59
Ref Export Revenues ($B)	$212.40	$66.00	$84.01	$100.83	$129.14	$161.26
Hi Oil Export Revenues ($B)			$95.26	$100.26	$121.33	$145.55
.						
Population in Millions	9.4	21.7	25.7	29.7	33.7	37.8
.						
Low Rev. Per Capita ($US)			$2,984	$3,213	$3,575	$3,904
Ref. Oil Per Capita ($US)	$22,596	$3,041	$3,268	$3,395	$3,832	$4,266
Hi Rev Per Capita ($US)			$3,706	$3,376	$3,600	$3,850

.

Chart 6.19

Rough Estimates of Future Saudi Oil Revenues, Population, and Exports Per Capita: US Census Bureau Data Population Data

(EIA Cases. Revenues Equal Daily MMBD X 365 X oil price. Export Revenues equal 0.81 X Total Revenues. Prices in Constant $US2000. Revenues per capita are Total export Revenues Divided by Population)

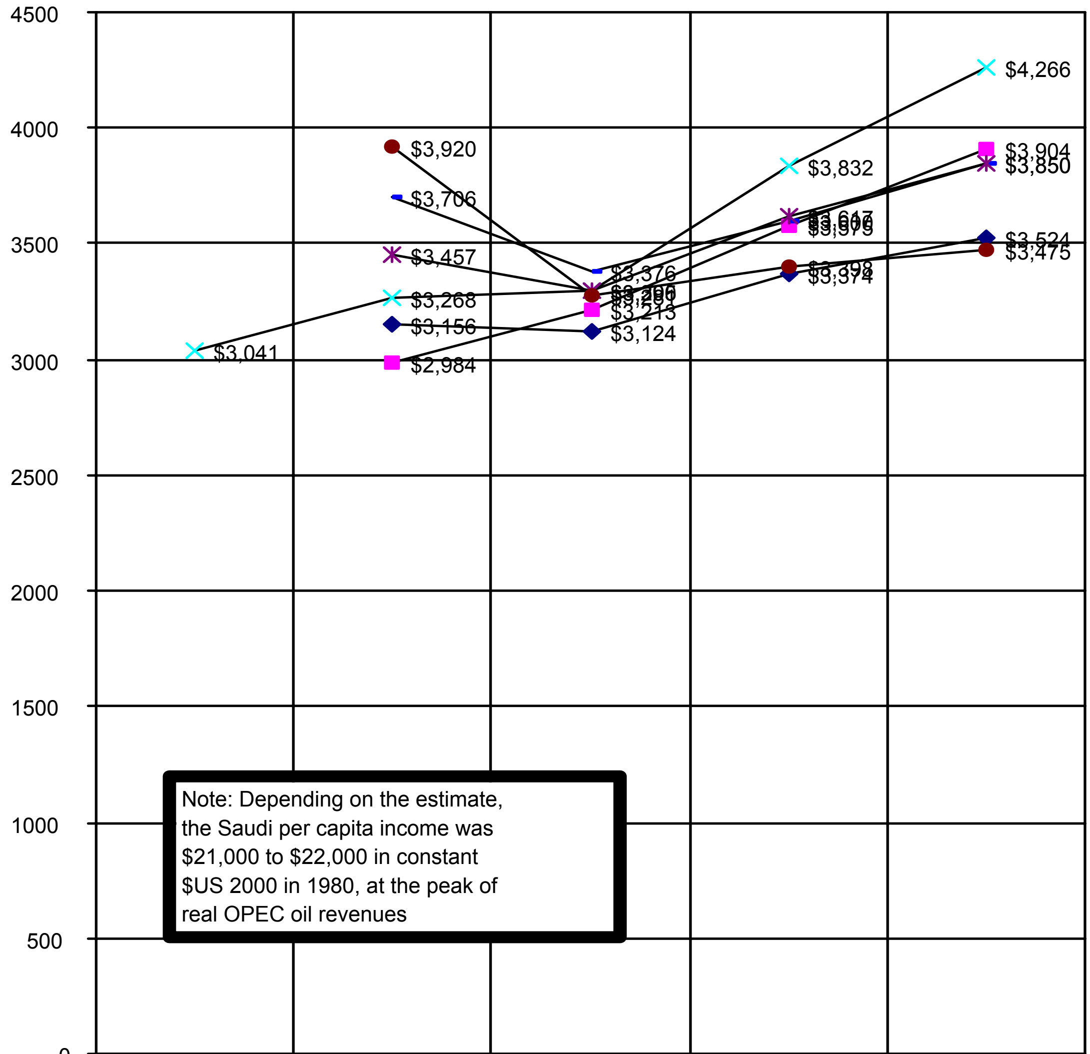


	1980	2000	2005	2010	2015	2020
Low Export Revenues ($B)			$76.69	$95.44	$120.47	$147.59
Ref Export Revenues ($B)	$212.40	$66.00	$84.01	$100.83	$129.14	$161.26
Hi Oil Export Revenues ($B)			$95.26	$100.26	$121.33	$145.55
.						
Population in Millions	9.9	22	24.3	30.55	35.7	41.88
.						
Low Rev. Per Capita ($US)			$3,156	$3,124	$3,374	$3,524
Ref. Oil Per Capita ($US)	$21,454	$3,000	$3,457	$3,300	$3,617	$3,850
Hi Rev Per Capita ($US)			$3,920	$3,281	$3,398	$3,475

Chart 6.20

Oil "Wealth" Equals Oil "Adequacy" or Oil "Poverty": Future Saudi Oil Exports Per Capita: 2000-2020

(EIA Cases. Revenues Equal Daily MMBD X 365 X oil price. Export Revenues equal 0.81 X Total Revenues. Prices in Constant $US2000. Revenues per capita are Total export Revenues Divided by Population. Cordesman case is 75% of Reference Case)



	2000	2005	2010	2015	2020
WB Low Rev		$2,984	$3,213	$3,575	$3,904
WB Ref.	$3,041	$3,268	$3,295	$3,832	$4,266
WB Hi Rev		$3,706	$3,376	$3,600	$3,850
.					
Census-Low Rev		$3,156	$3,124	$3,374	$3,524
Census-Ref.		$3,457	$3,300	$3,617	$3,850
Census-Hi Rev		$3,920	$3,281	$3,398	$3,475

The Challenge of Reducing the Government Sector

Political and military factors also increase problems Saudi Arabia has in reducing government spending and the role of government in its economy. Chart 6.23 shows that Saudi Arabia has an exceptionally high rate of state spending even in a region where the state dominates most economies.. Furthermore, the Kingdom's actual level of "statism" is higher than the data in Chart 6.23 indicate. Much of the "private sector" activity in Saudi Arabia consists of service industries, state-subsidized private industries, and activities that add little value to imports. The funding of such activity is ultimately dependent on petroleum-related export income and deficit spending.

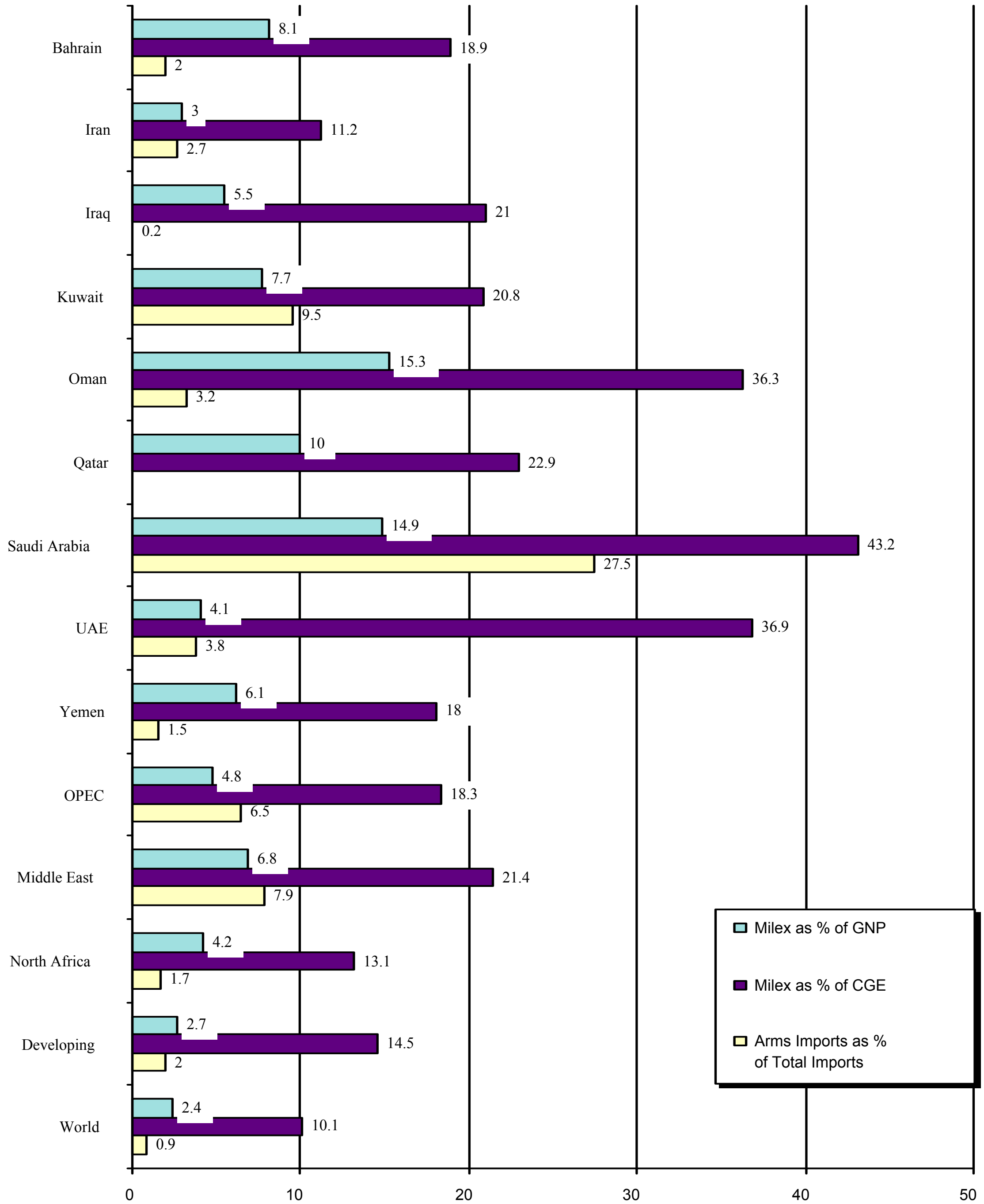
Chart 6.23 shows how military expenditures and arms imports impact on this situation. Saudi Arabia has good reasons for many of its military expenditures. Nevertheless, they do put a massive burden on the Saudi economy, the Saudi budget, and discretionary government spending. The trend data in Chart 6.23 provide a US estimate of the long-term trends in the Saudi GDP, central government spending, Saudi military spending, and arms imports. These data are measured in constant 1999 dollars, and they reflect many of the broader macroeconomic problems that have already been discussed. Chart 6.21 shows that the total cost of military expenditures and arms imports have averaged well over $20 billion a year for nearly two decades, that they have ranged from 13% to 29% of the GNP depending on the political and military conditions in the Gulf, and that they have ranged from 37% to over 70% of central government expenditures (CGE).[117]

National security is not an idle luxury. Nevertheless, the data in Chart 6.21 clearly illustrates the tragedy of arms in the Gulf, and the cost to Saudi Arabia of dealing with the threats discussed in Chapter II. Unfortunately, there is little near to mid-term prospect that the Kingdom can substantially reduce these expenditures and use them for economic reform and economic development.

Chart 6.21

Military Expenditures and Arms Transfers as an Aspect of "Statism" in the Gulf

(Military spending as a percent of Central Government Expenditures (CGE) and Gross National Product (GNP), and Arms Imports as a Percent of Total)

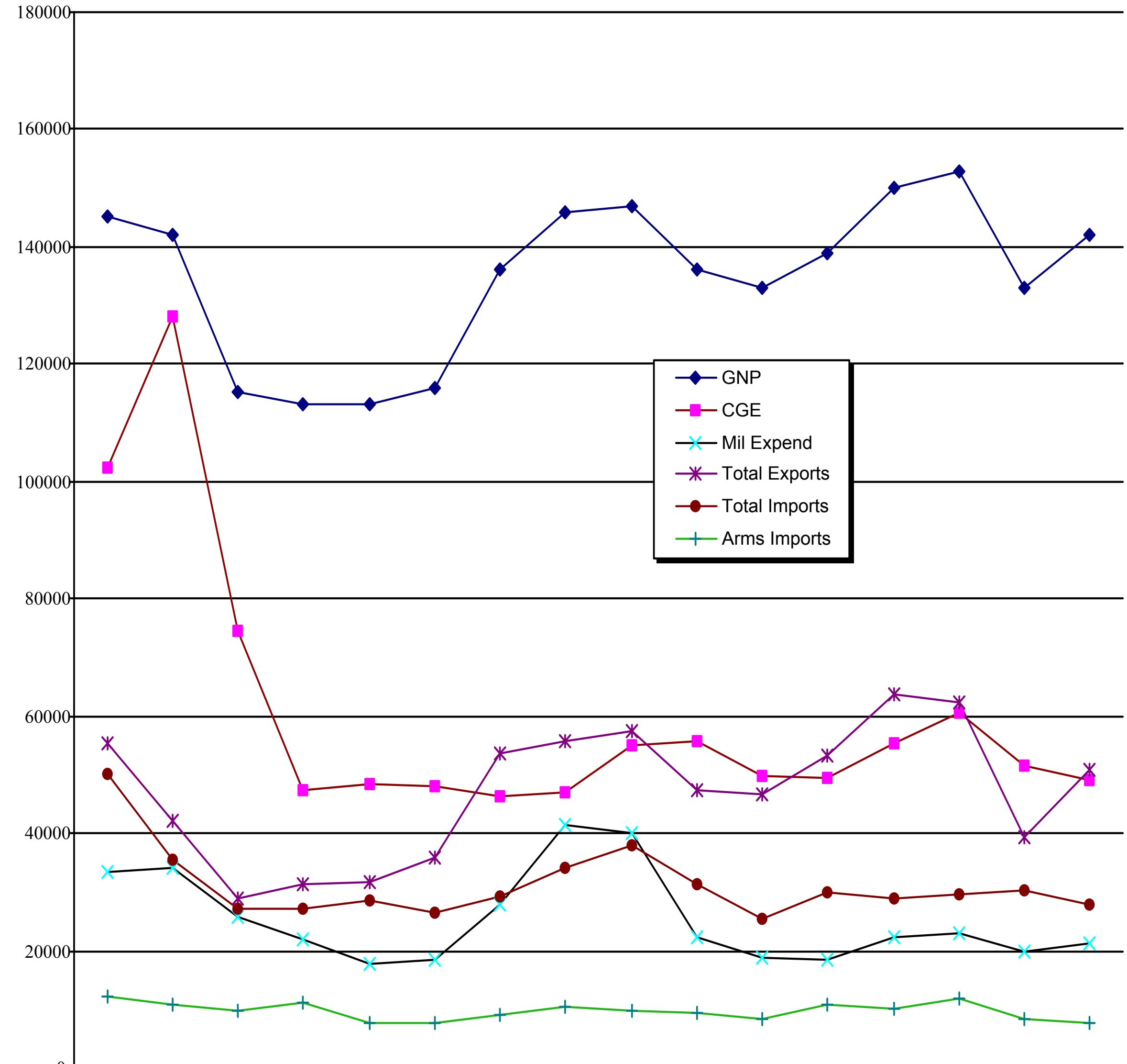


Source: Adapted by Anthony H. Cordesman from US State Department, World Military Expenditures and Arms Transfers, 1999-2000, Tables I and II, Bureau of Verification, Washington, 2002.

Chart 6.22

Saudi Gross National Product, Central Government Expenditures, Military Expenditures, Total Exports, Total Imports and Arms Import Deliveries: 1984-1999

(Constant $99 millions)



	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99
GNP	145300	142000	115200	113000	113000	116000	136000	146000	147000	136000	133000	139000	150000	153000	133000	142000
CGE	102200	128000	74600	47300	48500	47900	46200	47000	55000	55600	49800	49500	55300	60700	51500	49100
Mil Expend	33550	34200	25750	22100	17600	18400	28000	41400	39900	22300	18700	18400	22300	22900	19800	21200
Total Export	55420	41970	28920	31420	31810	35700	53760	55830	57350	47210	46480	53420	63600	62410	39400	50760
Total Import	50100	35620	27200	27100	28620	26600	29130	33960	37940	31400	25460	29990	29060	29520	30460	28010
Arms Import	12320	10850	9760	11050	7830	7671	9199	10280	9579	9242	8399	10680	10050	11710	8424	7700

Source: Adapted by Anthony H. Cordesman from ACDA, World Military Expenditures and Arms Transfers, 1995, ACDA/GPO, Washington, 1996 and US State Department, World Military Expenditures and Arms Transfers, 1998, Bureau of Verification and Compliance, Washington, 2000; World Military Expenditures and Arms Transfers, 1999-2000, Bureau of Verification and Compliance, Washington, 2002.

Managing and Restructuring the Saudi Budget

All of these issues increase the challenges that Saudi Arabia faces in managing its national budget. Revenue shortfalls, and budget deficits are not new problems for Saudi Arabia. Demographics, excessive subsidies and welfare payments, over-dependence on petroleum, politics, and the cost of war began to put serious pressure on the Saudi budget nearly a decade before the Gulf War. Chart 6.23 shows the macroeconomic trends involved in shaping the history of Saudi Arabia's budget deficits, and Chart 6.24 and Table 6.5 show that major budget deficits were the rule, rather than the exception, during the 1990s. The only time Saudi Arabia was able to avoid such deficits was during a period of peak oil revenues in 2000, and it retuned to deficit spending in 2001 in spite of a projected surplus and exceptionally high oil revenues.

The Kingdom's financial problems became truly serious after the first oil crash in 1986. Saudi Arabia's FY1988 budget was projected at 141.2 billion Riyals ($37.7 billion), down 17% from the 1987 level of 170 billion Riyals. Oil revenues were unofficially projected at 65.2 billion Riyals. The 1988 deficit was projected at 35.9 billion Riyals ($9.57 billion) versus deficits of about 50 billion Riyals in each of the previous four years.

Saudi Arabia sought to reduce this deficit by imposing 12-20% import duties, and local borrowing in the form of some $8 billion in bonds.[118] If it had not been for Iraq's invasion of Kuwait, these measures might have helped to reduce Saudi Arabia's budget deficits, but the cost of the Gulf War then made the Saudi situation much worse. Although Saudi oil revenues rose sharply during the war, Saudi Arabia had to make unplanned expenditures costing billions of dollars on the crisis, ranging from payments to members of the UN Coalition to expenses for the Saudi military and refugee housing. Estimates of these costs differ, but the IMF puts them at around $65 billion, of which $12.8 billion was paid to the United States. [119]

Saudi Budgets in the Early to Mid-1990s

The Saudi budget deficit grew from 6.4 percent of GDP in 1990 to 11% of the GDP in 1993, forcing the government to make significant cuts in its expenditures. This resulted in a 1994 budget plan calling for a 19 percent cut in government spending from $52.5 billion in 1993 to $42.7 billion. This was followed by the 1995 budget plan which, based on an underlying oil price

assumption of $14.00-$14.50 per barrel, called for an additional cut of 6.25% in spending. A combination of austerity measures and unexpectedly high oil revenues reduced Saudi Arabia's deficit to 8% of the GDP in 1994 and 6% in 1995. [120]

By the mid-1990s, Saudi Arabia had paid for the Gulf War, but it still faced serious budget problems. Additional increases in oil prices gave the Saudi government total revenues of 177 billion Saudi Riyals in 1996, instead of projected revenues 131.5 billion Riyals. This additional income could have given Saudi Arabia a slight budget surplus for the first time in recent history. In practice, however, Saudi spending leaped from a projected level of 150 billion Riyals to an actual level of 194 billion -- following a pattern that the Saudi budget always expands to consume every increase in oil revenues. As a result, the official estimate of the 1996 deficit reached 17 billion Riyals, close to the 18.5 billion Riyals that had originally been projected.

The government also increasingly dealt with its budget problems by increasing its domestic civil debt as a substitute for foreign loans. Foreign debt was reduced to low levels by the late 1990s, but only at the cost of increasing central government domestic debt.[121] In fact, Saudi Arabia was unable to make significant reductions its domestic debt, in spite of high oil revenues in 1999 and 2000. Domestic debt rose each year from 1994 to 2000. It rose from 336 billion Saudi Riyals and 76% of the GDP in 1994 to 625 billion Riyals and 119% of the GDP in 1999. It was still 616 billion Riyals and 95% of the GDP in 2000 and rose back to 630 billion Riyals and 99% of the GDP in 2001. It was projected to be 675 billion Riyals and 109% of the GDP in 2002.[122]

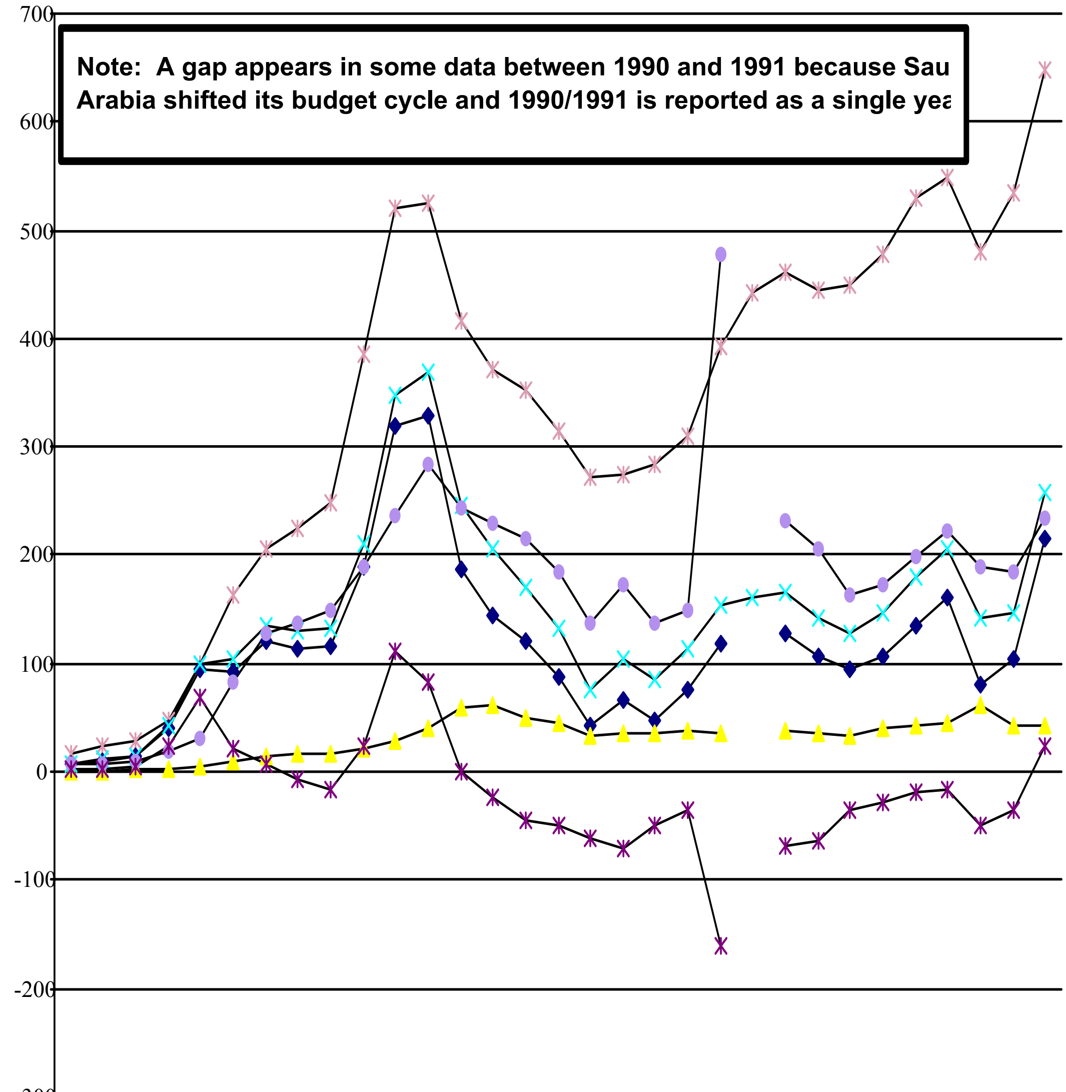
These trends in Saudi Arabia's budgets are shown in more detail in Table 6.5 and Chart 6.24, although the data in these charts omit a portion of Saudi Arabia's extraordinary expenditures on the Gulf War. If these additional expenditures are included, the Saudi fiscal deficit might have reached $37 billion during 1990-1991, and $10 billion during 1992. In fact, the war made Saudi financial management so uncertain that Saudi Arabia was forced to adopt a working budget for 1991 because it could not keep track of its expenditures. It then had to raise its estimated 1992 expenditures by 27% over the 1990 budget to allow for unanticipated costs. [123]

Chart 6.25 shows that Saudi Arabia also experienced a drastic drop in liquidity because of both the low oil revenues and its expenditures for the Gulf War. Saudi Arabia has never provided a full accounting of its budget expenditures during the Gulf War, but US estimates indicate that central government expenditures rose from $38.5 billion in 1989, in constant 1999 dollars, to $60.6 billion in 1990 and 72.5 billion in 1991, and then returned to $40.1 billion in 1992 and $37.6 billion in 1993. This total budget increase is partly explained by a rise in military spending from $18.4 billion in 1989 to $28 billion in 1990, $44.4 billion in 1991, and $39.9 billion in 1992, before dropping to $22.3 billion in 1992 and $18.7 billion in 1993. These trends not only show the total burden of Gulf War spending, but that Saudi Arabia had to cut back in some areas of domestic spending to limit its total budget costs. [124]

Under these conditions, it is hardly surprising that the Kingdom had to borrow some $7 billion, $4.5 billion from internationally syndicated loans and $2.5 billion from local banks. This need to borrow while paying interest created new tensions with Saudi Arabia's Islamic fundamentalists, who believe that interest is forbidden by the Koran.[125] Central bank reserves dropped from more than $100 billion to around $35-40 billion, and official foreign assets from well over $100 billion in 1989 to roughly $68.5 billion in 1994.[126] By 1995, Saudi Arabia had to cut some defense expenditures, including the delay and cancellation of certain arms purchases.[127] Saudi Arabia made the last payment on its $4.5 billion debt in June 1995, but continued to run a budget deficit. This deficit reached $7.4 billion in 1993 and rose to $10.7 billion in 1994 (some estimates show $9.28 billion) -- a rise that finally triggered more decisive action by the Saudi government.

Chart 6.23

Saudi Arabian Government Oil and Total Revenue versus Total Expenditures and Surplus/Deficit



	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	0
GDP	17	23	28	47	99	165	205	225	250	386	521	525	415	372	351	314	271	276	285	311	392	442	461	444	450	479	529	549	481	535	649
Petroleum Revenues	7.1	9.7	14	39	94	94	121	114	115	189	319	329	186	145	121	88	42	67	48	76	118	*11	127	106	96	106	136	160	80	104	214
Other Revenues	0.8	1.4	1.9	2.4	5.9	9.9	15	17	16	22	29	39	60	61	50	45	34	36	36	39	37	*36	38	36	34	41	43	46	62	43	44
Total Revenues	7.9	11	15	42	100	103	136	131	132	211	348	368	246	206	172	134	77	104	85	115	155	162	165	141	129	147	179	206	142	148	258
Total Expenditures	6.4	8.3	10	19	32	82	128	138	148	188	237	285	245	230	216	184	137	174	139	150	477	*47	233	206	164	174	198	221	190	184	235
Budget Deficit	1.5	2.8	5.2	23	68	22	7.7	-7.4	-17	23	112	83	1.3	-24	-45	-50	-61	-70	-50	-35	-16	*-	-67	-64	-35	-27	-19	-16	-49	-36	23
Budget Deficit as %															*12	*16	*22	*25	*17	*11	*19	*19	*14	*14	*7.	*5.	*3.	*2.	*10	*7.	

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 343-346, 360-361, 393-395, and 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 354-355, 406. Note that the Saudi budget cycle was changed in 1990, and the budget period from 1990-1991 is reported as a single year.

Table 6.5

Saudi Arabia's Annual Budgets: 1990-2002

Fiscal Year	Revenues		Expenditures		Deficit		Balance as
	B Riyals	B $US	B Riyals	B $US	B Riyals	B $US	% of GNP
1990	118	31.5	143	38.1	-25	-6.7	-
1991*	118	31.5	143	38.1	-25	-6.7	-
1992	151	40.3	181	48.3	-30	-8.0	-
1993	169	45.1	197	52.5	-27.8	-7.4	-
1994	120	32.0	160	42.7	-40	-10.7	-7.7
1995	135	36.0	150	40.0	-15	-4.0	-5.7
1996 - (Original Draft)	131.5	35.07	150	40.0	-18.5	-4.9	
1996 - Actual	177	47.2	194	51.73.	-17.0	-4.53	-3.6
1997	204	54.40	210	56.00	-6.0	-1.60	-2.9
1998 - Estimate 12/97	178	47.5	196	53.3	-18.0	-4.80	
1998 - Actual	143	38.13	189.0	50.40	-46.0	-12.26	-9.6
1999	147.0	39.20	181.1	48.27	-33.7	-9.07	-6.4
2000	-	66.82	-	62.76	45.0	6.06	3.5
2001 - Estimate	215.0	57.33	215.0	57.33	0	0	-3.9
2001 - Actual	230	61.3	255	68.0	25	6.7	-
2002 - Estimate (Jan 02)	157.0	41.90	202.0	53.90	45.0	-12.0	-7.3
2002 – Estimate (Aug 02)	220.0	58.67	239.0	63.73		-5.1	-2.8

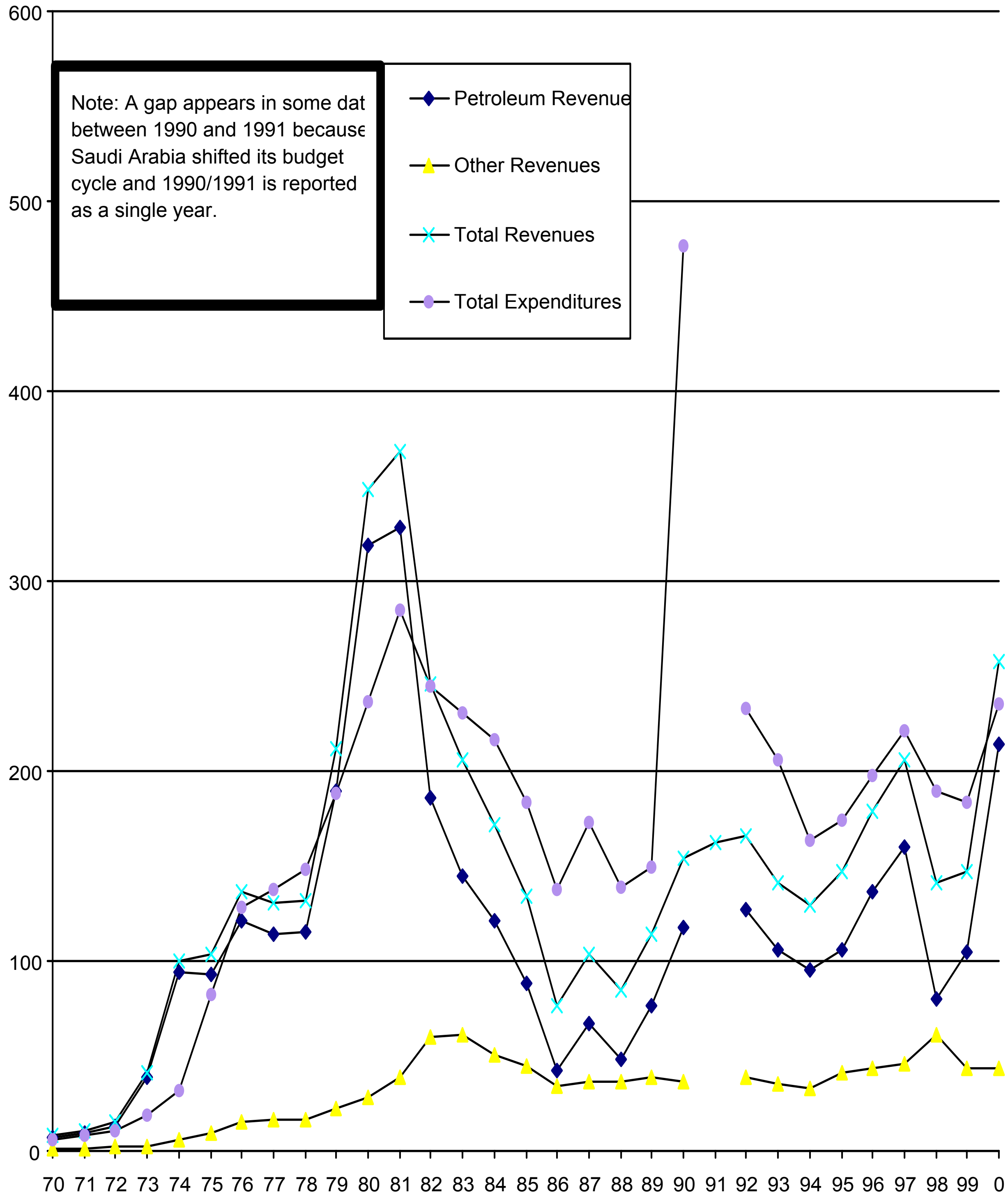
3 .75 Saudi Riyals = $1

* Major off-budget expenditures to finance Gulf War

Source: Data for 1990-1995 are adapted from data provided in the monthly newsletter of the Information Office, Royal Embassy of Saudi Arabia, Volume 12, Number 2, February, 1995, p. 3. Data for 1996-1998 have been adapted from IMF Article IV report 1994, Saudi Arabia, Volume 14, Number 2, February, 1997, p. 3; and Saudi Arabia, Vol. 18, No. 1, January 2001, p. 2, and Brad Bourland, The Saudi Economy in 2002, Riyadh, Saudi American Bank, February 2002, p. 2, and The Saudi Economy in Mid-Year 2002, August 2002, p. 12.

Chart 6.24

Saudi Arabian Government Oil and Total Revenue versus Total Expenditures

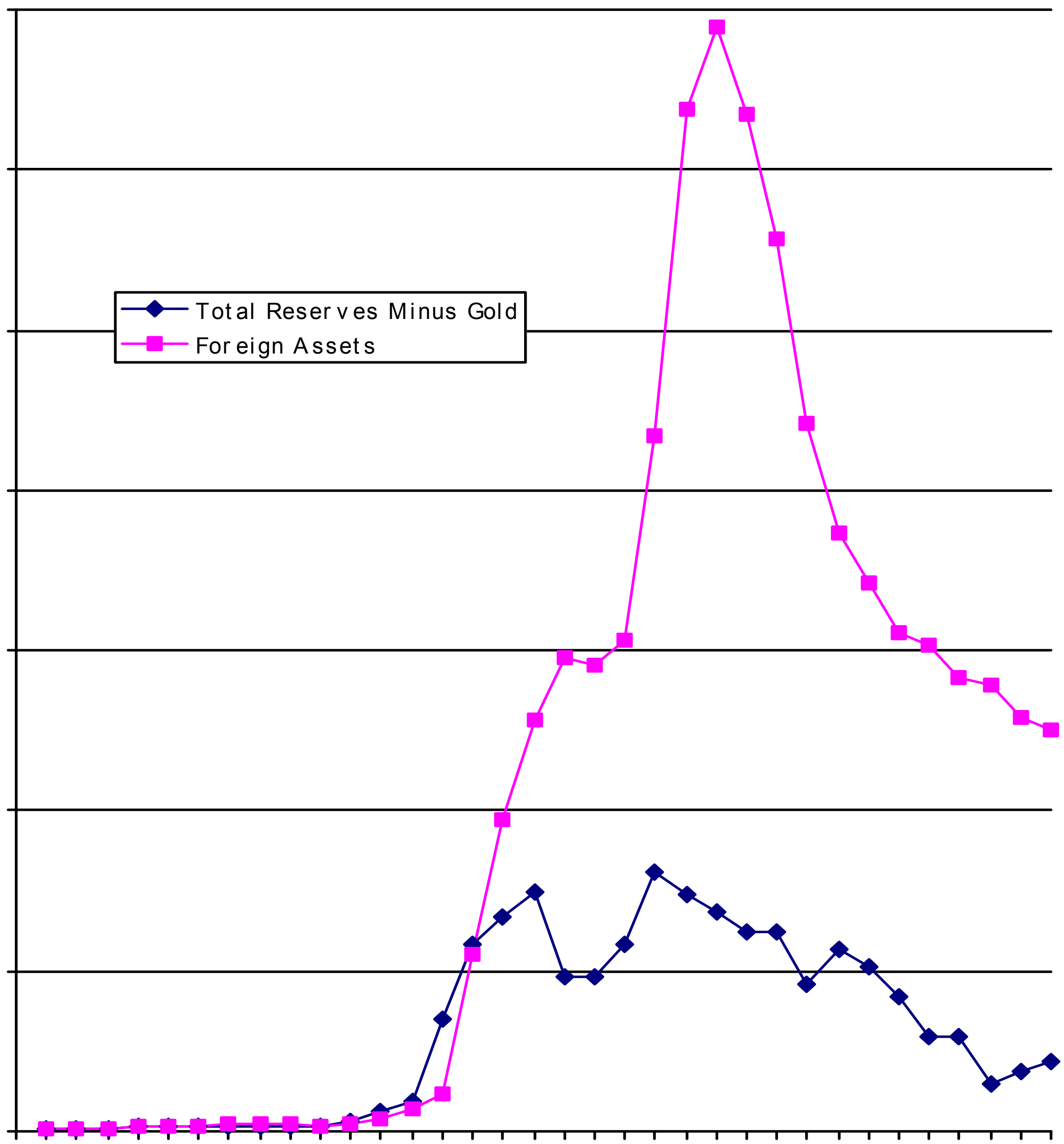


Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 343-346, 360-361, 393-395

Chart 6.25

Saudi Arabia: Government Foreign Assets and Liquidity: Part One

Liquidity in Billions of US Dollars: 1960-1994

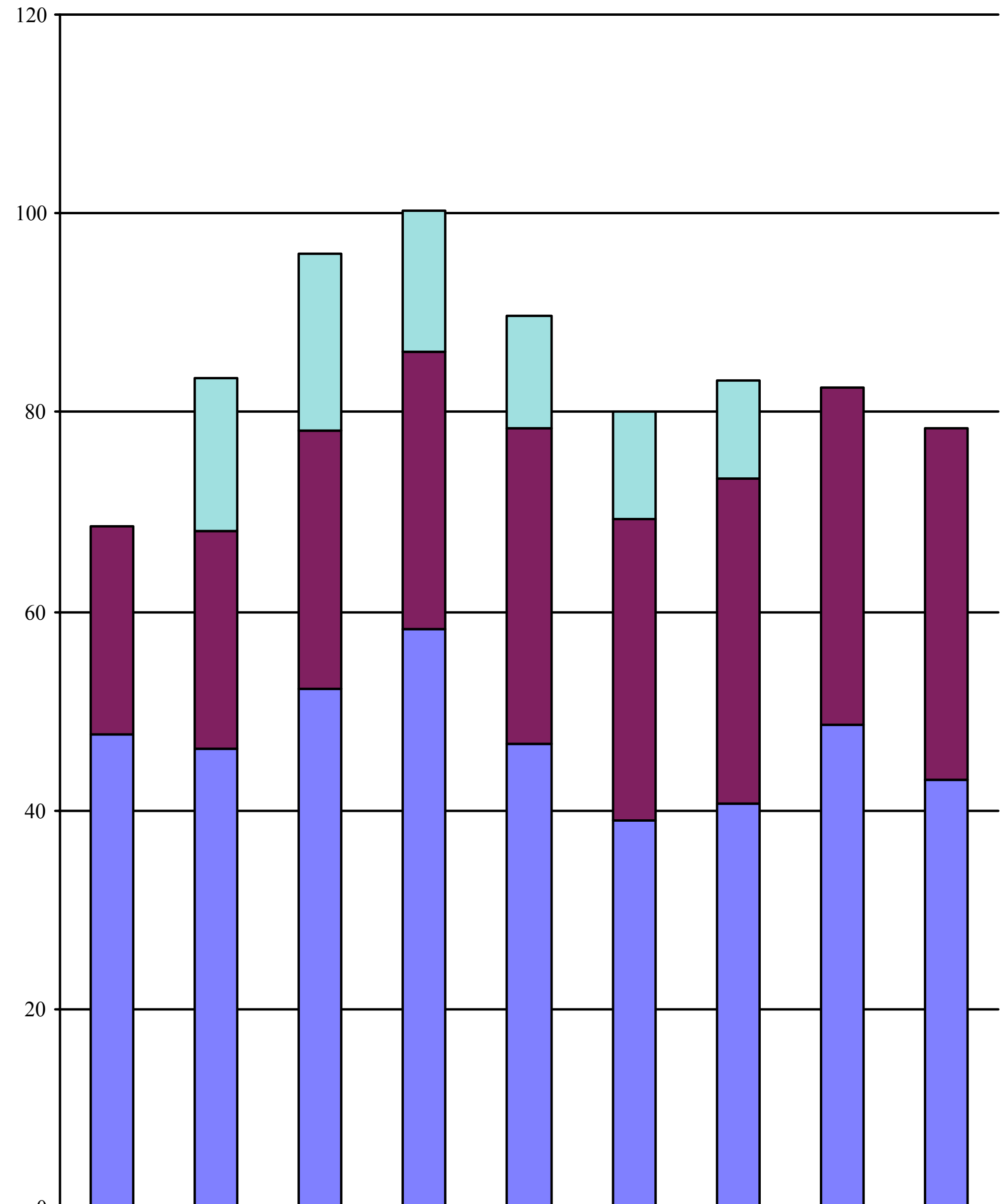


Note: No data on foreign assets after 1992.
Source: Adapted by Anthony H. Cordesman from International Energy Agency (IEA) Middle East Oil and Gas, Paris, 1995, pp. 305-309, and based on IMF, International Financial Statistics.

Chart 6.25

Saudi Arabia: Government Foreign Assets and Liquidity: Part Two

Official Foreign Assets: 1994-2002



	94	95	96	97	98	99	2000	1	2
Bank's Net Foreign Assets	-	15.5	18	14.3	11.4	10.8	9.8	-	-
Sub-Total	*68.51	*67.94	*78.04	*85.98	*78.34	*69.35	*73.45	*82.57	*78.50
Pension Funds	21	21.84	25.96	27.77	31.71	30.34	32.75	33.9	35.5
Central Bank	47.5	46.1	52.08	58.21	46.63	39.01	40.7	48.67	43

Source: Adapted by Anthony H. Cordesman from Brad Bourland, The Saudi Economy in 2002, Saudi American Bank, Riyadh, 2002, p. 2.

Budgets and The Sixth Development Plan

Saudi Arabia has been seeking to break out of its pattern of budget deficits ever since the Gulf War. The Saudi Sixth Development Plan, (1996-2000) sought to eliminate all deficits by the year 2000. Even at the time the plan was issued, however, it was recognized that this goal was based on unrealistically optimistic assumptions about both oil revenues and total spending.

The IMF's Article 5 report for 1995 took a more realistic view of Saudi finances and estimated that the Saudi budget deficit might well return to a level equaling 10% of the GDP by the year 2000 -- unless the Saudi government made further cuts in expenditures and increases in non-oil revenues.[128] The IMF report also indicated that Saudi Arabia might run a net deficit on current account of $8 billion to $10 billion by the year 2000, and that domestic debt may rise from 77% of GDP in 1994 to 110% in the year 2000.

These problems explain why many Saudi experts felt that the IMF was correct in calling for major reforms that went far beyond the steps the Saudi Arabia set forth in its Sixth Development Plan.[129] The proposed IMF reforms included: [130]

- Freezing total government expenditures at their 1995 level;
- A consumption tax of 5%; an excise duty of 10% on goods like jewelry, clothes, and vehicles; a 2% turnover tax for local and foreign companies;
- A 20% increase in gasoline and diesel fuel prices in 1996 and subsequent price rises to match inflation;
- An annual wage cut of 1% in government wages in 1996-1997 and a 2% cut in 1998-2000,
- Market prices for gasoline and diesel fuel, and
- Further reductions in all subsidies to the minimal level necessary to preserve the social safety net.

In the event, some aspects of the IMF projections proved to be overly pessimistic. The IMF failed to account for the reduction of imports and subsidies by the Saudi government in 1995, unexpected rises in oil prices during 1995-1997, and record profits by Saudi Arabia's downstream and industrial operations -- like those of the Saudi Basic Industries Corporation (SABIC). These developments led the Saudi government to estimate a deficit of just under $4 billion for 1995, or 4.1% of GDP, while IMF experts believed that the Saudi government might not be able to reduce its annual deficits to less than 4% of its GDP in 1995 and 1996. In fact,

some IMF experts estimated that the Saudi deficit would be closer to $5.5 billion instead of $4.0 billion.[131]

The actual situation was different. There was a considerable reduction in Saudi Arabia's actual and estimated deficits. Saudi deficit predictions for 1996 originally totaled $4.9 billion in current dollars, and would have created a deficit of around 15 billion Saudi Riyals or 3% to 4.1% of the Saudi GDP.[132] However, a surge in oil prices brought Saudi Arabia some $8 billion more in oil revenues in 1996 than it had originally projected. This extra revenue produced a nominal growth rate of around 8.7% of the GDP, or twice the 4.3% growth rate Saudi Arabia had projected in 1995. In fact, Saudi Arabia might have been able to eliminate most of its deficit if the government had not proved unwilling to pursue the additional spending cuts and revenue increases required to meet the country's fiscal needs.

At the same time, the IMF proved right about the need for continued reform even if its near-term forecasts were wrong. Once Saudi planners felt they could safely forecast increased oil revenues they cut back on many of the plans to control government spending they had begun to implement in 1995. They allowed the deficit in the 1996 budget to reach $5.07 billion.

Budget Deficits, the "Oil Crash," and "Oil Boom"

Saudi Arabia's 1997 budget called for total expenditures of $48.3 billion dollars (181 billion Riyals), revenues of $43.7 billion dollars (164 billion Riyals), and a deficit of $4.53 billion dollars (17 billion Riyals). Saudi Arabia originally estimated that this spending would produce a deficit equal to about 3-3.5% of its GDP. A rise in oil prices during 1997 provided Saudi Arabia with substantial additional funds.[133] However, spending also increased in 1997 to $54.8 billion (204 billion Riyals) creating a deficit of $4.21 billion. Moreover, Saudi Arabia planned its 1998 budget on the assumption it would have even higher oil revenues. Its 1998 budget originally called for revenues of $47.46 billion (178 billion Riyals), expenditures of $52.26 billion (196 billion Riyals) and a deficit of $4.8 billion (18 billion Riyals).

The "oil crash" in late 1997 had a serious adverse effect on these projections, Saudi Arabia had to announce on December 28, 1998, that its actual 1998 budget deficit had soared to 46 billion Riyals ($12.27 billion), versus a corrected deficit estimate of 18 billion Riyals in mid-1998. This occurred even though actual spending in 1998 was only 189 billion Riyals, rather

than the original projection of 196 billion Riyals. The problem was that revenues were only 143 billion Riyals, rather than the forecast 178 billion.[134]

The inability to predict rises in oil prices created other problems, and Saudi Arabia faced another serious financial squeeze in drafting its 1999 budget. On December 28, 1998, Saudi Arabia announced its budget for 1999. The draft budget projected revenues of $32.3 billion (121 billion Riyals) and expenditures of $44 billion (165 billion Riyals), resulting in a projected deficit of $11.7 billion (44 billion Riyals) - about 9% of the GDP. This was nearly equal to the deficit in 1998, which stood at $12.26 billion (46 billion Riyals), although the total budget for 1999 was 13% lower than the budget for 1998.[135]

Saudi Arabia cut back significantly on domestic investment in public service and infrastructure programs to minimize the reduction in annual services, welfare, and entitlements.[136] The most significant cuts were made in transportation and communications, social affairs and subsidies, and unallocated funds, which are estimated to include the areas of defense, civil aviation, security, foreign affairs, and government agencies.[137]

Saudi Arabia continued to focus on temporary spending cuts rather than true economic reform. It did not introduce serious price reform, or introduce major new taxes and take other measures to boost revenues. The most it did in 1998 was to reduce subsidies to the national airline by raising business and first class fares on domestic routes and to introduce a departure fee for international flights. In December 1999, the government announced plans to levy a highway toll as part of an attempt to raise state revenues.[138] Even the extra revenue from the reduction in airline subsidies did not reduce state funding, because Saudia Airlines needed to finance a massive plane purchase program if it was to keep up with domestic demand.[139]

The government did announce somewhat more realistic electricity prices for major consumers but deferred actual implementation until the expected merger of regional power companies in 1999. The government raised the price of gasoline by 50 cents in early May of 1999 and doubled the cost of work permits for foreigners. Sales of premium gasoline were intended to generate an extra $1,000 million a year at the new rate, but remains at levels comparable to the lowest prices paid at the pump in the US, and regular gas prices remained

sharply underpriced.[140] It did not announce rises in water prices, and did not raise the prices for visas, permits, other petroleum products, and telephone services as it did in 1995.[141]

Fortunately for the Saudi government, a rise began to take place in oil prices following an OPEC production cuts of March 1999. This produced a rise in oil revenues that Kingdom's budget deficit at the end of 1999 to $9.1 billion (34.00 billion Riyals), versus the $11.7 billion previously predicted. Nevertheless, the government still faced the risk it would encounter its seventeenth year of budget deficits in 2000. This led it to try to cut spending despite the increase in oil revenues. The state budget for the fiscal year 2000 has projected expenditure to $49.33 billion with estimated revenue of $41.87 billion. This gap in between revenue and spending, in spite of the current "oil boom," was largely the result of loan repayment, amounting to 17% of budget spending in 1999 -- mainly to Kuwait and UAE. [142]

The broad trends in recent Saudi budget plans are shown in Chart 6.28 At the time the budget for 2000 was formulated, there were many different estimates of how much Saudi economy and budget have or have not benefited from high oil revenues:

- An economist at the National Commercial Bank estimated that government expenditure was expected to increase between 8% to 10%, partly offsetting the decrease in the deficit.[143] According to SAMBA, the actual result at the end of 1999 was SR181 billion worth of spending and a 34 billion riyal or $9 billion deficit. [144]

- SAMBA indicated that the government had budgeted $49 billion, or 185 billion Riyals for 2000, which would only be 4 billion Riyals above 1999. The budget anticipated $41.87 billion (157 billion Riyals) in revenues. As a result, the deficit would be $7.47 billion (28 billion Riyals. This estimate, was based on an average price of around $18 per barrel for Saudi oil.[145] SAMBA also estimated that the nominal growth in the Saudi GDP was 8.4% in 1999, and would be 6% in 2000 (2% real growth.) [146]

In practice, oil prices rose as sharply in 2000 as they had dropped in 1998. Oil prices rose to extremely high levels because of a global economic boom and weather. This allowed the Saudi government to develop a revised budget with revenues of 248 billion Riyals ($66.13 billion) in 2000, and expenditures of 203 billion Riyals ($48.27 billion), resulting in a projected surplus of $12.0 billion (45 billion Riyals). Revenues were projected to be some 60% higher than the original budget projection of 157 billion Riyals ($41.9 billion). At the same time, expenditures were still projected at levels 10% higher than the government had originally planned.

It is notable that the rise in planned expenditures was limited relative to the rise in revenues, and some of the rise in expenditures would have occurred regardless of the rise in revenues. Saudi Arabia has an obligation to pay a thirteenth month of wages every three years because the Saudi lunar Hijri year is shorter than the Gregorian year, and this is obligation is not included in the Saudi budget. It accounted for 8 billion Riyals out of the 18 billion Riyal rise. An additional 10 billion Riyals was also paid to farmers and contractors for work done in previous years. This reduced the government's arrears from a peak of around $30 billion in the mid-1990s to around $3 billion at end-2000. The government did not add to its debt and seems to have put much of the unexpected surplus in revenues into foreign government investments.[147] Nevertheless, actual revenues were $68.82 billion in 2000 and expenditures still rose to $62.76 billion, creating a surplus of only $6.06 billion.[148] In spite of the planners' efforts, actual spending still exceeded the budget by 27%.[149]

Saudi Arabia showed similar restraint in planning its 2001 budget – a restraint that proved to be wise because of dropping oil prices and an unstable global economy, Saudi Arabia projected revenues of 215 billion Riyals ($57.33 billion) and expenditures of 215 billion Riyals ($57.33 billion), resulting in a balanced budget.[150] This involved an increase over the 2000 driven largely by the kind of entitlement and welfare costs discussed in Chapter IV. There was an 8.15% increase in human resource development, a 4.81% increase in transport and communications, a 10.1% increase in health services and human development, a 6% increase in infrastructure expenditures, and a 23% increase in municipal services. [151]

When the Council of Ministers announced its estimate of the actual expenditures in the 2001 budget on December 8, 2001, however, government spending had risen to 255 billion Riyals ($68.0) billion, and revenues were 230 billion Riyals (($61.3 billion) for a deficit of 25 billion Riyals ($6.7 billion). Revenues were 7% higher than forecast, but spending was 16.6% over budget. Saudi Arabia was clearly consistently underestimating expenditures by at least 10%.

As Chart 6.26 shows, it is far from clear that the situation will change in 2002, although the Saudi budget plan was down by 20% relative to 2001. Spending was projected to be 202 billion Riyals ($53.9 billion) and revenues to be 157 billion Riyals ($41.9 billion), creating a deficit of 45 billion Riyals ($12 billion). By mid-2002, however, the situation seemed more

favorable. Average annual oil prices year estimated at $21.75 per barrel in July 2002, versus $18.00 in January 2002. The projected GDP was estimated at 685.5 billion Riyals in July 2002, versus 616.16 in January, and real growth was projected to rise from –2.0% to +0.2%.

The impact of these changes was so great that government budget deficit was estimated to drop from $12.0 billion to $5.06 billion, and from 7.3% of GDP to 2.8%. The GDP per capita was estimated to $8,309 instead of $7,039, the current account balance was estimated to be $10.5 billion versus -$7.9 billion, and the government debt to drop from 109% of GDP to 95%. These favorable trends, however, were purely the result of world oil prices, driven up largely by fear of war with Iraq. They were little more than a further example of the impact of Saudi dependence on oil export income, and the future remained as uncertain as ever.[152]

As for the Saudi Seventh Development Plan, it sets broad financial objectives that – if properly implemented – would ease the Saudi government's problems. It does not, however, set clear goals for achieving such objectives nor provide any clear plan for future revenues and expenditures.[153]

- Increase non-oil government revenues;
- Reduce budget deficit to lowest possible level;
- Finance the deficit (if any) through issuing development bonds;
- Use surpluses of government oil revenues to reduce the public debt; and
- Maintain strict adherence to approved expenditure limits, ensuring that the limits set are not exceeded during the fiscal year.

There is no way to know exactly how the Saudi deficit in investment spending compares with the overall budget deficit. The Saudi budget does not provide a detailed enough breakout of operating costs vs. investment costs by sector to track the extent to which given expenditures keep up with the rise in demand imposed by increase in population, Saudi experts do feel, however, that there has been a growing backlog in may area of investment in infrastructure and social services.

Spending upon municipal services has not kept pace with need; there has been underinvestment in urban water and sewer infrastructure. Moreover, Part Two of Chart 6.26

shows that some of the activities most impacted by population growth – health, infrastructure, and water/municipal services -- have been funded at relatively low levels in recent years. The estimated rise in the planned 2002 budget seems to be an attempt to compensate in part for past underfunding but it can scarcely compensate for a near decade of low funding and the planned rise cannot be accomplished within the total shown without underfunding other high priority areas.

One thing is all too clear from these figures. As long as the Saudi government is dependent on crude oil and petroleum exports for 75%-85% of its revenues, even peak oil revenue years like 2000 do not allow Saudi Arabia to reach even a temporary solution to the government's spending problems. This is particularly true because the growth of the non-petroleum sector of the economy has not affected government dependence on oil revenues.

Oil revenues were 90.4% of total government revenues in 1975, 91.7% in 1980, 66.2% in 195, 77.8% in 1990 and 1991. They ranged from 74.0% to 77.9% during 1992-1997. They dropped to 56.5% in 1998, a year of exceptionally low oil revenues, and rose back to 83.1% in 2000, a year of high oil revenues. The official Saudi figures indicate that non-oil revenues have averaged 42 billion Riyals a year and 26% of the budget over the last eleven years, with a low of 16.9% in 2000 – a year of high oil revenues – and a high of 43.5% in 1998 – a year of low oil revenues. [154] They totaled 40.9 billion Royals in 1992 and 43.6 billion Riyals in 2000; this is an increase of only 6.6 percent in current Riyals over eight years and no increase in constant Riyals.[155]

There is no current prospect that future oil revenues will ever again provide anything like the immense surplus wealth the Kingdom obtained in the 1980s, and the government will face steadily increasing difficulties in capping spending at moderate levels because of population growth and the need to fund economic diversification.

The Need for Budget Reforms

There is no precise way to estimate either the size of future Saudi budgets or what level of future state spending the Kingdom actually requires. Past trends clearly show that the Saudi budget is under pressure, but they do not reflect any kind of structural crisis in either the Saudi economy or the Saudi budget. Most developing countries, and many developed ones, would count themselves fortunate if their problems were only as severe as the *current* problems of the Saudi government.

At the same time, Saudi Arabia faces growing problems in managing its state budget and ones that only major reforms can address:

- *There is a lack of overall transparency coupled to a lack of clear benchmarks in measuring the adequacy of government efforts to meet the needs of both the Saudi public and Saudi economic development.* While Saudi Arabia has improved the transparency of its financial reporting and budget data in recent years, the limited data it provides on the impact of the budget only reports on things to be bought or built, and on not performance relative to demand or public need. Effective planning and public discussion require a budget than not only is transparent, but also provides meaningful output measures. It also requires both the use of foreign official investments, and the level of both foreign and domestic debt to be addressed in detail. At some point, the budget must also account in much more detail for the impact of state industries on the budget, the full range of subsidies, payments to the Saudi royal family, and the division of the budget into investment, operating, and entitlements expenditures.

- *This transparency needs to be applied to military and national security expenditures, which need to be subject to the same cost-benefit review and debate as civil expenditures.* These expenditures account for over 40% of the national budget, and were reported to total 68.7 billion Riyals ($18.3 billion) in 1999 and 74.9 billion Riyals ($21.0 billion) in 2000.[156] In practice, Saudi Arabia's public reporting of its budget also conceals additional military expenditures that are being paid for off-budget through the transfer of oil, and off-budget expenditures paid through royal accounts.[157] Even this level of transparency, however, is new. Past Saudi budgets did not specifically identify military spending, but have lumped it together with various programs into an "other spending" category, that accounted for 54% of the 1996 budget, and this percentage still seems to have understated the true cash flow for arms imports.[158] This helped raise the final cost of the deficit to $5.9 billion in 1996, if payments for past arrears are included, than this figure ignored an additional $1.3-2.7 billion in arrears from previous years.[159]

- *A combination of Saudi Arabia's economic problems, budget deficit, and growing population have increased the burden of military spending per capita relative to GDP per capita.* These trends are shown in Chart 6.29, although it should be noted that the rate of military spending per capita peaked in the early 1990s because of the Gulf War. As a result, military spending per capita is significantly lower than in the early 1990s. Nevertheless, military expenditures per capita remain relatively high, and consume around 13-15% of all per capita income. The, annual defense budget still amounts to 16% of the GDP and imposes a strain on both the Saudi budget and Saudi capability to meet domestic economic and social needs, and financing Saudi military expenditures is likely to be a steadily growing problem.

- *It is increasingly uncertain that Saudi Arabia can increase the share of the budget that goes into investment to the levels of investment it will require.* Even if Saudi Arabia can control military expenditures and receive higher oil revenues, many of the bills for Saudi Arabia's rapid population growth are coming due. In fact, this trend has already begun. Education rose from a level of around 27 billion Riyals during 1995-

1996 to 41.7 billion Riyals in 1997 and 45.6 billion Riyals in 1998. While Saudi Arabia probably under spent on education and vocational training during the half decade following the Gulf War, this still brought the cost of education to 23% of the 1997 budget ($11.1 billion) with the percentage remaining constant for the 1998 budget. Furthermore, Saudi Arabia has not increased most public sector and government salaries since the 1980s. Even in a country with relatively low inflation, this creates a major potential demand for added government spending.[160]

- *Saudi Arabia's real welfare, social, and entitlements program is rising in cost relative to investment even if it is not sustaining the past level of expenditure per capita*. The rise between 2000 and 2001 has already been discussed. Similar rises also took place, however, during the "oil crash." The 1997 budget allocated 17.3 billion Riyals ($4.73 billion) for health and social development and 7.1 billion Riyals ($1.9 billion) for domestic subsidies. It also allocated 6.5 billion Riyals ($1.72 billion) for municipal services and water, 6.7 billion Riyals ($1.78 billion) for transportation and communications, and 8.3 billion Riyals ($2.2 billion) for infrastructure, industry, and water.[161] In spite of drastic cuts in revenues, the 1998 budget allocated 19.9 billion Riyals ($5.3 billion) for health services and social development, 7.5 billion Riyals ($2 billion) for municipal services and water, 17.3 billion Riyals ($11.6 billion) for transportation and communication and 10.5 billion Riyals ($2.8 billion for infrastructure, industry and electricity. A review of spending on autonomous governmental institutions indicates major increases were also made in subsidy-related spending on Saudi, flour mills, power, desalination, railways, ports, etc.[162]

- *As has been discussed in Chapter IV, a large amount of current expenditures for municipal services, water, transportation, communications, and infrastructure still go to pay for such subsidies while the Kingdom under-invests in the maintenance, upgrading, and expansion of capacity*. Saudi Arabia cannot sustain such subsidies when its own estimates indicate that it needs so much investment in new capacity. As has been discussed earlier, Saudi estimates indicate a requirement for at least 4.5 million new housing units by 2020, at an estimated cost in excess of $260 billion (980 billion Riyals). They also include 22,500 new primary schools, 6,000 new institutes of higher education, 5,400 clinics, and 360 hospitals.[163]

- *Saudi revenue streams are still far too dependent on the petroleum sector and duties*. The Kingdom needs to implement new tax laws, and to strengthen the collection of existing taxes and duties. The previous budget data has shown that income taxes, and taxes on domestic businesses, account for only token amounts of Saudi revenues. Wealthy Saudis have hundreds of billions of dollars in domestic assets and additional hundred of billions of dollars in private foreign investments. It may make sense to have tax laws that encourage domestic investment and the repatriation of capital, but it makes no sense to subsidize the wealthy for non-productive consumption with the government equivalent of a free lunch.

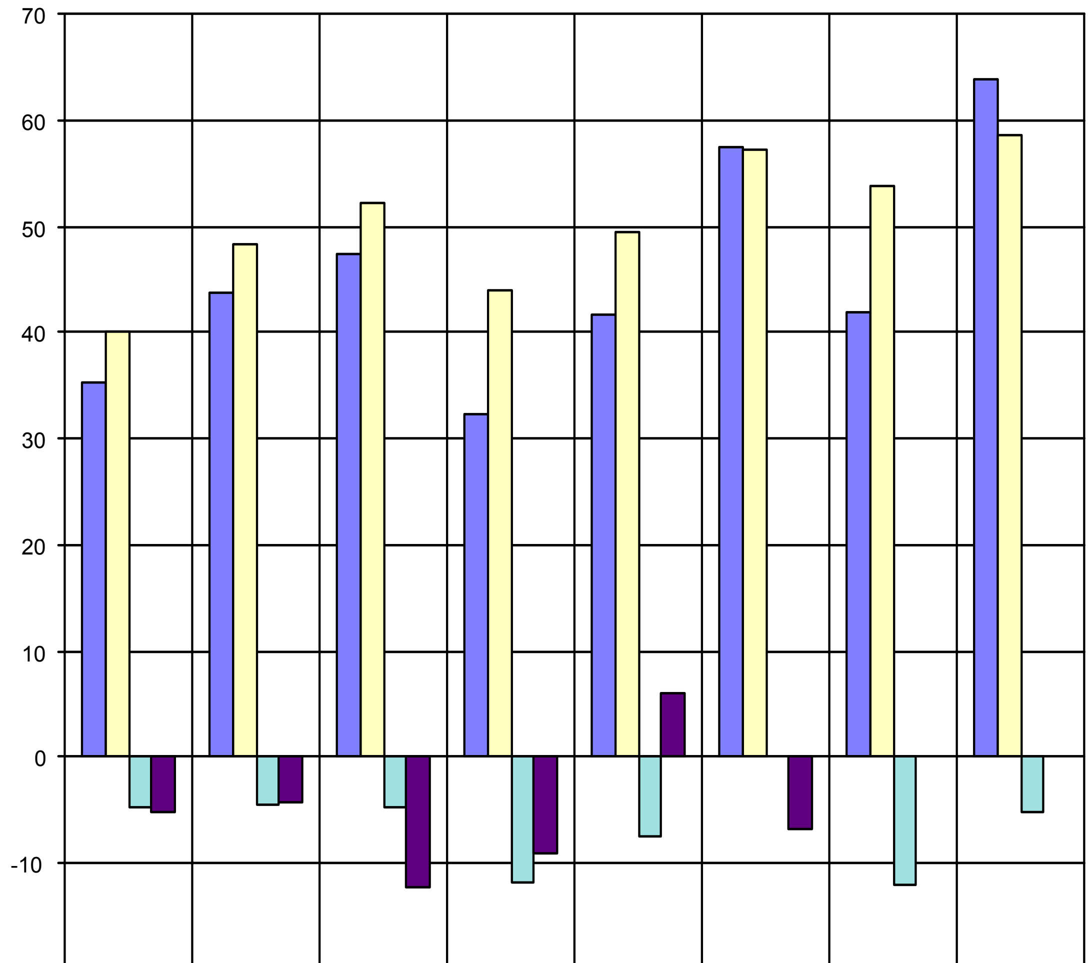
- *Civil service reform is needed just as much as the Saudisation of government jobs*. As has been discussed in Chapter IV, the Kingdom cannot solve its problems in Saudisation by hiring more Saudis to work in already over-staffed government jobs. The number of Saudis employed in government rose at roughly twice the rate of population growth during the 1990s, and now seems to be in excess of 600,000.[164] Most of these jobs contribute nothing to economic productivity and many Ministries and state firms are badly over-staffed. This is a major drain on the Saudi budget.

- *Privatization is Needed as Well as the Development of the Private Sector, but Shaping Government Activity Around Market Prices Is Even More Important.* The previous analysis has already stressed the importance of diversification and expanding the private sector. Privatization is probably equally desirable, particularly as a way of reducing investment burden in the state budget. At the same time, one needs to be careful about ideological statements that the Kingdom should privatize for the sake of privatization. Many of Saudi Arabia's state companies are relatively efficient, and it is not always clear that private Saudi or foreign companies and consortia would really be more efficient. The merits of privatization are a matter of the economics and efficiency of individual ventures and not economic theory. However, if Western experts tend to push privatization for the sake of privatization, Saudi government officials tend to push privatization as a means of dumping burdens on the private sector. The basic problem in many Saudi government services is that their present cost does not include either fair return on investment or recoupment of operating and maintenance costs. Private ventures cannot operate except on the basis of

market prices that include both all expenses and a fair profit. Subsidizing private ventures simply disguises subsidies and does not solve any of the Kingdom's problems, although it can sometimes be politically manipulated to disguise the nature of price rises.

Chart 6.26

Saudi Government Budget Plans– Part One
Expenditures, Revenues, and Planned vs. Actual Deficits
(In Current $US Billions)



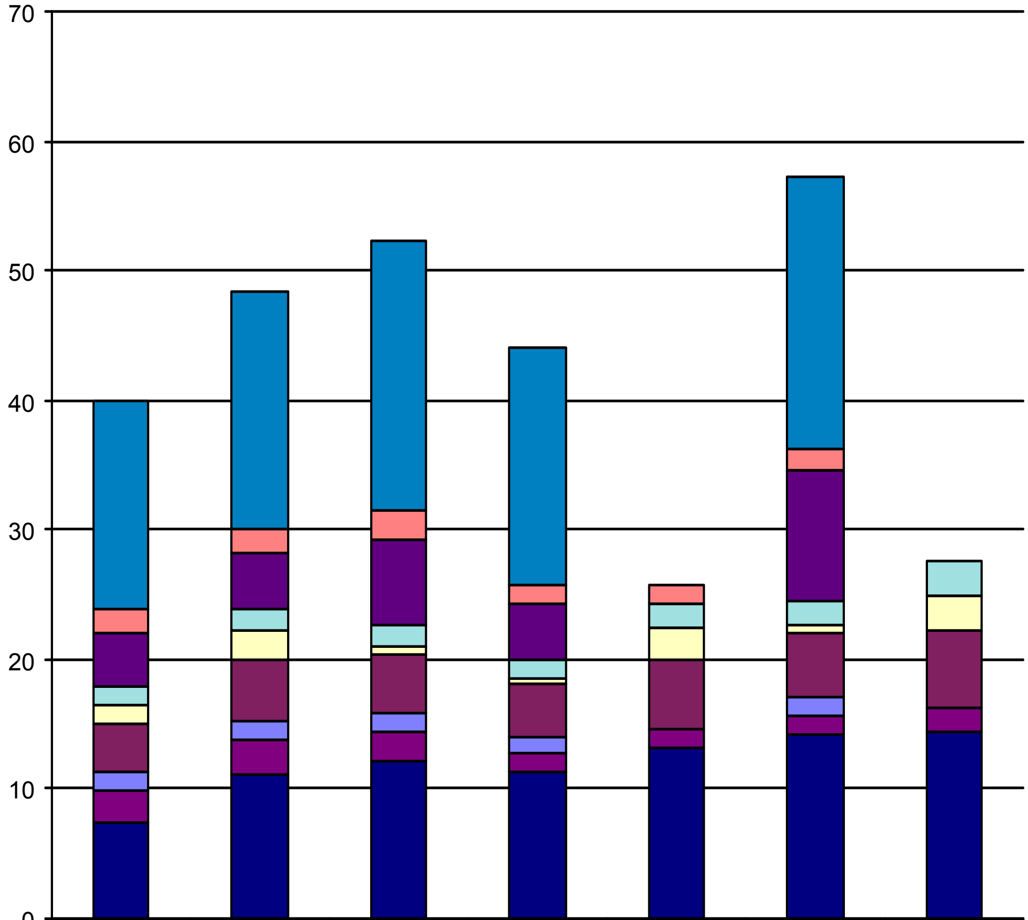
	96	97	98	99	2000	2001	Jan 02 Estimate	Aug 02 Estimate
Total Expenditures	35.2	43.73	47.47	32.27	41.67	57.33	41.86	63.73
Total Revenues	40	48.29	52.27	44.01	49.33	57.18	53.86	58.67
Planned Balance	-4.8	-4.56	-4.8	-11.74	-7.47	0	-12	-5.06
Actual Result	-5.07	-4.21	-12.27	-9.07	6.06	-6.7	-	

Source: Adapted by Anthony H. Cordesman from Brad Bourland, The Saudi Economy in 2002, Saudi American Bank, Riyadh, February 2002, p. 36, and The Saudi Economy at Mid-Year 2002, Saudi American Bank, Riyadh, February 2002, p. 36

Chart 6.26

Saudi Government Budget Plans– Part Two
Spending by Major Sector

(In Current $US Billions)



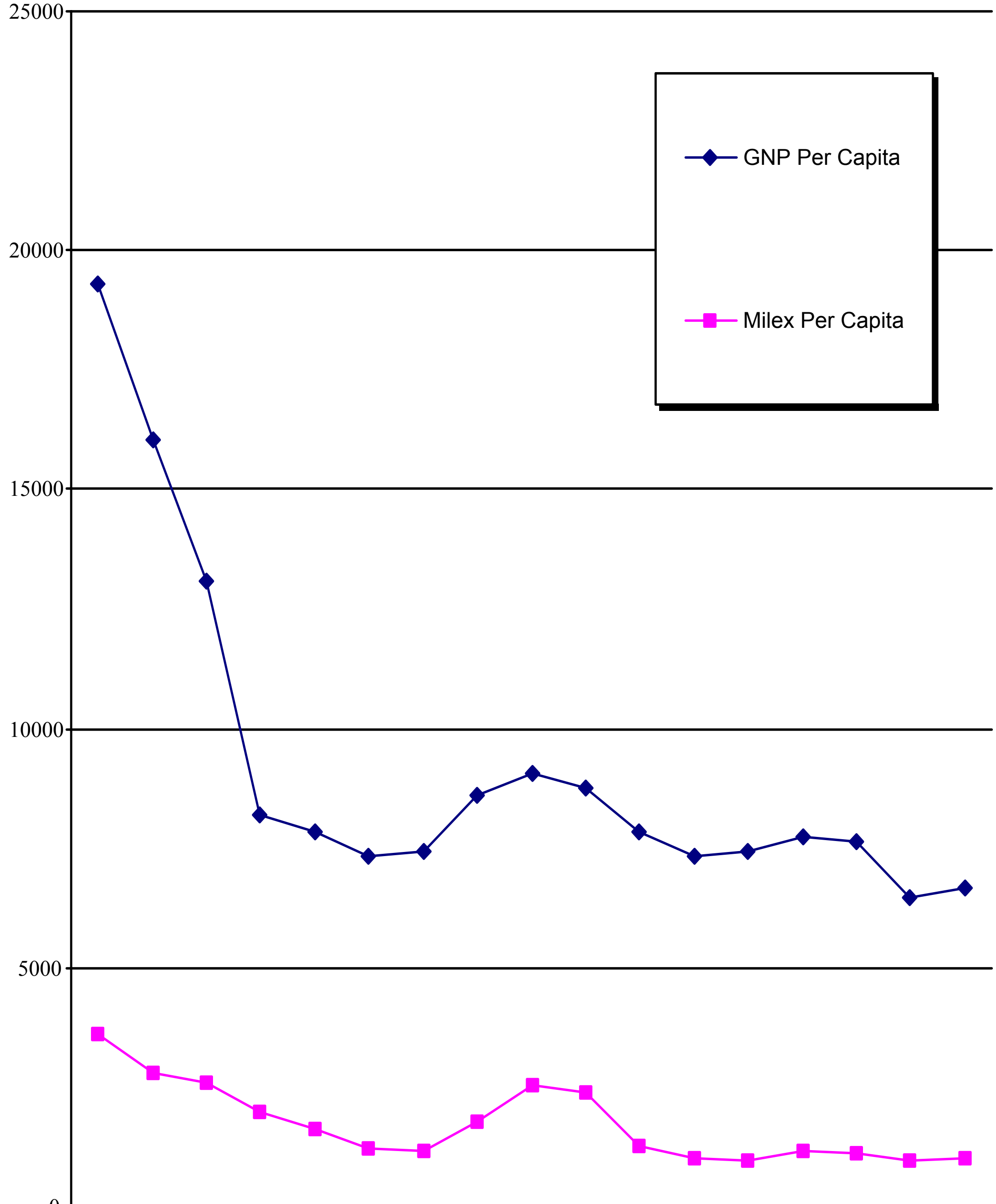
	96	97	98	99	2000	2001	2002
Defense and Security	16.03	18.13	20.85	18.32	-	21.02	-
Subsidies/Social Progr	1.84	1.89	2.08	1.38	1.47	1.64	-
Public Admin/Utilities	4.13	4.32	6.69	4.39	-	9.96	-
Water/Muni Services	1.44	1.73	1.73	1.44	1.89	1.92	2.53
Infrastructure Dev't	1.63	2.24	0.59	0.45	2.43	0.67	2.69
Health	3.55	4.75	4.37	4.05	5.31	4.82	6.08
Econ Resources Dev't	1.57	1.33	1.55	1.17	-	1.5	-
Transport & Comms	2.45	2.77	2.27	1.39	1.49	1.52	1.73
Education	7.36	11.12	12.13	11.41	13.17	14.13	14.48

Source: Adapted by Anthony H. Cordesman from Brad Bourland, The Saudi Economy in 2002, Saudi American Bank, Riyadh, February 2002, p. 36.

Chart 6.27

Saudi GNP Per Capita Versus Military Expenditures Per Capita: 1983-1999

(Constant $99)



	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99
GNP Per Capita	19320	16020	13070	8210	7830	7320	7420	8580	9040	8750	7830	7340	7440	7750	7630	6450	6680
Milex Per Capit	3630	2780	2610	2005	1620	1210	1180	1760	2570	2380	1280	1040	980	1150	1140	959	996

Source: Adapted by Anthony H. Cordesman from ACDA, World Military Expenditures and Arms Transfers, 1995, ACDA/GPO, Washington, 1996 and US State Department, World Military Expenditures and Arms Transfers, 1998, Bureau of Arms Control, Washington, 1999; World Military Expenditures and Arms Transfers, 1999-2000, Bureau of Verification and Compliance, Washington, 2002.

Foreign and Domestic State Debt

Debt is another factor that affects the Kingdom's future ability to develop its economy, carry out reform, and meet the goals of its five-year plan. As the previous discussion has noted, a combination of the decline in "oil wealth," and security problems like the Gulf War, forced Saudi Arabia to liquidate a substantial amount of its official foreign investment at the time of the Gulf War, although these investment levels have since recovered. It also forced Saudi Arabia to become a significant borrower. Estimates indicate Saudi state foreign investments dropped to levels below as $30 billion in the early 1990s.[165] Foreign debt rose from practically zero to 2% of GDP in 1990-1991 and then to 4% in 1992-1993, although the debt dropped to 1% in 1994.[166] The Saudis were forced to acquire their first sovereign loan since the Gulf War in the amount of $433 million dollars to finance an aircraft purchase from Boeing.

Chart 6.19 shows the comparative pattern of debt in the Gulf, and it is clear that the Saudi debt has not been high by regional standards. Nevertheless, Saudi Arabia's net outstanding domestic debt increased from about 23-24% of GDP in 1989-1991 to 53% in 1992, 63% in 1993 70% in 1994, 87% in 1997, 116% in 1998, 119% in 1999, 95% in 2000, and 99% in 2001. It is estimated to be 95% in 2002.[167] This is a rise from 342 billion Riyals in 1994 to 630 billion in 2001; the only year it dropped was in 2000, and it still totaled 616 billion. The debt was estimated to total of 630 billion ($171 billion) in mid-year 2002, and projected to rise to 649 billion ($176.1 billion) by the end of 2002..[168]

The Limited Impact of the Present Debt Burden

Domestic borrowing equal to, or greater than, 55% of GDP is normally an indication of serious economic problems, but the linkage between these borrowing requirements and the payment of wartime costs, and the fact that Saudi Arabia does not raise revenue from income tax, makes it difficult to apply such standards to Saudi Arabia.[169] Some economists argue that this level of debt is sustainable because of the limited exposure of banks to government debt, and their healthy position in terms of foreign assets.[170] Some 75-80% of Saudi domestic debt is held by two government pension funds (which do not report in any detail on their investment holdings), and less than 15-20% by commercial banks. Less than 5% is held by private companies and individuals in the form of bonds given in lieu of various payments and subsidies in past years. The fact the government essentially owes most of the debt to itself allows it to

manipulate it, and indeed shift funds to more productive foreign investments rather than repay domestic debt. This was the course the government followed during the boom year of 2000.[171]

Past History and Future Risk

Nevertheless, the recent history of Saudi borrowing still illustrates that debt can be a serious problem in years of low oil revenues and will become a much more serious problem if the Kingdom does not succeed in economic reform.

During the early 1990s, Saudi Arabia dealt with the foreign debt problem it incurred during the Gulf War by (a) paying off foreign debt at the cost of increasing domestic borrowing, (b) by delaying payments to foreign contractors, and (c) using the windfalls it obtained from unexpectedly high oil prices to reduce its domestic debt. Public borrowing allowed Saudi Arabia to finance major foreign purchases during the 1990s like the purchase of some $6 billion worth of Boeing and McDonnell-Douglas air liners although this was a key factor that raised the Saudi domestic debt to creditors to $94 billion by March 1995, and pushed debt to over 80% of the GDP.

These measures allowed Saudi Arabia to largely retire its Gulf War foreign debt by May 1995. However, the growing domestic debt had a negative impact on the Saudi private sector, whose growth is one of the most important priorities for reforming the Saudi economy. Increased public borrowing created a substantial government public debt that affected Saudi banking and investment capabilities. It also created a backlog in payments to foreign companies that some sources estimate reached several billion dollars in 1995.[172]

The Saudi government only avoided further massive increases in domestic borrowing during 1993-1995 by delaying or defaulting on countless domestic contracts. Saudi Arabia owed its farmers nearly $3 billion in subsidy payments in early 1996. While it has since "paid" them much of the money, nearly $2.5 billion of the payment consisted of non-interest bearing certificates that are little more than IOUs which defer actual cash transfers.[173] The government provided interest-bearing bonds worth more than 5,200 million Saudi Riyals ($1.387 billion) to pay off its overdue debts more than 120 major contractors, and asked other contractors to forgive the government's debt because of past profits. [174]

While the Saudi government repeatedly denied that it was delaying and defaulting on its payments, virtually every Saudi and foreign businessman operating in Saudi Arabia had practical evidence that these denials were false.[175] These delays and defaults raised still further questions about how long the Kingdom could continue its rate of domestic borrowing, and how much such borrowing might conflict with its efforts to privatize and diversify its economy.

Saudi Arabia was able to deal with some of these problems in 1996. Unexpectedly high oil revenues allowed Saudi Arabia to pay some $5.9 billion (22 billion Riyals) to its domestic creditors. It still, however, remained at least $1.3 billion to $2.7 billion in arrears.[176] The Saudi Ministry of Health remained notorious for its failure to pay its bills. The government also created potential future problems by initiating more new projects than it was clear it could pay for. [177] Estimates of the domestic debt varied but some felt it could have been as high as 120 billion dollars, about 80 percent of GDP. [178]

The government was successful in rescheduling its military debt, but only at the cost of increasing the total cost of the debt, including interest. By 1994, its arms purchases during and after the Gulf War had raised its total Foreign Military Sales (FMS) debt to the US to $23 billion. Saudi Arabia had additional military debts to Europe and to US firms that had sold to Saudi Arabia through commercial sales. This military debt interacted with Saudi civil debts, and forced Saudi Arabia to reschedule its FMS debt. This rescheduling took place in November 1994, and did little more than create an extended payment schedule. Saudi Arabia did, however, reduce the number of end items it bought, and reduced spending on munitions, military construction, and sustainment. It also eliminated orders to deal with worst-case contingencies.

King Fahd also issued four major guidelines: No new programs, reduce the total FMS debt to $10 billion, stretch out all military program payments where possible, pay all bills on time, and avoid new starts. These guidelines had a significant impact, and helped cut Saudi Arabia's total FMS debt dropped from $23 billion in FY1994, to $18 billion in FY1995, $14 billion in FY1996, and $10 billion in FY1997.

Saudi Arabia did not follow these guidelines with sufficient firmness, however, and did not reduce its new military purchases to the level required. A new rise in oil prices and revenues in 1995 and 1996 led Saudi Arabia to increase its new arms orders, as part of what one senior

advisor called an, "insatiable appetite for new hardware." Prince Sultan, the Minister of Defense rejected US advice to limit further major arms purchases and stay strictly within the $10 billion limit agreed to in 1994, and threatened to buy from other countries if the US did not sell. As a result, Saudi Arabia faced a new payments problem following the "oil crash" of 1997, and could not make all of its military payments to US contractors and other countries on time.

Saudi policies made some international banks reluctant to approve loans for major projects even before the "oil crash" began to sharply reduce Saudi oil revenues in late 1997. In January 1996, Saudi Consolidated Electric Company for the Eastern Province (Sceco-East) sought a $500 million loan as part of a $1.4 billion project to boost capacity at its Ghazlan power-generating plant. The uncertain political climate, the distortion of cash-flow assumptions by Saudi subsidies and Sceco's debt to another government entity, Saudi ARAMCO, all raised doubts in the minds of international financial institutions as to the Saudi government's future repayment ability. Some banks were unwilling to invest in a venture with government-subsidized companies, such as Sceco, believing them not to be commercially viable risks. This reaction from financial institutions underscores the need for faster privatization.[179]

As has been analyzed earlier, the "oil crash" that began in late 1997, increased the Saudi deficit to $13-15 billion, and put serious on the Saudi budget. As a result, Saudi Arabia had to borrow up to $5 billion from Abu Dhabi as an emergency bridge loan. Saudi Finance Minister Ibrahim al-Assaf, denied these reports, but it was clear that the Kingdom did have to borrow from its neighbors and had scarcely solved its structural debt problems.[180]

Bank claims on the government and quasi-government agencies rose to 28.5% of the total assets of Saudi commercial banks in late 1998. Saudi commercial banks still held enough foreign investments to have a $7.3 billion foreign interbank surplus plus foreign investments of nearly the same value. According to some estimates, this gave Saudi banks the capability to raise up to $11 billion to help the government in 1999, although only at the coast of a massive short-term draw down in foreign assets. According to some estimates, the government also took some $5 billion in Aramco assets and income in 1998, and another major draw down in 1999.[181] Total domestic and foreign reached $120 billion by March 1998, or about 80.1% of the GDP.[182]

According to SAMBA, the government's domestic debt rose to $160 billion or 600 billion Riyals in 1999. This was 115% of Saudi Arabia's GDP for 1999, as calculated by SAMBA. Other sources show an increase in domestic borrowing by the government from commercial banks in 1999 through bond purchases.[183] This level reached $120 billion by March 1998, or about 80.1% of the GDP.[184] In spite of its prior efforts, The Kingdom also still has some foreign debt, which stood at $10 billion in 1999, raising the total foreign and domestic debt to 120% of GDP.[185]

The issue of how much the Kingdom borrows in the future, however, is only one part of the story. There is also the issue of what it borrows money for. If the money is used for productive investment to support economic reform, diversification, and the private sector – and is counterbalanced through effective Saudi private and foreign investment – it will help meet the Kingdom's needs. If it is used to deal with budget deficits, operating expenses and entitlements -- or to fund showpiece arms and aircraft purchases -- it will add an unnecessary burden to the economy which could well become steadily worse as demographic pressures increase over time. Misuse of domestic borrowing will also act to limit both foreign investment and the repatriation of private Saudi capital.

It is striking that debt issues are not seriously addressed in the recent annual reports (36th and 37th annual reports in 2000 and 2001) of the Saudi Arabian Monetary Fund or in the public Saudi literature on the Seventh Development Plan. Debt strategy is a key part of the Kingdom's overall effort to achieve economic reform, and it needs to be as well managed and transparent as any other major economic activity. There is a clear need to combine the strategy for domestic and foreign borrowing with the strategy for investing in Central Bank and government pension fund official foreign assets, and to link this to clear plans for government domestic investment in both the government and private sectors. Saudi government fiscal reporting on past expenditures is quite good in some of these areas, but there is no public evidence of a coherent plan for the future.

Privatization and the Private Sector: Intentions versus Implementation

There is a broad consensus within the Saudi ruling elite, Saudi technocrats and educators, and Saudi businessmen and professionals that the nation needs to diversify its economy, to reduce dependence on the petroleum sector, to solve the problems in managing and financing the Saudi budget, and find ways of limiting the Saudi government's domestic foreign and domestic debt. There is a consensus that the Kingdom truly needs to make economic reform work, and it can only do so by strengthening the private sector, finding other sources of investment, and encouraging Saudi repatriation of capital.

Once again, Saudi Arabia's problem is not a lack of good intentions, or of setting the proper priorities, but rather that there is no matching consensus as to how much action is needed and how quickly and when Saudi Arabia should act. While Saudi Arabia has already made progress in many areas, the measures that the government has taken so far have lacked the scale and speed needed to restructure the economy at the rate required. It is also clear that the Seventh Development Plan does not provide an adequate map for future progress.

While it is impossible to assign precise priorities and values to the level of additional effort required, it is clear that success will depends on far more rapid progress being made in four areas:

- Strengthening the private sector.
- Privatization.
- Obtaining increased foreign investment, and
- Persuading Saudis to repatriate their foreign investments and invest in the Kingdom.

It is also important to understand that success in each areas will require major macroeconomic change. It is not enough to have some progress in each of these areas; there must be structural change in the entire economy and it must occur during the next decade. In the real world, however, all societies and economies have tremendous inertia. The trends shown earlier have shown this, and the growth of the government share of the non-oil sectors of the economy consistently outpaced the growth of the private sector during 1990-1997. In fact, this trend

accelerated during 1995-1997, a period in which government policy supposed to strongly favor the private sector. Saudi government and SAMA figures indicate that the private sector accounted for 35.3% of the GDP in 1997, which compares with 36.0% in 1990. In contrast, government activity in the non-oil sector rose from 25.9% of the GDP in 1990 to 28.5% in 1997. This growth fully offset the decline of the oil sector's share of the economy from 38.0% to 36.2%, and the government share of the total GDP rose slightly from 63.9% to 64.7%.[186]

Chart 6.28 shows just how static the share of the private sector and government non-oil sector have been since the end of Saudi Arabia's Fifth Plan. Similarly, Chart 6.29 shows that the Ministry of Planning reports that real growth in the non-oil sector of the economy has been far too low to meet the country's needs except in construction and government related areas. Chart 6.30 shows that the Saudi Arabian Monetary Agency Reports there has been virtually no meaningful growth in the non-oil sector under the Sixth Development Plan. The only major change shown in Chart 6.30 is a major drop in the value of the manufacturing sector, driven almost solely by an oil-price related cut in the value of refining in 1998.

Chart 6.31 focuses on the impact of two key sectors on the GDP. It shows the value of the industrial sector from 1989-1999, and its impact on the economy. It does reflect an increase in the value of the industrial sector in current prices and supplements the data provided earlier on the growth of Saudi companies and factories and private investment.. At the same time, the increase shown in Chart 6.31 would be much lower in constant Riyals, and industry only grew from around 8% of the GDP in 1989 to 10% in 1999 – scarcely the rate of change needed by the economy. At the same time, the heavily government-subsidized agricultural sector has also grown in current Riyals, and occupies much the same share of the GDP it did in 1989.

Saudi Arabian Monetary Agency data on the Saudi GDP following the end of the expenditures for the Gulf War by type of economic activity -- as measured in producers' values in constant prices (1970=100) – seem to sharply understate some aspects of government sector activity in the petroleum sector. Nevertheless, these data also that the growth of the private sector had only limited macroeconomic impact during the period from 1993-2000:[187]

- The heavily subsidized agriculture, forestry, and fishing sector had limited growth during the 1990s, rising erratically from 5,466 million Riyals in 1993 to 5,932 million in 2000 (+8.5% over eight years).

- Mining and quarrying other than the petroleum and gas sector, increased from 186 to 214 million Riyals (+17%), but this growth had negligible impact on an economy whose real growth increased from 62,265 million Riyals to 68,586 million (+10,2%).

- Manufacturing other than refining grew from 3,445 million Riyals to 4,451 million (29%), but this was dominated by government investment in industries like plastics.

- Wholesale and retail trade restaurants, and hotels, grew from 8,203 million Riyals to 8,932 million (+8.9%).

- Finance, insurance, real estate, and business services grew from 4,289 million Riyals to 4,710 million (+9.8%).

- Construction (much of which is government-funded petroleum and infrastructure construction) grew from 3,649 million Riyals to 5,087 million (+12.3%).

- Transport, storage, and communication (most of which is also government-funded) grew from 4,621 million Riyals to 5,087 million (+10.1%).

- In contrast the government-controlled petroleum, gas, and refined sector increased from 23,564 million Riyals to 24,201 million This was only an increase of 2.7+% over eight years, but affected 35-40% of the GDP.

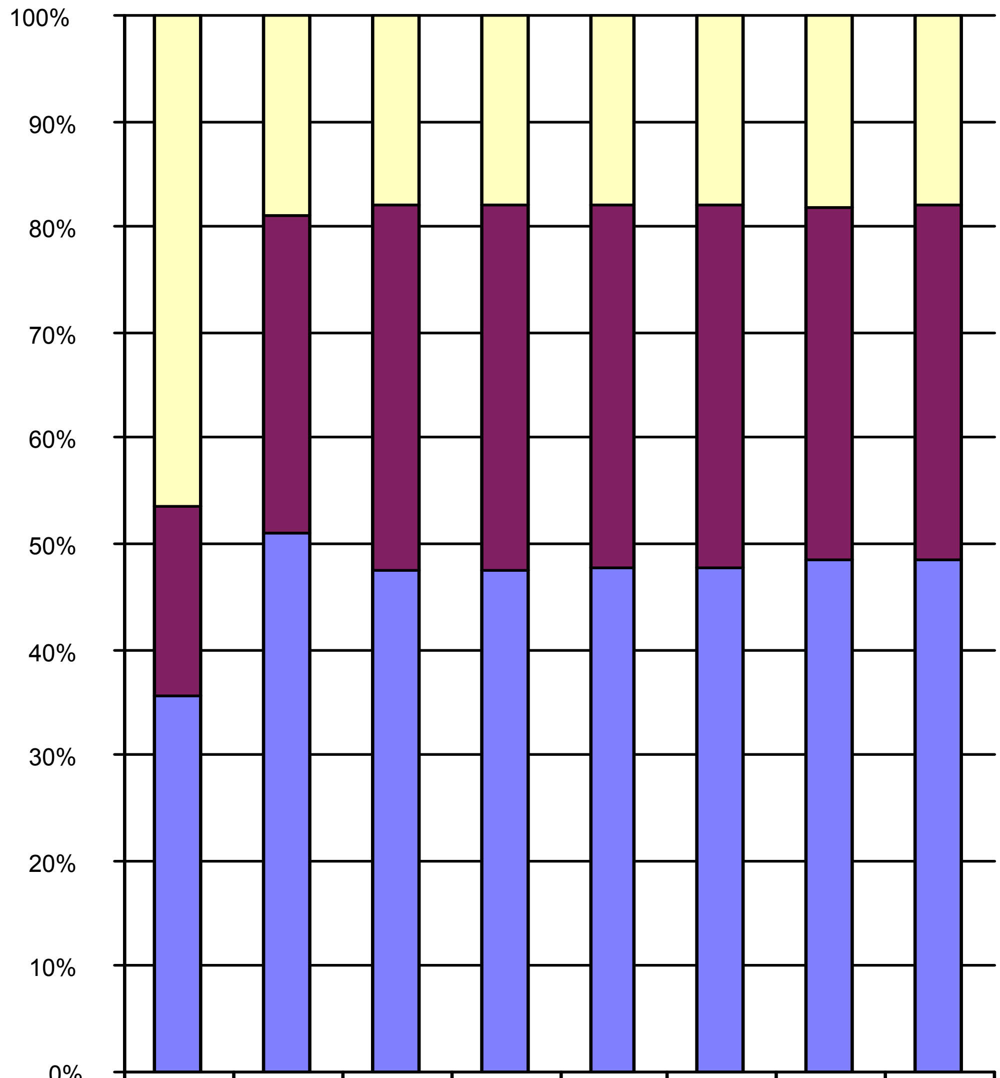
- Other clearly government-dominated activity include government services; community, social and personal services; and electricity gas and water. Their value grew from 8,434 million Riyals to 9,473 million (+12.3%). This rate of growth, however, was about half the roughly 25.6% growth in the Saudi population.

While there is no exact way to use the SAMA data to fully separate out government and private activity in the total Saudi GDP, the total of government petroleum activity and direct government services rose from 31,998 million Riyals in 1993 to 33,674 million Riyals in 2000 (+5.2%). The value of these categories amounted to 51% of the GDP in 1993, and 49.1% in 2000. This scarcely reflected a major move towards diversification, and none of the supporting data in the SAMA annual reports through 2001 as yet reflected serious structural progress in the areas where Saudi Arabia will need to move forward. [188] Similarly, if one looks at SAMA data only on private sector role in the non-oil portion of the GDP, the private sector role only increased from 28.9 billion Riyals in 1991 to 32.9 billion Riyals in 2000 in constant 1970 prices, a total increase of 14% over 10 years and an average annual real increase of less than 1.2.[189]

Chart 6.28

Private vs. Public Sector Share of the Saudi Economy

(In Billions of Riyals at Constant 1970 Prices)

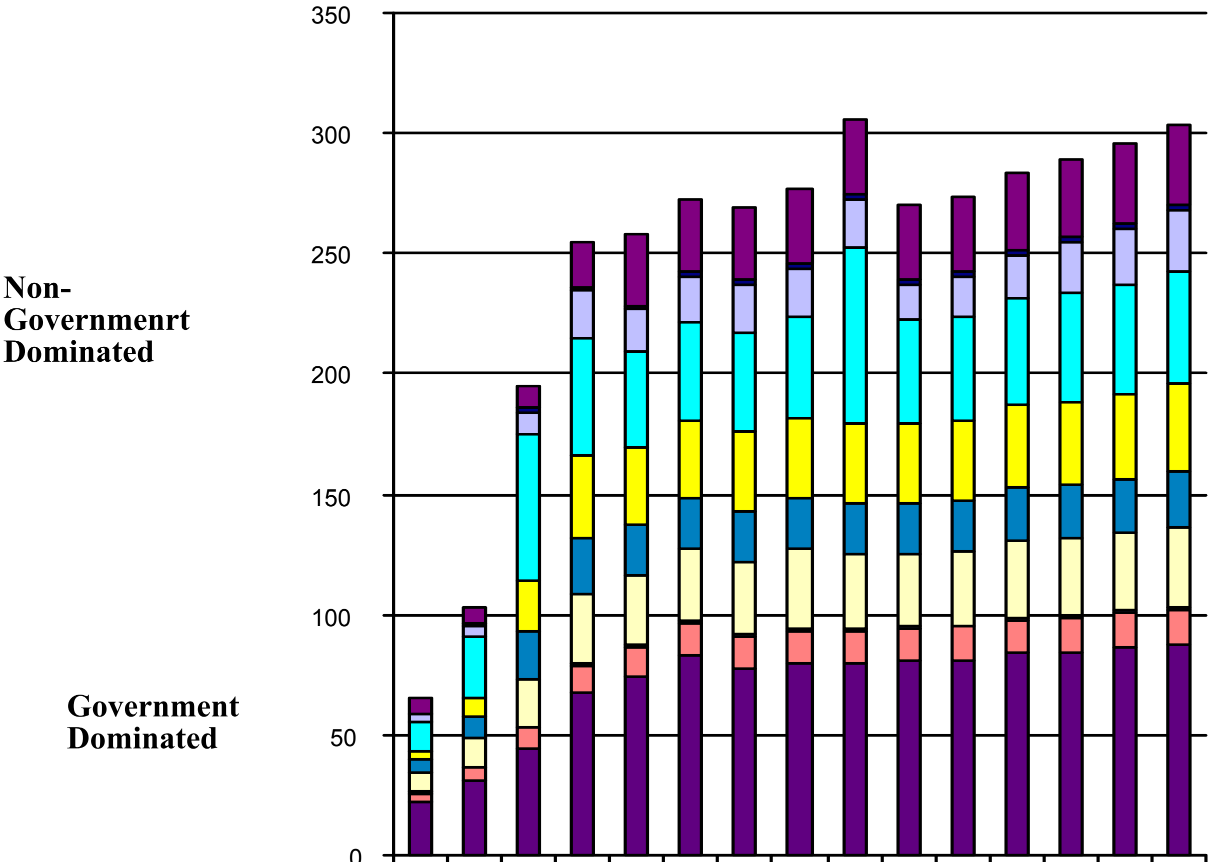


	1980	1990	End of Fifth Plan:	Start of Sixth Plan:	1997	1998	1999	2000
Government Non-Oil Sector	24.7	10.6	11.1	11.3	11.6	11.7	11.9	12.1
Government Oil Sector	9.5	16.7	21.4	21.8	22.1	22.6	22	22.7
Private Sector	18.9	28.3	29.5	29.8	30.9	31.3	31.9	32.9

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 190-192; 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 354-355, 406.

Chart 6.29

Ministry of Planning Estimate of Non-Petroleum Activity
in the Saudi Economy by Sector
(In Billions of Constant 1994 Riyals in Producers Values)



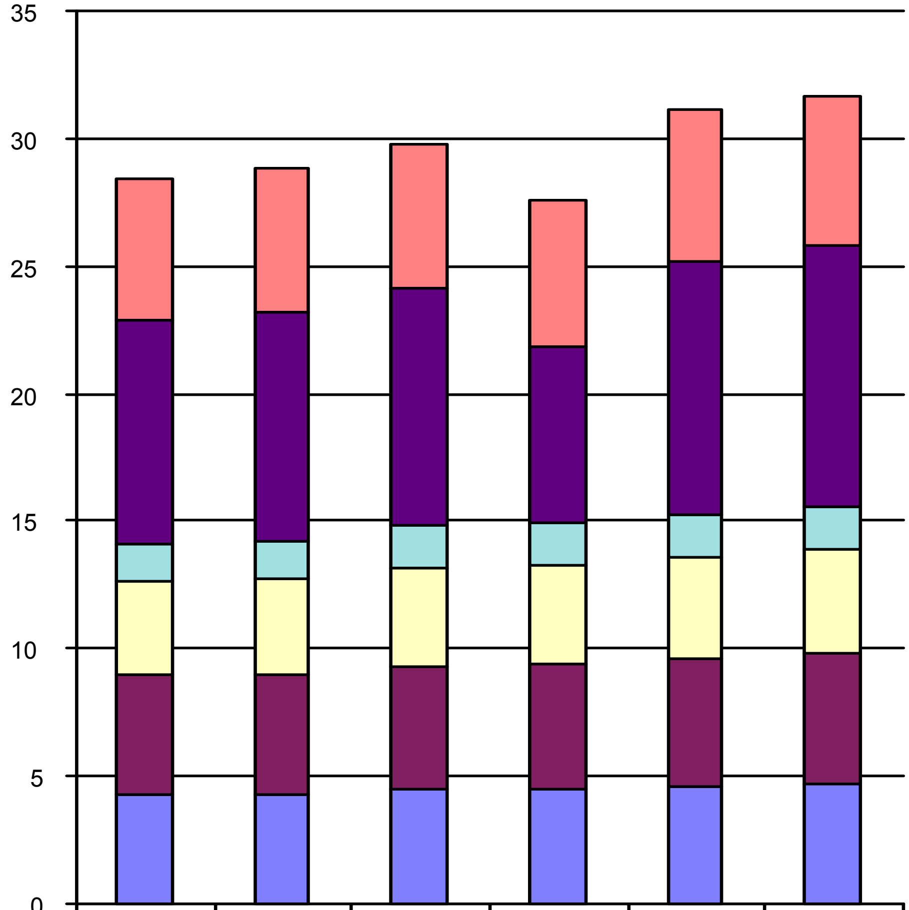
	70	74	80	85	90	91	92	93	94	95	96	97	98	99	2000
Agriculture & Fishing	5.6	6.7	9.3	18	30	30	31	31	31	31	32	32	33	33	34
Mining & Quarrying	0.6	1	1.5	2	2	2	2.1	2.1	2.1	2.1	2.1	2.2	2.3	2.3	2.4
Other Manufacturing	2.8	4.8	9.7	19	17	19	19	20	20	15	16	18	21	23	25
Construction	12	25	60	49	40	41	42	42	73	43	43	45	45	46	48
Trade	4.2	7.6	21	34	32	32	33	33	33	33	33	34	35	35	36
Finance & Real Estate	5.4	9.3	20	23	21	21	22	22	22	21	21	22	22	22	23
Transport & Communications	8	12	20	30	29	30	30	33	31	31	31	32	32	33	33
Electricity, Gas, Water	0.1	0.2	0.3	0.5	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.9	0.9
Community & Social Services	3.5	5	8.7	11	13	13	13	13	13	13	14	14	14	15	15
Government Services	23	31	44	67	74	84	78	80	80	81	81	84	85	86	88

Source: Adapted by Anthony H. Cordesman from Ministry of Planning, Achievements of the Development Plans, 1390-1421 (1970-2001), Facts and Figures, Ministry of Planning, 19th Edition, 2002, Tables 11 and 12.

Chart 6.30

Saudi Arabian Monetary Agency Estimate of Non-Petroleum Activity in the Saudi Economy:

(In Billions of Riyals at Constant 1970 Prices)

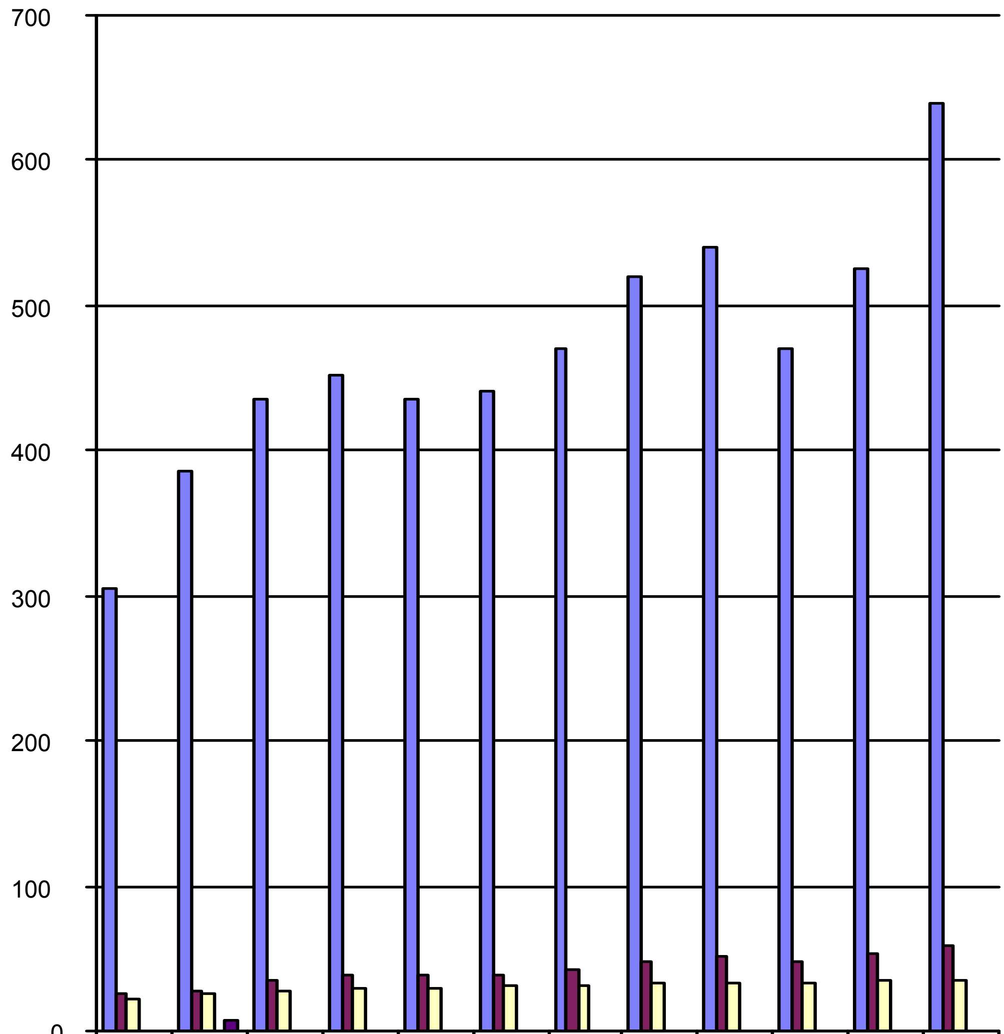


	1995	1996	1997	1998	1999	2000
Agriculture, Forestry, and Fishing	5.5	5.6	5.7	5.8	5.9	5.9
Manufacturing and Refining	8.8	9	9.3	6.9	9.9	10.2
Public Utilities: Electricity, Gas, and Water	1.5	1.5	1.6	1.6	1.7	1.7
Construction	3.6	3.7	3.9	3.9	4	4.1
Transport, Storage, Communications	4.7	4.7	4.8	4.9	5	5.1
Finance, Insurance, Real Estate, Services	4.3	4.3	4.5	4.5	4.6	4.7

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 193-194; 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 182, 356-258.

Chart 6.31

Saudi Industrial and Agricultural Activity as Share of GDP
(In Billions of Riyals at Current Prices)



	89	90	91	92	93	94	95	96	97	98	99	2000
Total GDP	304	385	435	452	435	442	471	520	539	471	525	639
Industrial Sector	25.2	27.3	35.8	39.3	37.8	39.5	42.8	47	50.6	48	52.5	58.8
Agricultural Sector	22.7	25.1	26.9	28.8	30	31.1	31.6	32.2	33.4	33.9	34.4	35
Industry as % of GDP	*8.3	*7.1	*8.2	*8.7	*8.7	*8.9	*9.1	*9.0	*9.4	*10.2	*10.0	*9.2
Agriculture as % of GDP	*7.4	6.5	*6.2	*6.4	*7.0	*7.0	*6.7	*6.2	*6.2	*7.2	*6.6	*5.5

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 194-196; ; 37th Annual Report- 1422H (2001G), Riyadh, SAMA, 2001, pp. 182-183.

The Seventh Development Plan and Meeting the Challenge of Diversification

It is to soon to know whether Saudi Arabia's slow rate of past progress is a clear indication of future Saudi actions. The economic reforms discussed at the start of this Chapter only began to be implemented in late 1999, and many key measures are still being worked out. It is difficult to restructure an economy to achieve the necessary level of major structural change in this period of time, and even to carry out enough reform to gather decisive momentum. Saudi success or failure will play out over a period of at least a decade, and may well take at least three five year plans to evaluate Saudi success.

Unfortunately, the Kingdom's Seventh Development Plan is most vague where it needs to be most specific. It does not really present a detailed plan for achieving economic reform and diversification. Instead, it sets some broad goals and benchmarks. These goals may be summarized as follows:

- Achieve average annual real GDP growth of 3.16%
- Emphasize private sector that is expected to grow at average annual rate of 5.04%.
    - *But, population growth rate is at least 3.0%. Plan essentially calls for zero increase in real per capita income during 2000-2004.*
- Achieve average annual non-oil growth rate of 4.01%
- Increase share of non-oil sectors in GDP from 68.4% in 1999 to 71.6% by late 2004.
- Achieve average annual growth rate of 3.44% in services sector, 3.05% in agriculture, 8.34% in non-mining, 5.14% in industrial sector.
- Electricity, gas, and water sector to grow by an average annual rate of 4.62% and construction by 6.17%.
- Achieve average annual growth rate of 8.29% in petrochemicals and 7.16% in other manufacturing.
    - No goals are set for increase oil and gas production, or maintaining surplus capacity. Saudi officials discuss raising capacity to 13 MMBD; maintaining 2 MMBD cushion of surplus production.
- Plan calls for increased gas production and to develop reserves and domestic use in order to serve development objectives and contribute in the diversification of income sources.
    - Enhance private sectors participation in petroleum industries.
    - Consolidate efficiency in production, refining, and distribution.

- Achieve average annual real growth rate of 6.85% in investment; increase investment from 22.7% of GDP in 2000 to 25.4% in 2004.

- Reduce State budget deficit as percent of GDP for –10.8% in 1999 to zero by 2004 by increasing government non-oil revenues and rationalizing government expenditures.

- Improve current account balance and go from deficit equal to 3% of BDP in 1999 to surplus of 6.9% in 2004.

What is clear is that even if all of these broad goals are met, the Kingdom would still not achieve major progress in macroeconomic terms during 2000-2004. Meeting these goals would at best create the conditions to achieve such progress in the next development plan while making important progress in some selected areas.

The Growth of the Private Sector

Saudi Arabia does have a base to build upon in spite of its past failures. The Kingdom may not have taken all the steps it should, but it does have its successes. It has long provided loans to finance up to 50% of new ventures in industry, agriculture, and commerce. It set up a Saudi Industrial Development Fund as early as 1974 to provide start-up loans for new industrial ventures and the growth of existing ones. By the end of 2000, this fund had provided loans worth more than 35 billion Riyals ($9.33 billion), and funded the creation of some 1,700 factories and small manufacturing ventures. Saudi Arabia had some 199 factories in 1970, with a total capital of 2.78 billion Riyals ($741.33 million. In 2000, it had more than 2,500 factories with a total capital of over 170 billion Riyals ($45.33 billion dollars).[190] The SIDF reports that it has a 96% recoupment rate on these loans. Further, in spite of increased public borrowing, Saudi banks show very high private sector earnings, and are steadily increasing their loans to the private sector.[191]

The top 100 Saudi companies had sales volume in excess of 260 billion Riyals in 2001, and pharmaceuticals, electronic components, food processing, packaging, mining, tourism, and construction are all seen as important areas for the further expansion of private sector activity. A substantial amount of this expansion should take place.[192]

As the first part of Chart 6.32 shows, the private sector now accounts for around 40% of the Kingdom's gross final consumption and well over 60% of its gross capital formation. Saudi Arabia estimates that the value of the private sector reached 42% of the GDP in 2000, or 618

billion Riyals ($164.8 billion dollars).[193] As the second part of Chart 6.32 shows, however, gross fixed capital formation was largely static during the 1990s -- a trend that reinforces the previous analysis of the slow rate of real growth in critical aspects of the Saudi economy. It is also clear from the second part of Chart 6.32 that any increase in private capital formation has been largely offset by a decline in government capital formation, reinforcing the data on government's tendency to deal with its budget problems by funding operations and entitlements at the expensive of investment and investment-intensive, high-cost renovation and maintenance activities.

If the Kingdom is to succeed in diversifying and restructuring its economy at the required levels and rates, however, it must achieve the following goals:

- *Persuade Saudis to investment a large part of the private capital they now have overseas.* According to one estimate, this totals around $250 billion in foreign banks, and another $600 billion in investments. The true total may be closer to $300 to $400 billion, rather than $850 billion. Nevertheless, this is still a vast amount of capital that could go into the domestic private sector.

  Ironically, a combination of a massive drop in Western stock markets from 2000 on, and Saudi tensions with the US after "9/11," may help. The lack of attractive and secure investment options in the West led Saudis to repatriate as much as $100 billion in 2001-2002. At the same time, Saudis also lost as much because of the drop in foreign stock values and found few attractive domestic investment opportunities beyonf banks and stocks centered around large existing enterprises.

- *Develop an effective approach to privatization, and one that does more than simply try to shift the burden of government capital investment in existing areas like infrastructure and the petroleum sector to the private sector and foreign investment.* This both means transforming state entities in to viable business that sell at market prices, or at least at minimal levels of subsidy, and creating major new private industries.

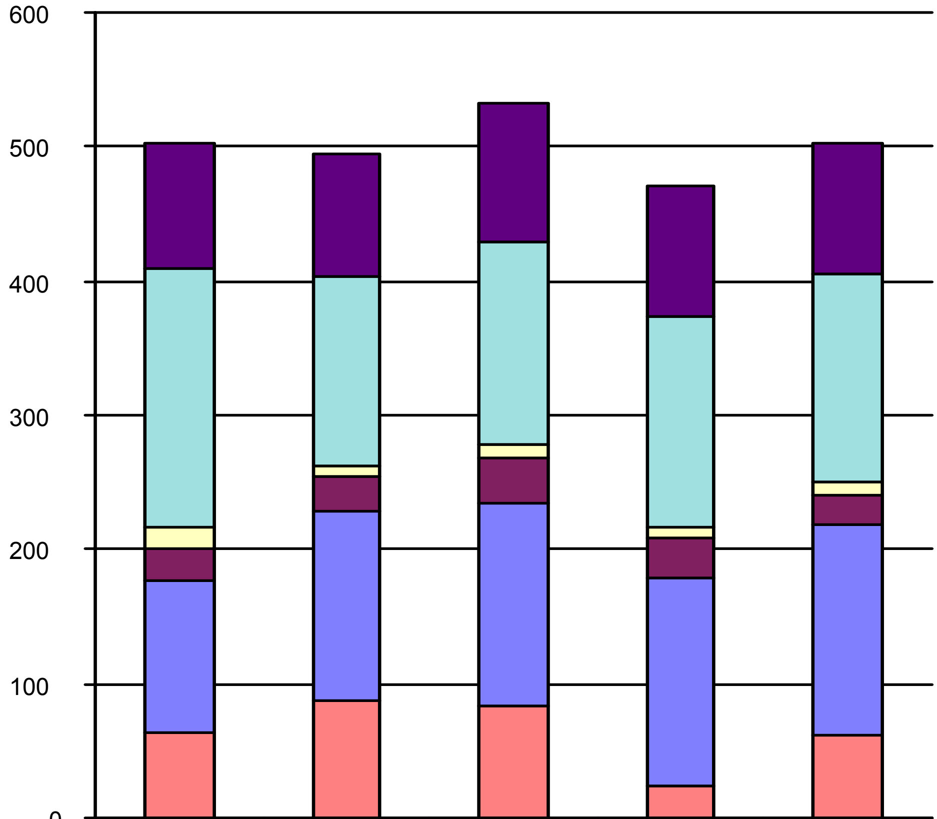
- *Develop a true stock market and banking system* free enough to both attract capital and produce productive investments.

- *Attract foreign capital on the basis of the ability to compete in the global capital market and at global rates of return on investment.*

- *Over time, move the government as far out of the economy as possible*, allowing the private sector to growth through domestic and foreign investment with as little government intervention and subsidy as possible,

Chart 6.32

Private vs. Public Sector Share of Gross Domestic Expenditure
and Gross Capital Formation - Part One
The SAMA Estimate
(In Billions of Riyals at Current Prices)

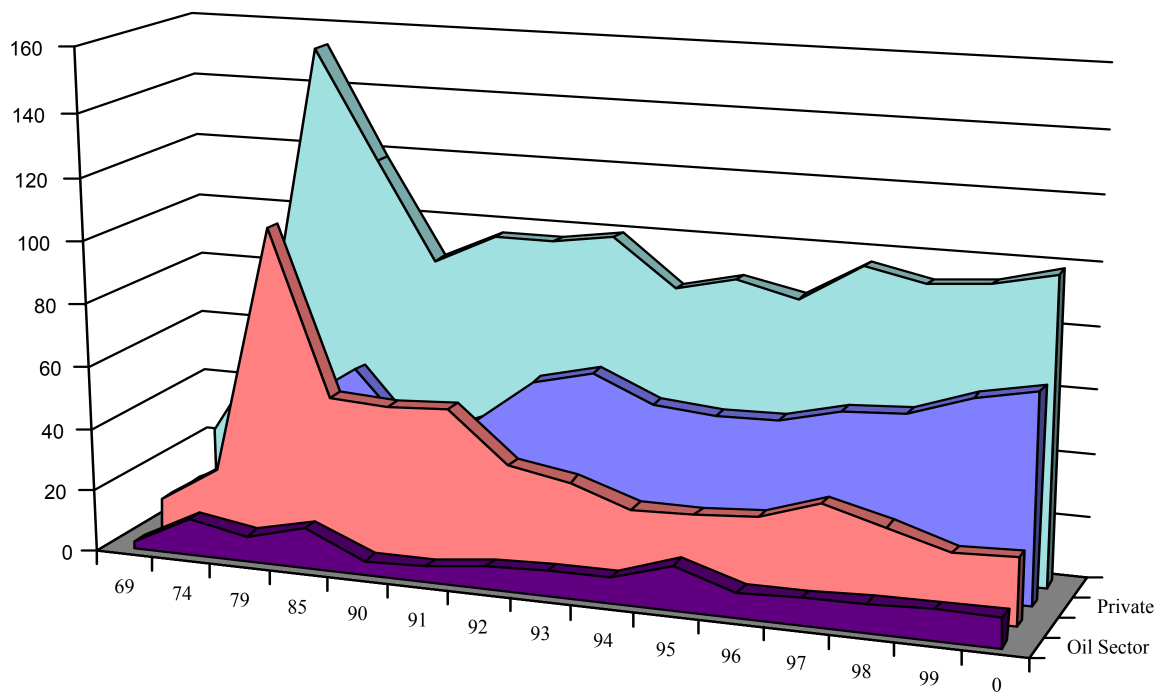


	End of Fifth Plan: 1995	Start of Sixth Plan: 1996	1997	1998	1999
Private Sector Gross Fixed Capital Formation	93.6	90.7	102.4	97	97.6
Private Sector Consumption	193.5	140.3	151.7	156.7	156
Government Oil Sector Capital Formation	14.8	8.5	9.1	9.2	9.8
Government Gross Capital Formation	25.2	26.9	33.9	28.1	21.6
Government Final Consumption	112.8	140.3	151.7	156.7	156
Net Exports of Goods and Services	63.2	87.4	82.7	23.1	62.4

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 193-194.

Chart 6.32

Private vs. Public Sector Share of Gross Domestic Expenditure
and Gross Capital Formation - Part Two
The Ministry of Planning Estimate
(In Billions of Riyals at Constant Prices)



	69	74	79	85	90	91	92	93	94	95	96	97	98	99	0
Oil Sector	2.3	12	8.5	13.4	4.8	4.9	7.3	8.1	8.2	14.2	8.1	8.6	8.8	9.4	9.4
Govennnent	10.7	22.6	102.7	50.3	49.1	50.3	33.7	30.6	24	24.2	25.5	32.1	26.6	20.8	21.6
Private	10.5	19.7	41.6	54.3	33.3	40.7	55.5	60.4	52.1	50.3	50.5	55.2	56.5	63.3	67
Total	23.5	54.2	152.8	118.1	87.1	96	96.5	99.1	84.2	88.7	84.1	95.8	91.9	93.4	98

Source: Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, 36th Annual Report- 1421H (2000G), Riyadh, SAMA, 2001, pp. 193-194.

The Success of Privatization by Firm and Sector

Saudi efforts at privatization are beginning to move ahead in, several important areas.[194] In addition to the creation of the Supreme Economic Council, the Supreme Council for Petroleum and Ministerial Affairs, the General Investment Authority, and the Supreme Tourist Authority, the government created a Fund for National Manpower Training in 2000. It also approved amendments to the social insurance system to make it easier to transfer workers between government and private sector jobs, and it issued regulations allowing the private sector to finance and operate private colleges. As noted earlier, on June 2, 2001 it also gave the SEC the mission of coordinating and supervising privatization, and of creating a plan and time schedule to privatize sectors like communications and postal services, Saudi, the electricity sector after consolidating and margining the regional power companies into one company, the General Railway Organization, and a number of facilities of the General Port Sector.[195]

The Privatization of SABIC and SIPC

Saudi Arabia's most significant accomplishment to date has been the partial privatization of the Saudi Basic Industries Corporation (SABIC). The Kingdom set up SABIC in 1976 to diversify into heavy industries that then required more capital and management expertise for private entrepreneurs and which could create the feedstocks and materials for private ventures in medium and light industries. These investments poured tens of billions of US dollars into major industrial complexes in Jubail, Yanbu, and Jeddah, producing feedstocks for fertilizers, chemicals, and resins and diversification into secondary industries.

SABIC is now one of two large state corporations, that along with the state oil firm -- Saudi Aramco -- dominate the Saudi economy (70%).[196] SABIC is the Middle East's largest non-oil industrial company, and SABIC now accounts for around 10% of world petrochemical production. Current plans will expand this capacity to 48 million tons by 2010. [197] In February 2001, SABIC completed a $1 billion expansion at the Yanbu petrochemical facility, making it the largest polyethylene plant in the world. These measures raised the value of private sector and public sector non-oil industrial exports (roughly 90% of all Saudi non-oil exports, to 24.8 billion Riyals ($6.6 billion) in 2000.[198]

In 2001, SABIC had a capitalization of around 13.3 billion Saudi Riyals, and was a complex of some 16 basic, downstream, and support industries -- producing around 28 million metric tons of petrochemical, plastics, fertilizers, metals, and industrial gases. It employed roughly 14,4000 personnel, and 75% were said to be Saudi nationals. SABIC also had a 20% share in Bahrain's two main aluminum companies, and a 25% share in its marketing company. It exported around 16 billion Riyals worth of non-oil exports, and its primary markets were in South East Asia. The Far East, North America, and Western Europe.[199]

In December 1994, the government approved the sale of three-quarters of its 70 percent share in SABIC.[200] SABIC is the Middle East's largest non-oil industrial company, and has been soliciting additional foreign investment in private petrochemical projects, such as a proposed $800-million plant proposed for Jubail.[201]

The success of Saudi privatization and foreign investment plans depends heavily on selling off the government's share of SABIC, and a number of other government ventures, although it is unclear how successful the government will be in the near future. These other ventures include the Saudi Petrochemical Company (Sadaf), which is a joint venture between SABIC and Shell Oil,. In February 1997, Sadaf launched a $1-billion expansion program that includes a new 700,000-metric-ton/year plant for methyl tertiary butyl ether (MTBE). Sadaf also is looking at setting up Saudi Arabia's first independent power plant (IPP) at its petrochemical complex in Jubail.

The Ministry of Commerce approved the establishment of another joint-stock company, the Saudi International Petrochemical Company (SIPC), on October 25, 1999. The Al-Zamil Group owns 15% of the Riyadh-based company, with the remaining 85% of shares issued for private placement among Saudi and GCC member state companies.[202] The SIPC is capitalized at SR 500 million ($133 million), and will have 10 million shares, each with a nominal value of SR50 a share, divided among 73 shareholders. However, the company's shares will not be traded for another two years.[203] The SIPC is slated to act as a holding company, with plans to form three separate petrochemical ventures in Jubail Industrial City. Total value of the plants is put at around $730 million.[204]

The Saudi government is seeking to establish a joint-stock utilities company to provide services to the industrial cities of Jubail and Yanbu. One such step is the formation of the Utility Company (UCO), which will be formed by the Saudi government's Public which of whom will hold four equal stakes.[205] A board of directors will manage the company for the first three years, after which management will be turned over to an independent administrative body. At that time, shares will also be opened to the general public.[206]

The Privatization of Natural Gas

As is discussed in more detail in the next chapter, Saudi Arabia has a massive program underway to convert the Kingdom to the use of natural gas, and exploit natural gas feedstocks, both to free more petroleum for export and to create new and more labor intensive "downstream" industries. In May 2000 invitations were extended to foreign oil companies to secure proposals for investment in Saudi Arabia, and paved the way to create memorandums of understanding dealing particularly with upstream gas projects. A seven-man council, headed by Foreign Minister Prince Saud al-Faisal, engaged in three major negotiations with international oil companies (IOCs) and the Supreme Petroleum Council was given the right to conclude contracts for "exploration, drilling and production of gas" with IOCs it reiterates previous edicts in retaining exclusivity to Saudi Aramco.[207]

In May 2001, Saudi Arabia selected companies to participate in a "Saudi Gas Initiative" with a potential value of $25 billion. This was the " the first major reopening of Saudi Arabia's upstream hydrocarbons sector to foreign investment since it had been nationalized in the 1970s. This Saudi Gas Initiative will integrate upstream gas development with downstream petrochemicals and power generation, and is by far the Kingdom's most important effort to attract foreign investment.

The companies that Saudi Arabia selected for the three "core ventures" of the Saudi Gas Initiative were, by area of development:

- Core Venture 1 - South Ghawar: ExxonMobil, Shell, BP, Phillips;
- Core Venture 2 - Red Sea: Exxon plus Marathon and Occidental;
- Core Venture 3- Shaybah: Shell, TotalFinaElf, and Conoco.

A report by EIA describes these efforts are follows: "The Core Venture 1, in South Ghawar, will be one of the world's largest ($15 billion) integrated natural gas projects, including exploration, pipelines, two gas-fired power plants, two petrochemical plants, two desalination units, and more. Core Venture 2 will involve exploration in the Red Sea, development of the Barqan and Midyan fields on the Red Sea coast in northwestern Saudi Arabia, as well as construction of a petrochemical plant, a power station, desalination capacity, etc., at a cost of $4 billion. Core Venture 3 will involve exploration near Shaybah in the Rub al-Khali ("Empty Quarter") of southeastern Saudi Arabia, development of the Kidan gas field, laying of pipelines from Shaybah to the Haradh and Hawiyah natural gas treatment plants east of Riyadh, and construction of a petrochemical plant in Jubail, at a cost of $4 billion."[208]

Saudi Arabia and the foreign oil companies failed to meet an initial December 1, 2001 deadline for an agreement on the "Saudi Gas Initiative." Part of the reason for the delay was disagreement over the price of the natural gas to be produced from the project, and part was the quality of the acreage offered.

The sheer scale of the effort has also, however, proved to be a problem since developing plans, contracts, and regulations for the effort is the largest single program in the Saudi government's history and is part of a broader gas development program that the Kingdom costs at $45 billion over the next 25 years.

The Privatization of Telecommunications

The government has announced that Saudi Arabia's telecommunications services will be privatized and a joint stock company will be set up to run the Kingdom's telephone and telex facilities. In September 1999, the Saudi Telecommunications Company (STC) took over from Saudi Telecom, which is operated by the Ministry of Posts, Telephones and Telegraphs. Although it is financially independent of the government, the STC is headed by the PTT Minister and is 100% owned by the state.[209] Plans for privatizing the company have experienced delays since it was established in April 1998, partly due to financial difficulties. In early June 1999, four Saudi banks - the Riyadh Bank, National Commercial Bank, Saudi British Bank and Arab National Bank- agreed to provide a syndicated loan of SR2.25 billion to STC to be used to make payments on arrears.[210]

There is a clear need for improved services. The Kingdom has around three million land lines, two million mobile phone users, and some 200,000 Internet subscribers (600,000 users), but it also has some 21 million people.

The Ministerial Committee on Privatization directed that a series of nine study groups be created in 2001 to determine how to privatize Saudi telecommunications activity. These included an information and technology team, a network work team and teams to handle financing, personnel, and other issues. Work is underway to create a specialized body with the administrative and financial autonomy to organize the telecommunications sector, and provide the rules and regulations to ensure fair competition among private firms. It will also control digital and frequency management, monitor the quality of services, and set goals for the overall development of the national system.[211]

The privatization process is accelerating and the Majlis as-Shura proposed a bill on Mary 15, 2001.[212] It also has examined what stake the government should retain in the company, and what percentage will be offered to foreign investors.[213] Valuations of the STC normally range from $10 to $15 billion.[214] A new telecommunications law passed in the summer of 2001. Saudi Telecom also help show that it was a viable private entity when it reported an annual profit of SR 3,479 in 2001.

It now seems like that 30% of the company will be sold to the public in late 2002, based on a valuation of 10 times its earnings of $1 billion in 2001.[215] This would mean a sale of some $3 billion worth of shares. The government is also discussing plans to open the Saudi GSM market up to competition in 2003. In theory, the sale of Saudi Telecom is one of several major sales that will allow the government to reduce its domestic debt to the General Organization for Social Insurance, although some such sales could involve a swap of shares rather than cash repayment.[216]

The Privatization of Saudi Airlines

King Fahd first advanced the idea of privatizing Saudi in 1994. Since that time, Saudi has been slowly restructured to make it more viable as a commercial entity, and in September 1999, Saudia's board gave instructions to form a committee to obtain the consulting services necessary for a detailed privatization plan. In May 2000 Saudi Arabian Airlines invited investment banks to prepare bids for privatization of the state-owned carrier, although the scale of privatization -- whether it is to be a full-scale sell off or a partial sale of the airlines services such as its catering, in-flight sales and international sales offices -- was not clarified. Saudi signed contracts with the consulting firms it selected on August 10, 2000, and work began on October 30, 2000. These studies are still in progress, but the goal is to float Saudia on the Saud stock market for public subscription.[217]

The Privatization of Postal Services

The government has permitted the private sector to invest in postal agencies. The initial goal is 100 agencies, and contracts for 73 were signed by the end of 2000. Investment has been allow in surface and mobile postal services since 1995, and 26 services were under contract by 2001. The government is also privatizing the maintenance of postal buildings, some 137 construction projects at a cost of 1.2 billion Riyals, and the renovation of postal buildings. Tentative royal approval has been given to converting the entire postal service to an autonomous public corporation, and the World Bank is assisting in derating the required administrative and postal regulations. [218]

The Privatization of Electricity

As has been discussed earlier, Saudi Arabia needs about $120 billion for power generation projects over the next 20 years, with the annual demand growth for electricity in the Kingdom estimated at 4.5 percent. To meet this demand the country must increase its power generation capacity to 70,000 megawatts by the year 2020, from 21, 000 megawatts at present, at a cost of more than $4.5 billion per year. As has been discussed in the previous chapter, most of this investment is expected to come from the private sector, possibly including foreign investors. The vast majority of this capacity is to be natural gas-fired or combined cycle, as part of the government's plans to expand gas utilization in the power sector.[219]

The government has already acted to restructure and merge the Kingdom's electricity companies into one company, This led the government to create the Saudi Electric Company (SEC) by consolidating the country's 11 regional power companies (including the four SCECO's -- East, West, Central, and South -- which controlled 85% of the country's power supplies. Electricity Minister Dr. Hashem Ibn Abdullah Yamani signed the merger agreement between Saudi Arabia's 10 existing power companies (SCECOs) on February 16, 2000, and the Saudi Electric Company (SEC) was established as a joint-stock company owned 50% by the Saudi government on April 5, 2000.

The company's initial capital was set at 33.8 billion Riyals based on its asset value. It was divided into 675.2 million shares at 50 Riyals each, statute provides for increasing the company's capital by an amount equal to the net value of the dissolved General Electricity Corporation, and raising money through an increase in the fees collected and receivables of the Electricity Tariff Fund. [220]

The US Department of Energy reports that a key reason for the Saudi government action was that the four SCECO companies had long operated at a loss because they were required to sell power far below cost to Saudi consumers, as well as due to inefficiencies and difficulties with non-payment of bills. The government had subsidized the cost of electricity since at least the early 1970s, and had paid a guaranteed dividend to private shareholders without regard to earnings.

The restructuring of the SCECO system was intended to lead to a more general streamlining/privatization of the Saudi power sector, such as a further splitting of SEC into units dealing with generation, transmission, and distribution companies. Although 85% of the company was initially still owned by the government, the idea was to open the electricity market to independent power producers who could sell power to the transmission and generating arms of SEC. The SEC was expected to develop three separate sector companies for generation, transmission and distribution.

The implementation of the proposed merger plans was slow. The SEC initially became become more of a holding company for the four key power authorities and the Saudi Consolidated Electric Companies. Each company initially remained more or less autonomous,

and each of the four main executives reported back to the main executive of the SEC who had yet to be named. No overall strategy was laid out, and each company pursued its own interest. The delay in building Sesco-Central's 1800MW PP-9 plant being a case in point. There were no new projects in 2000, despite pressure on the national grid.

By 2001, however, Saudi Arabia had largely consolidated the smaller companies into the Saudi Electric Company SEC) which started active trading in July 2002. The SEC was also reported to now have a capital in excess of 90.6 billion Saudi Riyals. The SEC also made a profit --in theory -- although this profit only totaled 711 million Riyals in 2001 after Zakat, and was largely unreal since it did not include a fair price for gas fuel or facilities.

The SEC is seeking higher electricity tariffs to allow for private sector competition in power generation, and is seeking to unbundled its generating, transmitting, and distribution structure to allow for such competition. Several projects are also already underway that employ financing mechanisms that are new to Saudi Arabia's electric power sector.

For example, the 1,200-MW, PP9 power station north of Riyadh has been funded with extra revenues generated by a special tariff imposed on heavy users since January 1995. The $1.7-billion Ghazlan II power project is being financed by an internationally syndicated, $500-million, commercial loan (the first such loan in Saudi history), and being built by a consortium led by Mitsubishi and Bechtel. Ghazlan II consists of four, 600-MW steam turbine units, which are expected to come online, approximately one unit per year, through 2002. Combined with the existing 1,600-MW Ghazlan I facility located on the Gulf coast north of Dammam, the entire complex -- when completed -- will have power generating capacity of 4,000 MW and will supply Saudi Arabia's Eastern Province. In March 2001, Ghazlan I temporarily halted operations following a fire.

Saudi plans for a $1.7-billion, 1,100-MW, gas-fired power plant at Shuaiba on the Red Sea coast are moving ahead, and Crown Prince Abdullah attended a groundbreaking ceremony in May 2000. Asea Brown Boveri had been awarded the contract on a turnkey basis, and the plant is to be constructed in three stages, with the first stage scheduled to come online in mid-2001. The SEC also signed a $419-million contract with the Anglo-French engineering company Alstom to expand the Shuaiba oil-fired power plant -- Phase 1 of which is nearly complete -- by

780 MW (units 4 and 5). These two new units should enter service in late 2003 or early 2004. Finally, in May 2001, CMS Energy, along with joint venture partner A.H. al Zamil Group, was chosen to build Saudi Arabia's 230-MW, Sadaf cogeneration power project. This project represents Saudi Arabia's first privately owned IPP.

On October 9, 2000, Saudi Arabia approved plans for setting up a new utility company (UCO) in the twin industrial cities of Yanbu and Jubail. The company, named Marafeq, is being founded by the Royal Commission, the Public Investments Fund, Saudi ARAMCO, and SABIC, with local investors also holding a stake in the company. The UCO may be privatized when it becomes profitable, but its establishment of UCO may not signify a big step forward. The four shareholders are all state-owned or affiliated in some way, and shares will not be offered to the public for another three years, therefore making UCO a company that is not truly privately-owned. Originally, UCO was meant to be a limited liabilities company with American firms Bechtel and Parsons Corporation taking ten percent each. However, in October 1997, Saudi officials announced that foreign investors would not be included, although the two firms would be offered an advisory role in the company.[221]

The US Department of Energy reports that creation of the SEC also could open the door to private sector construction of new power plants on BOO (Build-Own-Operate) and BOT (Build-Own-Transfer) bases.

The future of IPP's (Independent Power Producers) in Saudi Arabia remains uncertain, however, and major challenges remain -- including: tariffs, legal and operating framework, taxation, and fuel supply. The failure to bring electricity prices closer to market prices is a key example. Saudi Arabia introduced a new tariff structure for electricity charges in April 2000. The resulting charges remained far below the market cost – including return on investment and recapitalization charges. The increases in tariffs also focused on customers using 10,000 kilowatts a month, who faced a doubling of charges. They did affect some 93% of Saudi households, who consume less than 5,000-kilowatt hours per month.[222] Even so, the SEC announced on October 9, 2000, that it was rescinding these increases (effective October 28) in the face of widespread resistance. Rescinding a small step forward that only affected the very richest consumers is scarcely a move towards privatization and reform of the Saudi power sector, and will reduce SEC revenues and potential profitability.

Other projects have been delayed.[223] The second-phase 700-megawatt expansion of the Shuaiba plant the SEC received only two bids. The build-own-operate option met with even less success, even though the deadline was extended to May 1999. The lack of financial regulation was attributed to be one of the chief reasons for the lack of interest in power projects.[224]

The government intends that a separate transmission company will be created that can buy electricity from a variety of suppliers when a unified national power grid is completed. This could be another important step in the commercialization of the power sector. Only two of the country's four power regions are now connected. Creating a unified national grid could require over 20,000 miles of additional power transmission lines, and Saudi Arabia requires major additional investment in power transmission.

The Privatization of the General Railway Organization

The Kingdom has long sought to expand the railway system it created in Eastern Saudi Arabia in 1946 to link its ports in the Gulf to Riyadh. It sees an expanded rail system as essential to developing its mining industry in the Jalamid region in the northwest with a route through al-Jawf, Ha'il, and al-Qasim; and to handling the growing transport problems of the Hajj and the expansion of a tourist industry by linking Riyadh to Makkah, Medina, and the Red Sea port of Jeddah. Other links would expand the system to Jubail. While Saudi Arabia developed plans to do this through government funding, and also tried to make rail development a part of oil deals with nations like Japan,

The government has never found the capital to build such railways, or a foreign partner willing to take the risk. It has, however, face problems both in developing a mining industry, and in creating an efficient commercial transportation system. During the 1990s, freight shipments by rail declined from a peak of 1,017 million ton kilometers in 1991 to 821.9 million in 2000, and freight from 2,093 thousand tons to 1,623, although passenger kilometers did increase from 129 million passenger kilometers to 288 million. During this same period, the number of registered trucks nearly doubled from 84,056 to 145,410, and more than double in capacity and the number of buses increased from 1,984 to 10,726. The length of paved roads, however, only increased from 39,500 kilometers to 46,300. an improved rail system cannot possibly cover

Saudi Arabia but it might reduce the problems it faces in terms of road construction costs and moving bulk cargo.[225]

As result, the Kingdom has shifted to a plan to have the private sector participate on the basis of "build, operate, and transfer" (BOT), and has studied the feasibility of covering the cost of expansion, operation, and maintenance through this method. This study led to a Royal Court Directive being issued on June 17, 2000 that called for a formal study plan to be developed by the Ministerial Committee on Privatization, which in turn instructed the Public Investment Fund to prepare an implementation plan in coordination with the Ministry of Transport, Ministry of Finance and National Economy, Ministry of Planning and General Port Authority.[226]

The Privatization of the General Port Authority

Saudi Arabia had eight major ports in 2000 – six commercial and two industrial – with 183 berth and an annual design capacity of 251.5 million tons. These ports were overbuilt, with an average utilization rate of 48.5%, and the Kingdom had a major incentive to try t make them more efficient through privatization.[227]

Some ports are already being run by the private sector on an income-sharing basis under 10 year lease contracts.[228] The General Port Authority awarded 21 ten to twenty year contracts for projects during 1998-2000 involving services at the Kingdom's eight ports. These contracts involved direct investments of 18.7 to 484.6 million Riyals. All the awards have gone to Saudi companies or joint ventures. The total private direct investment as of late 2001 was 2,140 million Riyals, affecting operations with annual revenues of 1,021 million Riyals.[229]

The state owns the port assets but the private sector operates them. The tasks to be performed included handling of general goods, containers, bulk grain, roll-on cargo, chilled and frozen goods, and providing maritime services such as the operation of piers and goods handling equipment. Contracts have also been issued to lease the King Fahd Vessel Repair Yards, and two reexport areas in the ports at Jeddah and Dammam.

Overall Progress in Privatization

The Saudi government is actively encouraging private investment in metals industries, down-stream industries, and similar manufactures. While SABIC is primarily a petrochemical conglomerate with 16 affiliates and subsidiaries and a market capitalization of nearly $10 billion, it does involve other industrial activity. One affiliate, Saudi Iron and Steel is able to invest in $1 billion rolling mills. Saudi private steel mills and aluminum products companies also involve large-scale businesses.[230]

Unfortunately, the government's actions to date have only been partly market-driven and some seem more of an effort to shift the investment burden away from the government rather than seriously privatize functions now operated by the state sector on a commercial basis. Privatization can only have the required impact on growth and reform if it means the conversion of state-held functions to truly competitive private enterprises that can charge market prices, reduce labor and overhead costs to become more productive, and make a profit.

Work by Brad Bourland of the Saudi American Bank shows the scale of the future effort that is still needed:[231]

- The Kingdom's electrification plan calls for capacity to increase from 23,000 megawatts in 2001 to 60,000 megawatts in 2023, at a cost of 433 billion Riyals, or $115 billion. This requires average annual expenditures of $4.6 billion a year, and average annual expenditures of $5.3 billion during 2000-2005. The Saudi Electricity Company alone estimates investment needs of $4.6 billion a year from the private sector.[232]

- The average annual cost of upgrading telecommunications is $3 billion a year from 2000 to 2005.

- The new gas initiative described in the next chapter will require expenditures of about $25 billion over the five to ten year period following 2001. This requires a minimum annual average expenditure of $2.5 billion a year.

- The Kingdom spent around 15 billion Riyals ($4 billion) a year on petrochemicals during 1988-1998. The Seventh Development Plan calls for 8 percent growth, which would mean spending roughly $4 billion a year.

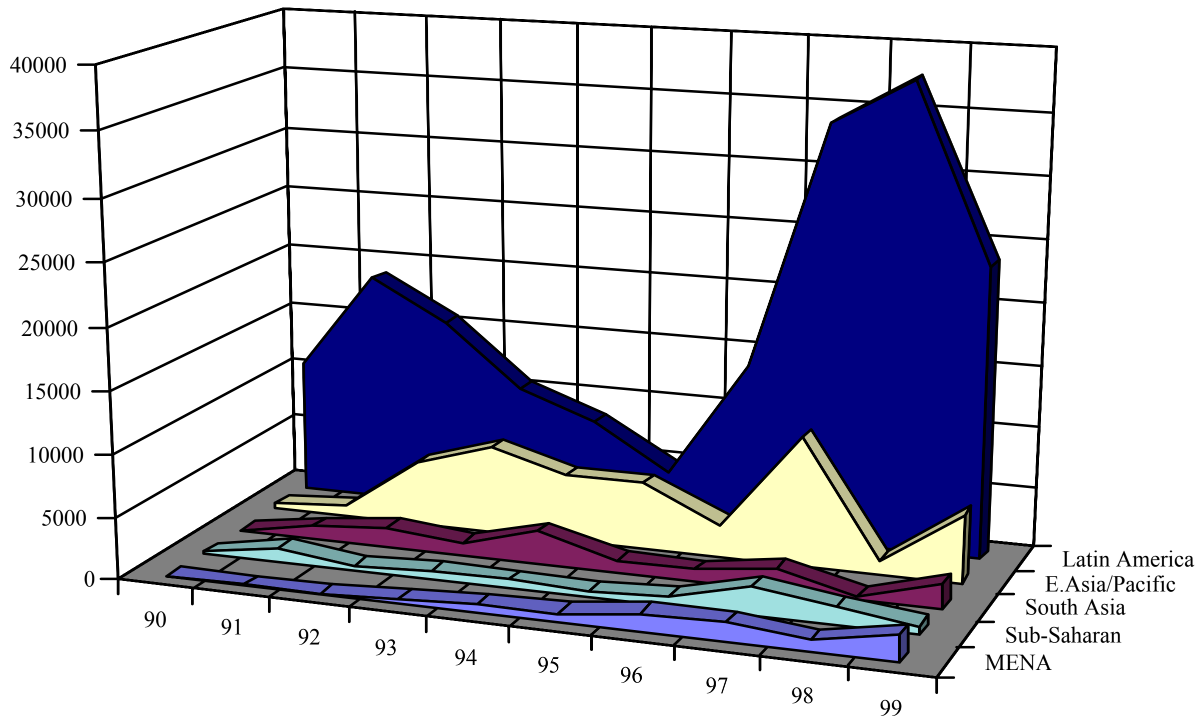
- Desalination is expected to meet a goal of 50% of average personal consumption of 300 liters per day. This would cost 46.5 billion Riyals ($12.4 billion) between 2001 and 2020. This is an average of 2.3 billion Riyals a year, or $620 million.

- Mining is seen as a major source of diversification. One key project is a $1.2 billion phosphate mine, but this requires a $1.2 billion railroad. At present no real investment is taking place, but a major expansion of the mining sector could easily require $10-25 billion in future investment over a decade of intensive development activity.

Bourland estimates that if the investment cost of privatizations are ignored, the required government capital expenditures would total about $15 billion a year, or up to 10% of the GDP. Funding all of the required investment could bring the total up to 25% of the GDP, and $15-20 billion would then have to come from the private sector. This is a very significant level of investment and even if 30% was financed through equities, there would still be a requirement for some $10 billion a year in financing, which compares with $7.5 billion a year in current lending by foreign and domestic banks. This means a significant increase in both domestic and foreign lending, as well as domestic and foreign investment. Saudi Arabia has so little real-world experience with privatization that it is difficult to tell what can and cannot be done. Charts 5.24 and 5.25 also send a mixed message. They show that the Middle East as a whole has had a terrible record in this area in comparison with faster developing regions in the world. At the same time, they show that rapid change has been possible in other regions.

Chart 6.33

Privatization Revenues Have Lagged Badly Behind Other Regions: 1990-1999
(Transfer of Productive Assets from State to Private Investors: $US Current Millions)

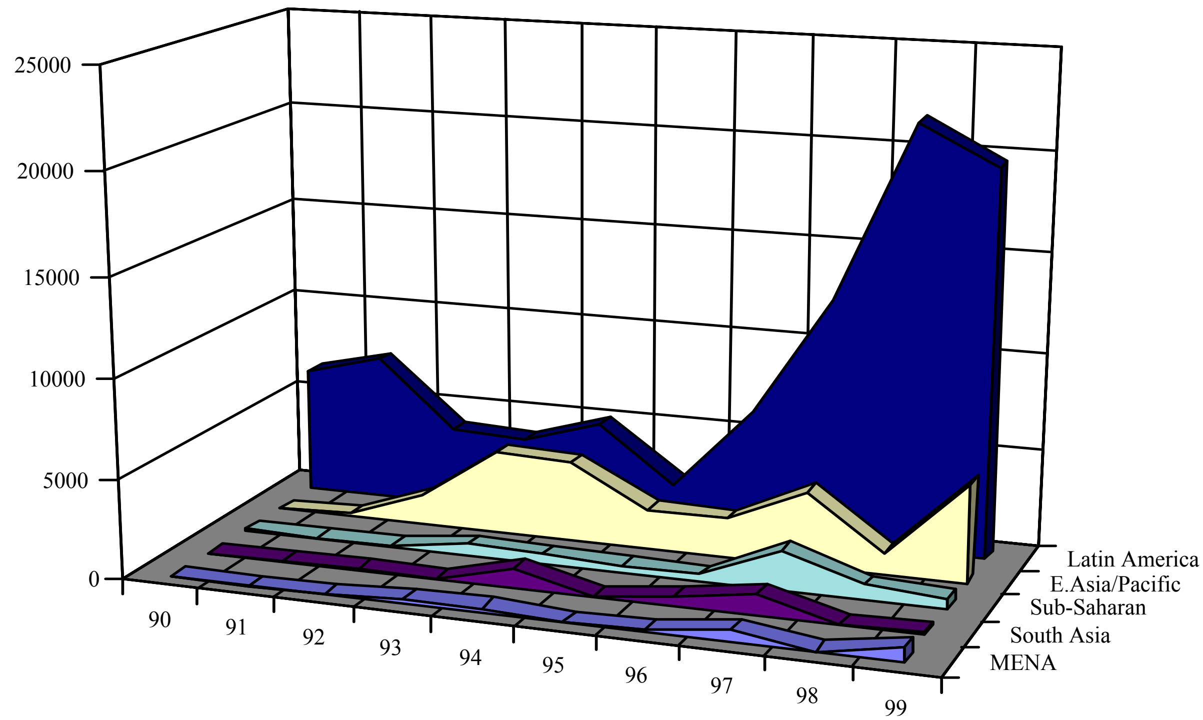


	90	91	92	93	94	95	96	97	98	99
MENA	2	17	69	417	782	746	1478	1612	1000	2074
Sub-Saharan	74	1121	307	641	605	473	745	2348	1356	694
South Asia	29	996	1557	974	2666	916	889	1794	174	1859
E.Asia/Pacific	376	834	5161	7155	5508	5410	2680	10385	1091	5500
Latin America	10915	18723	15560	10488	8199	4616	14142	33897	37685	23614

Source: Adapted by Anthony H. Cordesman from World Bank, Global Development Finance, 2001, Washington, World Bank, 2001, pp. 180-190

Chart 6.34

Negligible Regional Foreign Participation in Privatization: 1990-1999
(Transfer of Productive Assets from State to Private Investors: $US Current Millions)



	90	91	92	93	94	95	96	97	98	99
MENA	0	3	19	183	246	16	126	623	43	747
South Asia	11	4	44	16	997	38	528	1043	11	104
Sub-Saharan	38	5	66	566	453	275	299	1969	694	418
E.Asia/Pacific	1	102	1556	4156	4036	2026	1990	3775	1082	4982
Latin America	6358	7384	4037	3765	5058	2206	6448	12486	21535	19567

Source: Adapted by Anthony H. Cordesman from World Bank, Global Development Finance, 2001, Washington, World Bank, 2001, p. 190.

Private and Foreign Investment and Banking Reform

If Saudi Arabia is to attract and keep the foreign and private domestic investment it needs, it must fully reform its economy to (a) have suitable investment laws for both foreign and domestic investors, (b) create a legal system that can fully enforce contracts and debt collection, (c) create the equivalent of a strong merchant banking and investment banking sector, and (d) have a fully functional stock market.

The Saudi government has called for the banking sector to steadily improve its equity and its share of loans to the private sector.[233] So far, however, the Saudi banking system has been slow to develop. Despite being the largest economy in the Arab Middle East, Saudi Arabia still has relatively few banks. In 1997, it had only nine private commercial banks, far less than the UAE's 40 or so institutions and Lebanon's 70-plus. As of October 2001, Saudi Arabia has 10 local and one foreign commercial bank (International Gulf Bank of Bahrain which opened in 2000), with combined assets of $124.8 billion. There were nine banks listed in the Saudi stock market and they controlled 50% of the market's capitalization and had some 1,000 branches. The commercial banking sector is also becoming more modern: retail banking is becoming the focus of most banks, and the credit card and ATM business is booming. There is a joint credit card venture between American Express and Saudi Investment Bank.[234]

The Saudi banking sector seems financially sound except for government domestic borrowing, but as has already been discussed, commercial banks are not really investment-oriented. The banking industry is still very much the creature of the state and is being used to fund the government's debt and budget deficits. As Chart 6.37 shows, Saudi investment in treasury bills and development bonds rose from 43.5 billion Riyals after the Gulf War to 102.3 billion by 1999.[235]

SAMA reports that total bank commercial bank claims on the private sector were only $172.2 billion Riyals in 2000 – a comparatively low figure – and increased by only 1% between 1999 and 2000. Out of this total, only 8.3 billion Riyals were investments in private securities, and 160.1 billion Riyals were in the form of loans. Out of the 164.3 billion in such loans, less than 25 billion were for manufacturing, processing, mining, and quarrying. In contrast, 58 billion were for commerce, services, and finance.[236] At the same time, there has been a steady

increase in the percentage of total assets in bank investment funds invested abroad, and total foreign assets increased to 101.2 billion Riyals in 2000, and have recently been increasing by 5-10% per year.[237] Investments in domestic mutual funds increased from 5.3 billion Riyals in 1992 to 14.7 billion in 2000, but investments in foreign funds increased from 7.1 to 22.9 billion Riyals. There were 138 such funds in 2000, with total assets of 38.6 billion Riyals, by 22.0 billion – or 57% -- were invested overseas.[238]

The Kingdom also has several government owned banks: The Saudi Agricultural Fund, the Public Investment Fund, the Saudi Industrial Development Fund, the Saudi Credit Bank, and the Real Estate Development Fund. These government-owned banks do provide funds for development. The Public Investment Fund grants loans and equity participation on a medium and long-term basis for industrial and commercial purposes, such as electric power development. The Saudi Industrial Development Fund provides medium and long-term loans up of to 50% of the cost of an industrial project as well as marketing, financial, and technical advice.[239]

The government owned banks had granted outstanding loans of $39.3 billion as of October 2001, but much of this was in the form of housing and real estate loans, or loans granted on non-market terms. The total disbursements of the Saudi Industrial Development Fund were 27.8 billion Riyals at the end of 2000, for 2,320 loans, and the annual rate of loans was 1.1-1.2 billion Riyals. The Public Investment Fund had 20.8 billion in dispersed loans, but the amount dropped by 4.8% in 2001, and the total number of loans outstanding dropped from 1,185 to 1,077.5 or by 9.1%. In contrast, the Real Estate Development Fund had outstanding loans of 69.5 billion Riyals.[240]

Investment and Stock Market Reform

The growth of the Saudi stock market is shown in Charts 6.35 and 6.36.[241] The first Saudi shares started trading as early as 1935. SAMA was given supervision and control of all share trading activity in 1984, and a modern Electronic Share Information System was introduced in 1984.[242] In 1965, the Saudi stock market had a total capitalization of nearly 60 billion dollars, although only 71 firms were traded, largely by major banks, and little disclosure was required of a company's financial position. Since the government controlled the banks, and forced them to finance Saudi Arabia's debt, there were other problems that affected Saudi investment in the

private sector. Some estimates indicate that lending to the government accounted for about 25 percent of banks total assets.

The total value of shares traded reached 25.4 billion Riyals ($6.77 billion) in 1996 and $16.56 billion in 1997. The turnover of shares remained relatively low because of the extent of government ownership of quoted shares that was estimated to account for about 25%. The banking sector owned slightly over another 40%, SABIC was the most heavily capitalized entity and accounted for twenty one percent of the total market. The market reached a total market capitalization of 172 billion Riyals ($45.86 billion) in 1996, a rise of more than 12% over 1995. Market capitalization reached $58.6 billion by 1997.[243] The Saudi stock market was so heavily dominated by Saudi banks, however, that it had little liquidity – its annual turnover averaged only 15% of total capitalization. Furthermore, the government placed severe limits on foreign investment and the ability of the Saudi private sector to diversify into the capital-intensive private sector that Saudi Arabia so badly needed.[244]

Significant growth took place in the late 1990s. The Saudi stock market had a total capitalization of $173.1 billion in 2000. It accounted for 45.3% of the total capitalization of shares in the Arab Monetary Fund Index, versus 20.8% for Egypt and 13.4% for Kuwait. No other Arab country has 10% of the total.[245] The Saudi American Bank reports that the market rose by 43% in current dollars in 1999, 11.3% in 2000, and 7.6% in 2001 – showing a rough correlation to Saudi oil export revenues and their impact on the health of the Saudi economy.[246]

SAMA statistics indicate that the total value of shares trade in current Riyals rose by 15.4% during 1999-2000, from 56.6 billion Riyals to 65.3 billion. It also reports that market capitalization grew by 12.1% in 1996, 29.7% in 1997, dropped by 28.3% in 1998, grew by 43.1% in 1999, and by 10.9% in 2000. The value of trade shares grew by 93% in 1996, 144.4% in 1997, dropped by 17.0% in 1998, grew by 9.8% in 1999, and by 15.4% in 2000.[247]

This growth was led by the construction sector and the value of cement shares rose 58.7% in 2001. The services sector rose by 19.1% in 2001, electricity by 13.4%, Banks by 7.9%, and agriculture by 2.6%. The industrial sector, however, was down by 9.6%, again illustrating Saudi vulnerability because of a lack of diversity. SABIC's value dropped by 26.6% due to low oil prices, and SABIC alone accounted for 17% of the total capitalization of the market.[248]

Nevertheless, Saudi Arabia was slow to restructure its stock market to encourage private domestic investment on a free market basis, and the Saudi stock market had remained more a government-controlled banking consortium than a real stock market. It is still largely an over-the counter market in which the commercial banks buy and sell shares by means of an electronic trading system which was established by SAMA in 1990. Commercial bank shares still accounted for 35% of the value of the total bank shares trade in 2001, although industry now accounted for 43.5%.[249]

The rise in industry's share of the Saudi stock market has helped development, but many Saudi companies are virtually closed joint-stock companies and many of their shares are unavailable for trading. Many of the largest, family-run businesses are not traded on the market, and investment outside Saudi Arabia is often far more attractive for both Saudis and foreigners.[250] The failure to change public attitudes to treat local stocks for what they are – as low cost instruments to raise money- also led Saudis to continue to invest abroad. It is estimated that Saudi capital overseas amounted to sums between $500-800 billion before September 11, 2001 and some estimates go much higher.[251]

The performance of the Saudi market improved in 1999-2002, in spite of these problems. Saudi Arabia has seen a shift back towards investment in Saudi stock market since "9/11," in part because of fear of US efforts to seize or control assets, resentment of US and Western policy on terrorism, and a major drop in the value of Western and Asian stocks.

Lifting of restrictions on foreigners taking equity positions in 1999 did fail to produce the expected increase in capital flow. However, the stock market rose as a result of the rise in oil prices and a related 10% raise in spending over the year's projected budget. The NFFEI index broke the 2000 mark, making a swift recovery from a 28% drop in 1999, which was a result of the fall in oil prices and knock-on effect of the South East Asian Financial Crisis.[252] High oil revenues led to a 43% increase in the stock index by the start of 2000, another 11.3% rise in 2000, and a rise of 7.6% in 2001. Daily trading volumes averaged between 2 and 3 million shares per day.[253]

Capital flows also shifted, although with mixed results. Fear of staying invested in the West; the backlash against the Second Intifada, and the collapse of Western stock markets led to

significant repatriation of private and government capital and or reinvestment out side the US after the beginning of 2000. This was helped by the fact that Saudi Tadawuli All-Share Index (TAS) was up 14.6% in the first half of 2002, while world stock markets continued to experience major losses. This rise was driven by speculation over more realistic electric prices and restructuring of the industry, a 10.6% rise in the shares of nine banks that make up 50% of stock market capitalization, and a 10.8% rise in the value of industrial shares like SABIC.[254]

The Saudi market also moved towards greater risk-taking with mutual funds offered by domestic banks rising by 68% over the last 2 years.[255] Institutions such as SAMA, Saudi Holland Bank and Bank al-Jazira opened mutual funds to foreign investors, in the wake of the change in regulations for foreign investors.

However, the drop in the value of oversea investments led to a decline in the Saudi private and government capital resources invested overseas. A Saudi American Bank estimate of Saudi losses in Western stock markets during 2000-2002 goes as high as $160 billion, and indicates that Saudi central bank foreign assets dropped by $6.2 billion in 2001 alone, declining to $42 billion versus $56.9 billion in 1997. (Even so, the Saudi government still had total foreign assets of $77 billion in mid-2002. This total was about 84% of the domestic money supply, 34 months worth of imports, and 2.4 times the private sector-held public debt, and still gave the Kingdom good liquidity compared to most nations.) [256]

These trends show that the Saudi stock market has great potential, but now has a structure that fails to attract enough private and foreign investment to act as an adequate for economic change and growth. Its performance and market capitalization may be good by Middle Eastern standards, but it remains low by the standards of other regions. It is clear that a major degree of liberalization and true privatization is still needed if the market is to play its proper role in economic growth. Te Saudi government needs to restructure capital market regulations from the current structure dominated by SAMA and the Commerce Ministry, to develop a formal stock exchange with an independent regulator

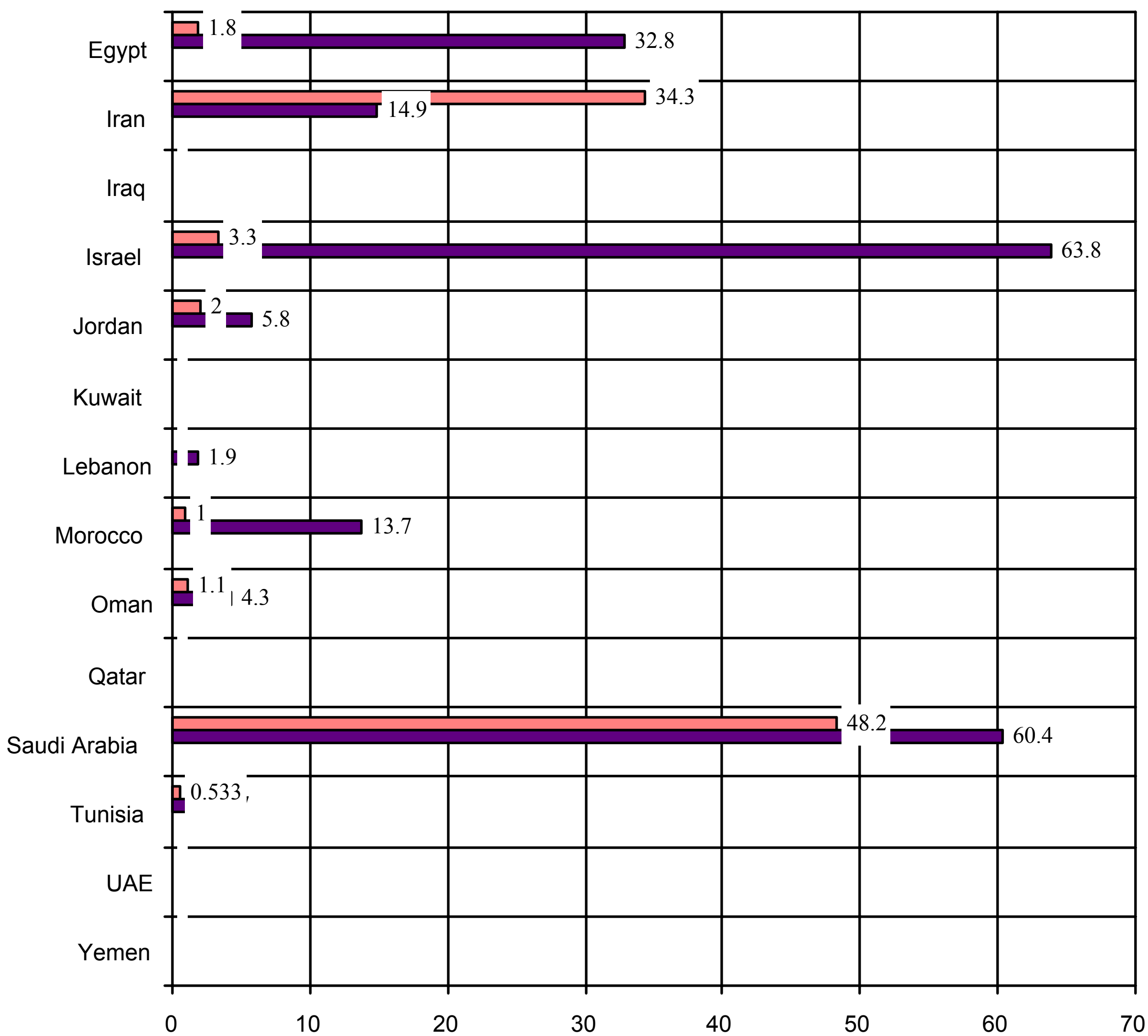
The fundamental changes required in the form of a new Capital Markets Law have dragged on for several years, and the law is still in draft. The lesser reforms the government announced in June, 1997 seemed to be designed more to avoid a repetition of the kind of

speculation that went on in Kuwait's "camel market" than to encourage serious investment. Companies that wished to convert to public joint-stock companies had to be at least 10 years old, have made a profit in the previous year, offer at least 51% of the shares to the public, have minimum assets and partner equity of $20 million, show a profit of 10% in each of the five years preceding an application to convert to joint stock status, and project a 10% of larger profit for each of the coming five years.[257]

Chart 6.35

The Saudi Stock Market Led Regional Growth During 1990-1998, Where the Private

($US Current Billions)



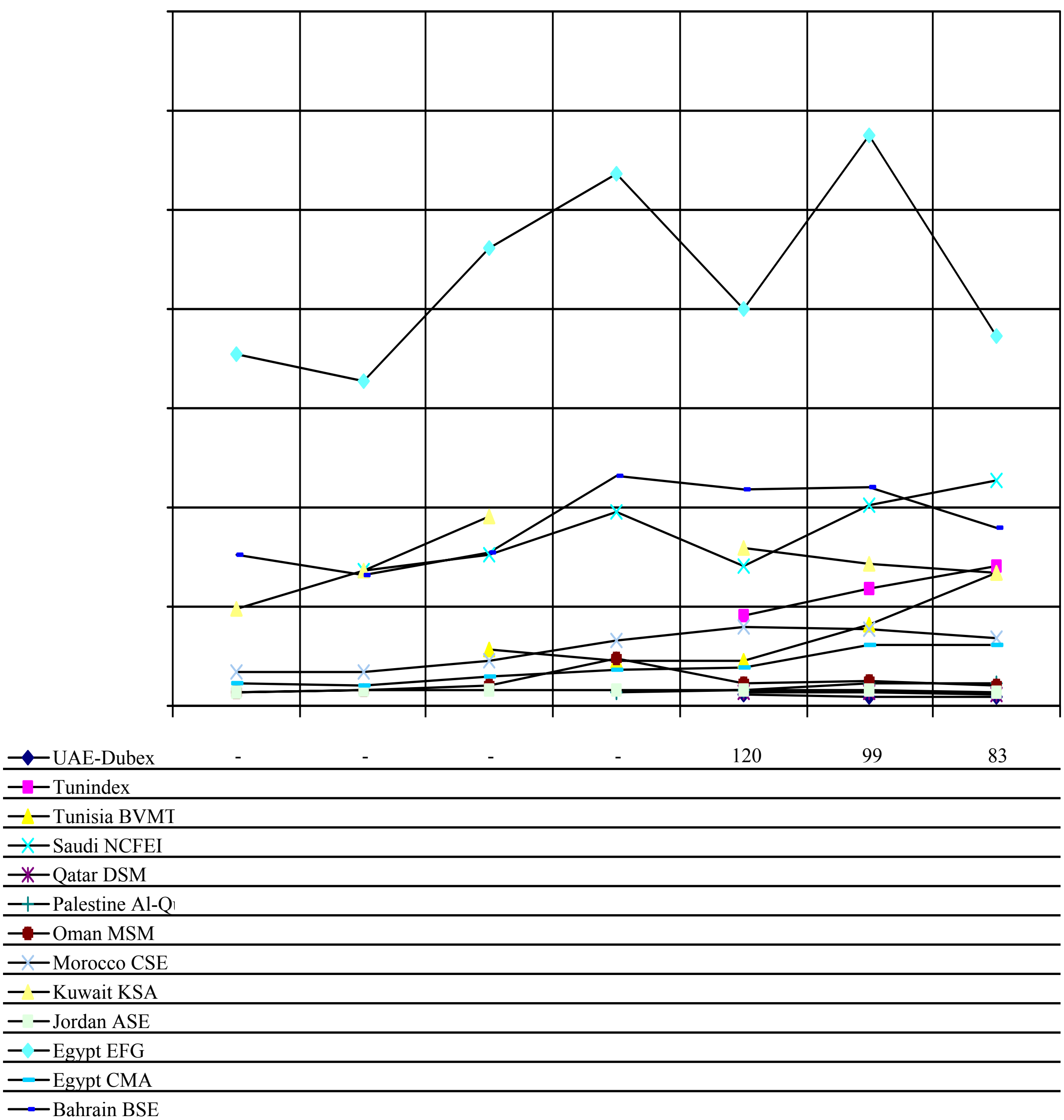
	Yemen	UAE	Tunisia	Saudi Arabia	Qatar	Oman	Morocco	Lebanon	Kuwait	Jordan	Israel	Iraq	Iran	Egypt
Capitalization in 90	-	-	0.533	48.2	-	1.1	1		-	2	3.3	-	34.3	1.8
Capitalization in 99	-	-	2.7	60.4	-	4.3	13.7	1.9	-	5.8	63.8	-	14.9	32.8
% of GNP in 99	-	-	*11.4	*33	-	*29.4	*44.1	*13.8	-	*79	*39.5	-	*13.1	*29.5
% if GNP in 90	-	-	*4.2	*40.8	-	*9.4	*3.7		-	*49.8	*6.3	-		*4.1

Adapted by Anthony H. Cordesman from Middle East Economic Digest, February 13, 1998, p. 10.

Chart 6.36

Growth of the Saudi and Other in MENA Stock Markets Fell Far Below the Rise in US and European Markets During 1994-2000

Capitalization in Local Currency)

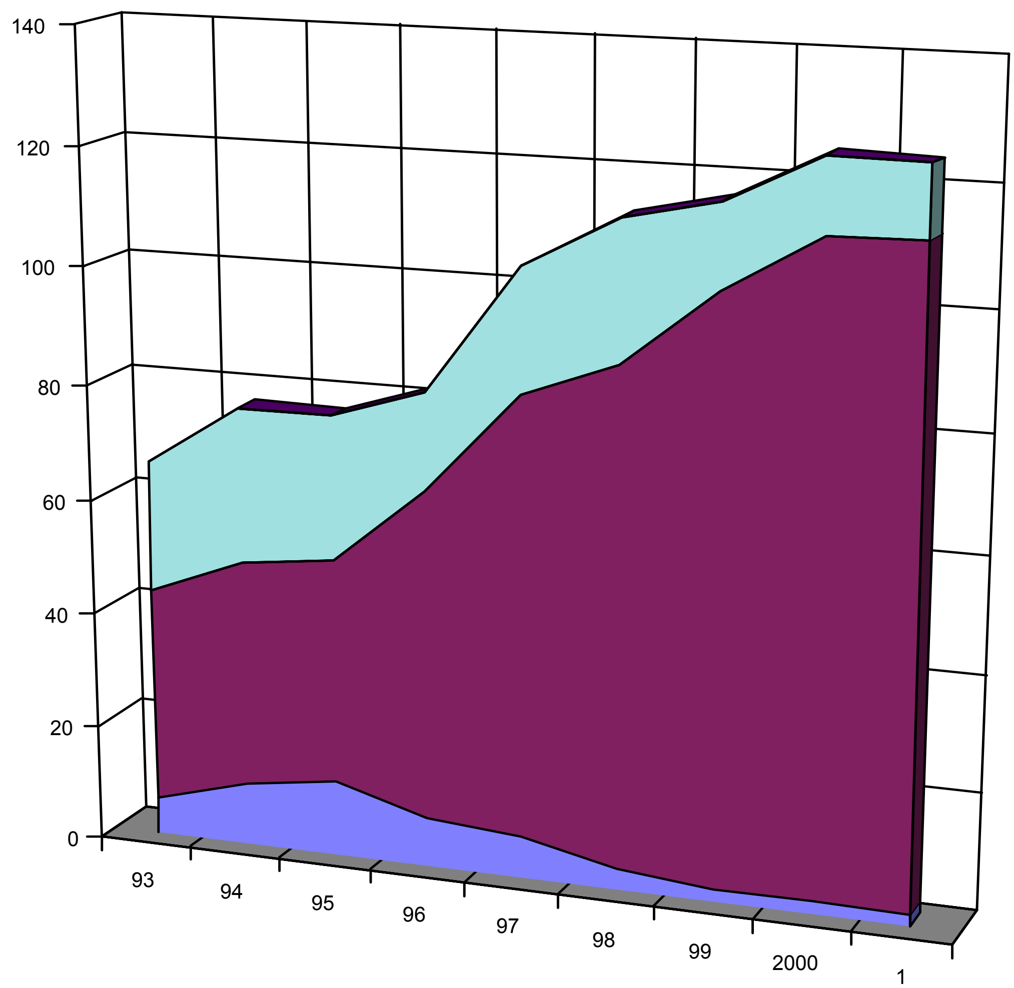


Adapted by Anthony H. Cordesman from Middle East Economic Digest, December 15, 2000.

Chart 6.37

Saudi Bank Investment in Government Securities: 1993-1999

(Billions of Riyals)



Total	*66.1	*77	*76.7	*82	*104.1	*113	*116.6	*124.7	*124.4
Bank credit to Public Service Enterprises									
Sub-Total									
Development Bonds									
Treasury Bills									

Adapted by Anthony H. Cordesman from Saudi Arabian Monetary Agency, Thirty-Sixth Annual Report, 1421H (2000G), Research and Statistics Department, September 2000, p. 95; and Thirty-Seventh Annual Report, 1422H (2001G), Research and Statistics Department, December 2001, p. 300.

Opening Up Saudi Arabia to Foreign Investment

As has been discussed at the start of this Chapter, Saudi government was slow to open capital markets to foreigners but h changed its polices since 2000. While Charts 6.37 and 6.38 show the Kingdom has been more successful than other Middle Eastern states, it has failed to attract foreign direct investment (FDI) in anything like the proportion that matches the size of the economy. Between 1984 and 1997 the FDI for Saudi Arabia was $4.32 billion, while Singapore achieved $51.4 billion, Malaysia $36 billion and South Korea $14.6 billion.[258] Foreign corporations were taxed at a rate of 25% on the first SR100,000 ($26,666) of profits, 35% on anything above that amount, up to SR500,000($133,333), 40% on profits above SR500,000 up to SR one million($266,666), and 45% on everything above this amount.

The new Foreign Direct Investment Code announced on May 10, 2000, allows foreigners to own property either independently or with a Saudi partner. It allows investors to remit funds abroad, and reduces taxes by 15% for foreign companies with an annual profit in excess of 100,000 Riyals ($26,700).[259] It also reduces the country's tax rates on foreign business profits to a limit of 30% versus the previous ceiling of 45%, and allows foreign companies 100% ownership of projects and property ownership from the previous limit of 49% stake in joint ventures requiring a Saudi sponsor.

Foreign businesses now qualify for Saudi Industrial Development Fund (SIDF) soft loans even if the corporation is 100% foreign owned, and the real estate law has been amended to allow foreigners to own real estate. Saudi visa rules for American businessmen were also changed to make it easier and cheaper to visit Saudi Arabia.[260] Amending the system of local sponsorship for doing business in the country is also under consideration, with a special committee set up by the government to prepare a report on the possibilities for modification.[261] Prince Abdullah has also announced tax incentives for foreign investors for research, development and Saudisation.[262]

Finance Minister Ibrahim bin Abdel Aziz Al-Assaf announced plans to allow direct foreign investment in the Saudi stock market, the largest in the Arab world on November 8, 1999, but made it clear that that complete liberalization of investment and the stock market was not foreseen in the immediate future.[263] The government also issued another directive in early

November 1999 authorizing Saudi banks to open their unit trusts, focusing on local stocks, to foreign investors.[264] These included 12 unit trusts valued at 2.2 billion Riyals ($587 million).

The creation of the Saudi Arabian General Investment Authority (SAGIA) on April 10, 2000, provided a centralized body to create new incentives for foreign investment.[265] As has been discussed earlier, the SAGIA is intended to provide "one-stop-shop" for foreign investor, and has representatives from 16 government agencies. Its goal is make a single agency responsible for approving and overseeing each foreign investment project, and to reduce the time for approving a foreign investment to 30 days,[266]

The SAGIA submitted its list of activities that would not be covered by the new foreign investment laws to the Supreme Economic Council in July 2000.[267] The final SAGIA list was approved by the SEC on February 12, 2001. As has been discussed earlier, however, the list still presents major barriers to effective foreign investment in many areas, although Saudi Arabia will probably reduce this list even further if it succeeds in joining the WTO:[268] The following areas were excluded:

- *Industrial Sector:* Exploration for and production of petroleum and petroleum products, except for services relating to mining; the manufacture of military equipment, Machinery, and uniforms; and the manufacture of explosives for civilian use.
- *Services Sector*: Provision of relations for the armed forces, investigative and security work; insurance services; real estate investment in Makkah and Medina; tourist guidance services related to the Hajj and Umrah pilgrimages; manpower agencies and those dealing with recruitment from overseas; real estate brokerage; printing and publications; wholesale and retail distribution include medical retail such as private pharmacies; and commercial agencies – the exception of concession rights services – provided than foreign ownership does not exceed 49%, there is a special need, and no more than one such investment is made per province.
- *Other Areas*: Education services at the elementary, secondary, and adult levels; telecommunications services; land and air transport; delivery and distribution of electric power within the general grid; space transport services; delivery of products through pipelines; services provided by midwives, nurse, physiotherapists and paramedics, services related to fisheries; and poison centers, blood banks, and quarantine facilities.

Nevertheless, the SAGIA reported in January 2001 that foreign investment commitments had reached $1.6 billion, including 53 licenses (29 industrial, 24 non-industrial).[269] It is also important to note that there are sectors where the Kingdom has increasingly encouraged foreign investment. These include oil and gas equipment and services, auto parts and service equipment, telecommunications services, electrical power systems, chemical production equipment,

computer software and services, franchising, air-conditioning and refrigeration equipment, building products, cosmetics, toiletries, pharmaceuticals, operation and maintenance services, medical equipment, and clothing.[270]

SAGIA reported in April 2002 that it had granted a total of 784 licenses to foreign investors over the last two years for projects worth $10.2 billion. Some $8.3 billion (SR31 billion) were for 467 projects owned only by foreign investors. The remaining 317 projects ($1.9 billion or SR 7.2 billion) were for joint ventures, with Saudis having a $1 billion stake.[271]

An example of SAGIA activities is the issuing of three industrial licenses for a world-scale petrochemical project to be built in Jubail Industrial City by a newly established US-Saudi joint venture, Jubail Chevron Phillips. The project is estimated cost SR 3.776 billion (over US $1 billion), including an expansion of the group's existing plant in Jubail. The capital is to be raised through equity investment of SR 1.2 billion (about US $320 million) and a low-interest loan from the Saudi Industrial Development Fund (SIDF). The first such joint venture between Chevron and the Saudi group was established in 1996, and began manufacturing operations in 2000. It was the Kingdom's first privately financed basic petrochemical industry, with an investment of about SR 2.5 billion (US $650 million), and uses CPChem's proprietary Aromax technology to produce benzene. As has been discussed earlier, the government is also opening up new areas in the Saudi energy sector.

Once again, however, existing reforms are not enough.[272] US experts report that the Saudi Arabian General Investment Authority (SAGIA) can still present problems for Saudi investors, and is a challenge for foreign investors. They indicate that there is still some internal confusion over the project approval process resulting from an overly centralized authority structure. This means that small-scale deals that do not have multi-jurisdictional facets are comparatively simple, however, the lack of centralization requires that the investor engage in serious bureaucratic acrobatics to gain approval. These problems are further compounded by the need to deal with actors outside of SAGIA such as the Ministry of Industry to obtain permits for electricity and water. Just because investors can invest does not mean that they will invest, as long as it difficult and overly bureaucratic to do so. Nonetheless, SAMBA estimates that the reforms Saudi Arabia has already taken will strengthen the non-energy sectors by half a percent annually to steady growth rate of 6% annually. [273]

Saudi Arabia has been too slow to open up its markets to provide transparency; adopt modern accounting methods; and reform its commercial code, regulations, and legal procedures. The Saudi tax code is still a nightmare that interferes with foreign investment without raising revenue. Saudi and GCC nationals only pay zakat, a modest wealth tax that averages 2.5% of the non-fixed capital employed. Foreign corporations sometimes enjoy an initial tax holiday, but then pay taxes four to five times higher. In late 1997 steps to “level the playing field” were undertaken. Among measures introduced were deep reductions in the top marginal rate paid by foreign companies. The tax reforms announced by Abdullah in October 1999 may reduce these barriers to foreign businesses, but it is too early to tell.

In spite of higher oil revenues in 1999-2000, Saudi government payments can still lag from 6 to 15 months. Tariffs average 12%, and reach 20% for infant industries -- some of which are defined in ways that amount to favoritism for given firms. The 30% set aside for Saudi nationals in government contracts, and other offset provisions, are often administered in ways that make it extremely difficult to use the money efficiently. In many cases, the money is allocated on the basis of favoritism and corruption, and often in ways that simply recycles imports and the efforts by foreign workers without benefiting the Saudi economy.

The concept of intellectual property protection is relatively new to Saudi Arabia and efforts to protect intellectual property rights are uneven. In April 1996 the US government moved Saudi Arabia to Watch List status from the Priority Watch List, in recognition of progress made in intellectual property right over the previous year. The Saudi patent office has a backlog of several thousand cases, and losses to computer software companies due to illegal copying are considered significant.

Saudi Arabia also continues to move slowly in fully implementing a new foreign capital investment regime. The Minister of Industry and Electricity stated that the “modernization” of the investment regime is “in the final stages” and that the new legislation will be announced by the end of 1999, but had not done so as of mid 2001.[274] .Yet, incremental increases in foreign investment simply will not meet the Kingdom’s needs. Saudi Minister of Industry and Electricity Salih al-Husaini has stated that Saudi Arabia would need “30 billion Saudi Riyals (8 billion US dollars) annually over the next 20 years to turn the Kingdom into a semi-industrial state.”[275]

Chart 6.38

Foreign Direct Investment Has Improved Since the New Oil Boom Began in 1999

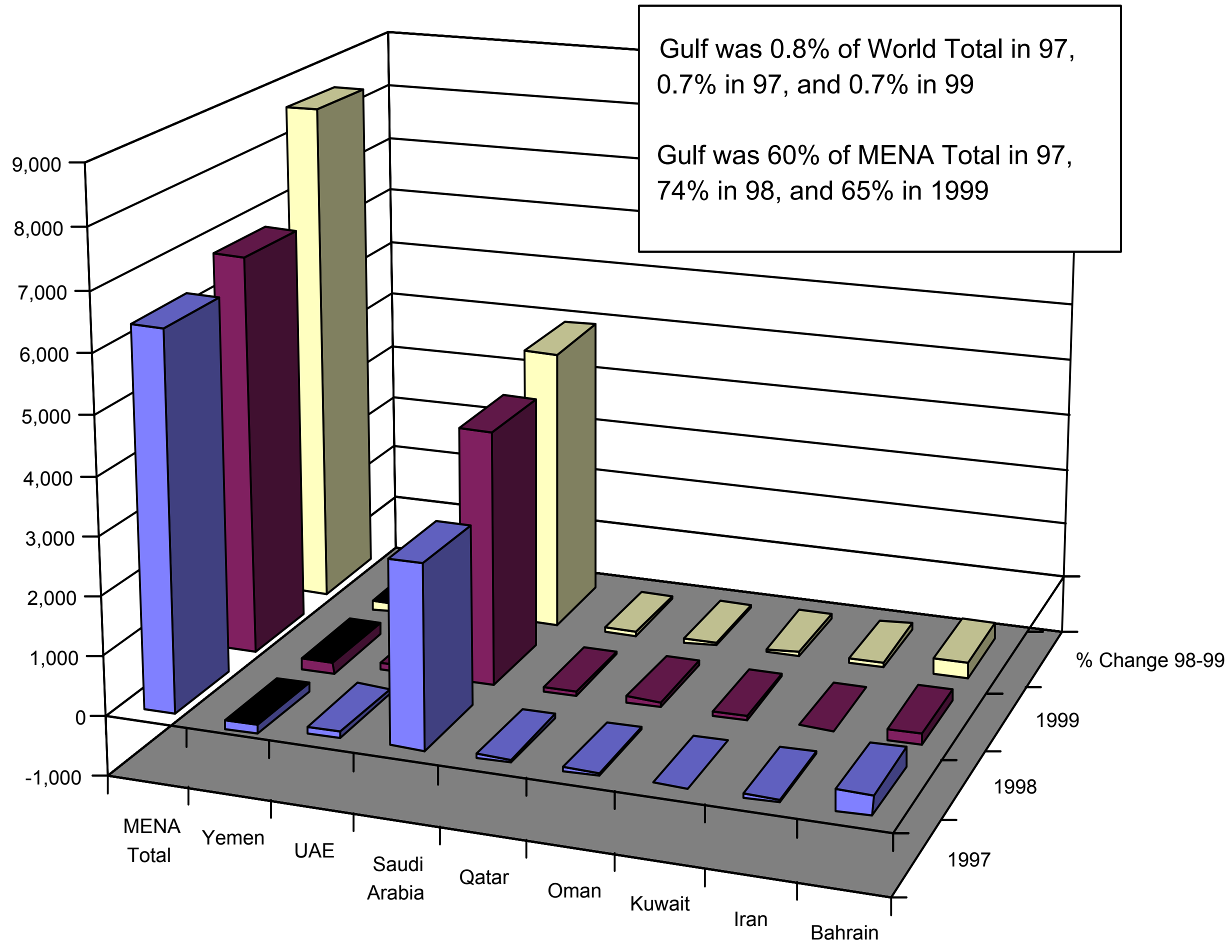
($US billions)

Source: Adapted by Anthony H. Cordesman from Middle East Economic Digest, November 10, 2000, p. 26, and World Investment Report 2000, UNCTAD, Geneva, Switzerland.

Chart 6.39

Saudi Arabia is the Only Gulf State to Attract Significant FDI but These Amounts are Low By Global Standards

($US billions)



	MENA Total	Yemen	UAE	Saudi Arabia	Qatar	Oman	Kuwait	Iran	Bahrain
1997	6,364	-139	100	3,044	55	53	20	53	329
1998	6,791	-210	100	4,289	70	106	59	24	181
1999	8,647	-150	160	4,800	50	70	72	85	300
% Change 98-9		*-28.6	*60	*11.9	*-28.6	*-34.0	*22	*254.2	*65.7

Source: Adapted by Anthony H. Cordesman from Middle East Economic Digest, November 10, 2000, p. 26, and World Investment Report 2000, UNCTAD, Geneva, Switzerland.

Broader Goals for Economic and Social Reform

It is difficult to sum up the trends in Saudi Arabia's search for structural economic reform without either appearing over-optimistic and Panglossian, or appearing over-critical and joining the Cassandras that have predicted one Saudi crisis after another that never appeared. Perhaps the best answer is to let the previous trends speak for themselves, and note that everything depends on the consistency and intensity of the government's future actions.

It cannot be stressed too firmly that none of the structural economic and demographic challenges the Kingdom faces are likely to prove critical in the near to mid-term. The Saudi government has time. It may still be acting too slowly, but it has recognized virtually all of the nation's economic problems except the need to reduce the rate of population growth.

Many of the solutions the government has identified will be workable *if* the government aggressively implements them and Saudi Arabia has ample time in which to take decisive action. As the previous analysis has shown, Saudi Arabia's budget deficit has already been reduced by a combination of higher oil prices and austerity measures. Saudi Arabia has been able to repay its foreign debt and has already financed much of the infrastructure needed to modernize the country. It is unlikely that Saudi Arabia will have to pay for another Gulf War, and many Saudi arms purchases have been "front loaded" so that arms imports in the late 1990s and early 2000s will cost substantially less than in the aftermath of the Gulf War.

Nevertheless, the analysis in Chapter V, and the analysis in this chapter, have shown that Saudi Arabia does face serious structural economic problems. It has also shown that the problems will be compounded by the impact of constant social change, high birth rates, internal political divisions, and a "youth explosion." No one outside Saudi Arabia, and probably no one within it, can be certain of just how serious the impact of the resulting tensions within Saudi society will prove to be over time. None currently seem to threaten the government, and there are few signs that a cohesive opposition is beginning to emerge. Nevertheless, the Saudi government can scarcely ignore the importance of such tensions, and it faces the added problem of dealing with a highly conservative Islamic revival at a time when it must move towards internal reform, modernize Saudi society, and deal with the West.

Saudi Arabia traditionally moves slowly. It advances ideas long before they are really implemented, experiments with different approaches to implementation, discusses and coordinates, and partially implements what it agrees upon. This approach has often worked for the Kingdom in the past. It is doubtful, however, that this pace of action can succeed in the future. Reform must match the pace of the challenges it attempts to deal with, and the seriousness of these challenges is clearly accelerating faster than the present pace of reform.

The Kingdom must also look beyond economic considerations as it intensifies its effects at reform. Economics are always tied to politics, and Saudi society and the structure of government must also evolve along with the economy if Saudi Arabia is to preserve its internal stability. The government must build an informed consensus around economic reform, and this is another reason that it must continue to expand the role of the Majlis, and find ways to allow peaceful debate of social and economic issues and of the need for modernism and reform versus the need to preserve traditional values. It must provide increasing popular control of Saudi national resources. It must come to grips with the issue of defining a uniform commercial code and rule of law that applies to all its citizens, including the royal family.

At some point in the mid-term, the Kingdom must come to grips with the issue of taxes and entitlements. Saudi economic reform also cannot ignore the political realities created by its existing welfare and entitlements programs, and must continue to ensure that wealth is shared throughout its society. In the process, Saudi Arabia must redefine its "social contract."

Saudi Arabia cannot afford the cost of remaining a patriarchical welfare state and its increasingly well-educated youth is unlikely to tolerate the social role such a state gives them. Saudi Arabia must look beyond oil exports to ensure its budgets are brought into better balance and that its society and economy develop. It must increase revenues by directly taxing wealthier citizens. It must reduce state spending and create a more balanced economy by eliminating most subsidies and converting to market prices. It must make a full commitment to privatization and reform of the educational system, as well as social attitudes, to produce Saudi citizens able and willing to fill the places of expatriate workers.

Endnotes

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[1] These estimates have been summarized in Table 1.1, Chart 1.2 Chart 1.3, Chart 1.4, Chart 1.6. Chart 4.5, Chart 4.7, and Chart 4.8

2 CIA, World Factbook, 1996, "Saudi Arabia," World Factbook, 1999, "Saudi Arabia," and CIA, World Factbook, 2000, 2001, and 2002, "Saudi Arabia."

3 World Bank, World Bank Atlas, 1997, Washington, World Bank, 1997; World Bank, World Development Indicators, 2002, Washington, World Bank, 2002, p. 20.

4 Saudi Arabia, June 1997, p. 2.

5 Reuters, August 14, 1996, 1202.

6 Saudi Arabia, February 1997, p. 3.

7 Saudi Arabia, February 1997, p. 3.

8 See 1988-1995 International Financial Statistics, IMF, Washington, 1996, and Middle East Economic Digest, June 13, 1997, p. 24.

[9] Energy Information Agency (EIA "Saudi Arabia," January 2000, www.eia.doe.gov/emeu/cabs/saudi.html.

10 Saudi Arabia, June 1997, pp. 1-2.

11 Saudi Commerce and Economic Review, February 1996, No. 22

[12] Kingdom of Saudi Arabia, Ministry of Planning, Seventh Development Plan, pp.118-120.

[13] Taken from Brad Bourland, The Saudi Economy in 2002, Saudi American Bank, Riyadh, February 2002, pp. 8-9.

[14] Energy Information Agency (EIA "Saudi Arabia," January 2000, www.eia.doe.gov/emeu/cabs/saudi.html., Middle East Economic Digest, May 9, 2000, p.18, May 26, 2000, p.17,

[15] Date of the Royal Order. For a full statement of responsibility, see Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 44-46.

[16] Monthly Newsletter of the Royal Embassy of Saudi Arabia, "Formation of new Economic Council," September 1999, p. 1.

[17] US-Saudi Business Brief, Vol. VI., No. 1, 2001, p. 3; Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 44-46.

[18] Saudi Embassy in the US, press release /01 spa/09-23-econ.html

[19] Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 44-46.

[20] Saudi Press Agency Information Release, "16-member Economic Consultative Commission formed in Saudi Arabia," September 23, 1999.

[21] Monthly Newsletter of the Royal Embassy of Saudi Arabia, "Formation of new Economic Council," September 1999, p. 1.

[22] Drawn from comments by St. John Armitage.

[23] Middle East Economic Survey, November 1, 1999.

[24] Middle East Economic Survey, November 1, 1999; Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 47-48.

[25] Brad C. Bourland, The Saudi Economy: Mid-Year 2000 Update, Riyadh, Saudi American Bank, August 2000, p. 10; Saudi Arabia, Spring 2001, Vol. 18, No. 1, pp. 7-10; Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 47-48..

[26] Energy Information Agency (EIA "Saudi Arabia," January 2000, www.eia.doe.gov/emeu/cabs/saudi.html; Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 46-49.

[27] Information Office of the Royal Embassy of Saudi Arabia Ushering in a New Era of Foreign Investment" Saudi Arabia, Summer 2000 Volume 17 Number 2 pp. 7.

[28] See his interview in Gulf Business, Vol. 6, Issue 12, April 2002.

[29] Associated Press, May 9, 2001, 1435; Saudi Arabia, Spring 2001, Vol. 18, No. 1, pp. 12

[30] Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 49-50.

[31] Saudi Arabia, Spring 2001, Vol. 18, No. 1, pp. 7-8.

[32] Saudi Arabia, Spring 2001, Vol. 18, No. 1, pp. 9-10. The Foreign Investment Act reads as follows:

ARTICLE 1:

The following expressions and terms shall have the meaning ascribed beside each, unless the context deems otherwise:

A. THE COUNCIL: The Supreme Economic Council.

B. BOARD OF DIRECTORS: The Board of Directors of the General Investment Authority.

C. THE AUTHORITY: The General Investment Authority.

D. THE GOVERNOR: The Governor of the General Investment Authority and Chairman of the Board of Directors.

E. FOREIGN INVESTOR: The natural person of non-Saudi nationality or otherwise the body corporate, where all partners are non- Saudi nationals.

F. FOREIGN INVESTMENT: Investment of Foreign Capital in a licensed activity under this Act.

G. FOREIGN CAPITAL: The Foreign Capital in this Act shall mean, for example but not limited to, the following funds and rights as long as they are possessed by a Foreign Investor:

* Money, securities and commercial instruments.

* Foreign investment profits if they are invested to increase the capital, expansion of existing projects or establishment of new projects.

* Machinery, equipment, supplies, spare-parts, means of transportation and production requirements relevant to the investment.

* Legal rights i.e., licenses, intellectual properties, technical know-how, administrative skills and production techniques.

H. PRODUCTION FACILITIES: Projects for the production of industrial and agricultural products (plant and animal).

I. SERVICE FACILITIES: Service and construction projects.

J. THE ACT: The Foreign Investment Act.

K. THE RULES: The Rules of Implementation of this Act.

ARTICLE 2:

Without prejudice to the requirements of regulations and agreements, the Authority shall issue a license for a Foreign Capital Investment in any investment activity in the Kingdom, whether permanent or temporary.

The Authority shall make a decision about the investment application within thirty days after the completion of documents provided for in the Rules. In the event that the specified period elapsed without the Authority rendering a decision about the application it shall be obligated to issue the required license for the investor.

If the Authority shall deny the said application within the specified period, then the pertinent decision of denial shall be justified, and the party against whom the decision of denial had been issued shall have the right to contest such decision according to regulations.

ARTICLE 3:

The Council shall have the authority to issue a list of activities excluded from Foreign Investment.

ARTICLE 4:

Subject to Article 2, the Foreign Investor may obtain more than one license in different activities, and the Rules shall specify the necessary measures

ARTICLE 5:

Foreign Investments licensed under the provisions of this Act, may be in either of the following forms:

1. Facilities owned by a national and a Foreign Investor.

2. Facilities wholly owned by a Foreign Investor.

The legal form of the Facility shall be determined according to regulations and directives.

ARTICLE 6:

A project licensed under this Act shall enjoy all the benefits, incentives and guarantees enjoyed by a national project according to regulations and directives

ARTICLE 7:

The Foreign Investor shall have the right to reallocate his share as derived from the selling of his equity, or from the liquidation surplus or profits generated by the facility, out of the Kingdom or to use by any other legal means, and he shall also be entitled to transfer the required amounts to settle any contractual obligations pertaining to the project.

ARTICLE 8:

The foreign facility licensed under this Act shall be entitled to possess the required real estates as might be reasonable for practicing the licensed activity or for the housing of all or some of the staff as per the provisions for non-Saudi nationals real estate acquisition.

ARTICLE 9:

The Foreign Investor and his non-Saudi staff shall be sponsored by the licensed facility.

ARTICLE 10:

The Authority shall provide all those interested in investment with all necessary information, clarifications and statistics, together with all services and procedures to facilitate and accomplish all matters pertaining to the investments.

ARTICLE 11:

Investments related to the foreign investor shall not be confiscated wholly or partially without a court order, moreover, it may not be subject to expropriation wholly or partially except for public interest against an equitable compensation according to Regulations and Directives.

ARTICLE 12:

1. The Authority shall inform the Foreign Investor in writing when violating the provisions of this Act and its Rules in order that such violation be rectified within a period of time determined appropriate by the Authority for rectifying such violation.

2. Without prejudice to any greater penalty, the Foreign Investor under the existence of the violation shall be subject to any of the following penalties:

A. With hold all or part of the incentives and benefits allocated for the Foreign Investor.

B. Imposition of a financial fine not exceeding 500,000 SR. (Five hundred thousand Saudi Riyals).

C. Cancellation of the Foreign Investment license.

3. The imposition of the penalties referred to in paragraph (2) herein above, is rendered by a resolution by the Board of Directors.

4. A petition against the penalizing resolution may be brought before the Board of Grievances according to its regulations.

ARTICLE 13:

Without prejudice to the Agreements in which the Kingdom of Saudi Arabia shall be a party of:

1. Disputes arising between the Government and the Foreign Investor relating to his licensed investments under this Act shall as far as possible be settled amicably, and if this shall prove to be impossible, then the dispute shall be settled according to regulations.

2. The disputes arising between the Foreign Investor and his Saudi partners relating to his licensed investments under this Act shall as far as possible be settled amicably, and if this shall prove to be impossible, then the dispute shall be settled according to regulations.

ARTICLE 14:

All Foreign Investments licensed under this Act shall be treated in accordance with the Tax codes valid in Saudi Arabia and its amendments.

ARTICLE 15:

The Foreign Investor undertakes to abide by all regulations, rules and directives valid in Saudi Arabia together with international agreements in which it is a part thereof.

ARTICLE 16:

The implementation of this Act shall not prejudice the vested interests of Foreign Investments that legally existed before this Act shall come into force, however, these projects in conducting their activity or increasing their capital shall be subject to its provisions.

ARTICLE 17:

The Authority shall issue the Rules, which shall be published in the Official Journal, and shall be effective as of the date of its publishing.

ARTICLE 18:

This Act shall be published in the Official Journal, and shall be effective thirty days after its publishing, and shall invalidate the Foreign Capital Investment Act issued by the Royal Decree no. (M/4), dated 2/2/1399 (H), together with any contradicting provisions.

The regulations affect the Foreign Investment Act are as follows:

FIRST: DEFINITIONS

ARTICLE 1:

For the purpose of implementing this Regulation, the following expressions and terms shall have the meaning ascribed beside each, unless the context deems otherwise:

The President: The President of the Supreme Economic Council.

The Council: The Supreme Economic Council.

The Board of Directors: The Board of Directors of the General Investment Authority.

The Chairman of the

Board of Directors: The Chairman of the Board of Directors of the General Investment Authority.

The Governor: The Governor of the General Investment Authority.

The Authority: The General Investment Authority.

Foreign Investor: A natural person not being a Saudi Arabian national or a body corporate where shareholders are not all Saudi Arabian nationals.

Foreign Investment: Investment of Foreign Capital in a licensed activity under the Act and this Regulation.

Foreign Capital: The Foreign Capital in the Act and this Regulation shall mean for example, but not limited to, the following funds and rights as long as they are owned by a foreign investor:

1. Money, securities and commercial instruments invested in the project.

2. Foreign Investment profits, if invested to increase the capital, expansion of existing projects or establishment of new projects.

3. Machinery, equipment, apparatus, spare parts, means of transportation and production requirements relevant to the investment.

4. Intangible rights i.e., licenses intellectual property, technical know-how, administrative skills and production techniques.

Ownership of the Foreign

Investment Projects: Ownership of Foreign Investment projects shall taken one of the following two forms:

1. Projects owned by a national investor and a foreign investor.

2. Projects wholly owned by a foreign investor.

The Act: The Foreign Investment Act.

The Regulation: The Regulation of the Foreign Investment Act.

The Center: The Comprehensive Service Center provided for in Article 9 of the Order of the Authority.

SECOND: AREAS FOR INVESTMENT

ARTICLE 2

The Authority shall have the power to license investment of any foreign capital in the Kingdom whether permanent or provisional and in all investment activities except the activities excluded under Article 3 of the Act or that the power to license is assigned to an organization other than the Authority itself.

ARTICLE 3

The Board of Directors shall suggest a list of the activities excluded from foreign investment and shall submit the same to the Council in pursuant to Article 3 of the Act. The Board of Directors shall from time to time update and suggest amendments to the list, which shall be published in the Official Gazette after the Council’s approval.

THIRD: PRIVILEGES, INCENTIVES AND GUARANTEES

ARTICLE 4

The foreign investment projects shall enjoy the privileges, incentives and guarantees enjoyed by national projects in accordance to laws valid in the Kingdom that include freedom of flow of funds to the Kingdom and outside, recognition of private ownership, and that the investments shall be not confiscated without a court judgment or subjected to expropriation except for public interest against an equitable compensation, obtaining loans and customs duties exemptions. In addition to that, the said projects shall have the right to own land required to perform the licensed activity or for housing staff in accordance to the rules of Real Estate Acquisition for non-Saudi Act. The projects are also entitled to recruit and sponsor the foreign investor and his non-Saudi staff.

FOURTH: CONDITIONS AND CRITERIA FOR LICENSING

ARTICLE 5

The conditions for granting a foreign investment license by the Authority shall include the following:

1. The investment activity requested for licensing should not fall under the list of activities excluded from foreign investment and it should be among those within Authority's power to license.

2. Product standards and production processes should be approved by the Kingdom laws, or in case such laws do not exist, the laws of the European Union or the laws of the United States of America.

3. The amount of the capital invested should not be less than twenty five million Saudi Riyals with respect to agricultural projects, and five million Saudi Riyals for industrial projects an two million Saudi Riyals for other projects.

4. The foreign investor must not have been found guilty of violating this Act, the previous Acts or any such Acts relating to investment.

5. The investor must not have been previously convicted for financial or commercial violations whether in the Kingdom or in other countries as he must submit an affidavit in this respect together with his investment application.

6. A grant of license shall not result in breaching any international or regional agreements endorsed by the Kingdom.

ARTICLE 6

The investor may obtain a license for more than one project in different activities upon the following conditions:

1. The conditions set forth under Article 5 of this Regulation must be satisfied.

2. The investor, when submitting a new request, must not own or be a partner in a project proven by the Authority to be in default or delay of operation for reasons due to the investor.

3. The investor should not have committed a major violation to the rules of the Act and its Regulation.

ARTICLE 7

The investor may purchase local or foreign investment entities or the share thereof provided that he should satisfy the conditions set forth under Article 5 & 6 of this Regulation.

FIFTH: LICENSE PROCEDURES

ARTICLE 8

The Authority shall prepare an investment guidebook containing a description of licensing procedures, forms, and documents required for granting a license. The guidebook shall also include the necessary information investors, including the applicable laws and regulations governing the investment, incentives, privileges and guarantees the investor may enjoy so as to ensure awareness of the investment climate in the Kingdom before submitting a license application. The guidebook shall contain in addition to the privileges, incentives and guarantees provided for in Article 4 of this Regulation, adequate of the following information e.g.:

1. Foreign Investment Act, its Regulation and supplement decisions.
2. Support of National Industries Act.
3. Zakat Laws, taxation, customs, customs exemption and condition thereof.
4. Labor and Social Insurance Act and other directives related to labor employment.
5. The Company Act and Commercial Registry Act.

The guidebook shall also contain information about the social custom prevailing in the Kingdom and residence laws. This guidebook shall be updated regularly.

ARTICLE 9

The application for Foreign Capital Investment shall be submitted to the Application Reception Unit at the Center on the provided form after satisfying all required information and documentation, as indicated within, and duly signed by the applicant or his authorized agent. The form should at least contain the following particulars:

1. The information about the applicant, his title, the shareholder in the project and their references.
2. The information about the project intended to be established.
3. A detailed statement of the capital intended to be invested in the project.
4. The permanent addresses of the Saudi and foreign partners: State, City, P.O. Box, Phone and Fax numbers, E-mail address, if any.
5. Contact person, when need to contact arises, during the review process of information and documents.

The said form shall also contain an acknowledgement by the investor stating that he had reviewed the Investment Act and this Regulation and that he shall abide by the rules stated therein.

The required documents shall consist of the following:

1. (a) Companies, corporations and similar institutions:

Resolution by the Proprietors, the Board of Directors or the Chief Executive for Investment provided that the said Resolution includes the name of the partner or other partners, if any; a certified copy from the professional license and commercial registry for Saudi companies and corporation, or similar documents for the foreign companies and corporations; an authorization for the person assigned to complete the licensing procedures that indicates his name and identity.

(b) Individuals

Copy of the investors' passport for foreign investors and the identity card for Saudi nationals. In case of authorization, the power of attorney should state the name and identity of the agent and the name of the partner or other partners, if any.

2. A time schedule indicating the phases of execution by the investor after obtaining the license.

The Authority shall announce in due time any documents or particulars that it deems necessary in the future.

The investor or his agent shall be responsible for the information and statements submitted, and the Authority may revoke the project license if it becomes evident that the investor concealed material information if disclosed the license would have denied licensing and the investor shall assume the consequences of this conduct.

ARTICLE 10

After depositing the documents, the Center shall provide the applicant with a preliminary delivery receipt that shows application number and date. The Center shall examine these documents within five working days from the date of deposit to ensure that the said documents comply the licensing requirements. The Center shall contact the applicant through the contact channel provided in the application, and the investor should immediately answer the Center with regards to any inquiry or request.

After completion of review, the investor shall be given a final receipt indicating that the required documents under this Regulation are deposited, stating the date, hour, day, month and year. This given date shall be considered as the initiating date for the official period required for deciding on the license request.

The Center shall prepare a distinct record to log license requests immediately upon receipt and shall create a file for each request with a specific file number.

ARTICLE 11

The Center shall, within fifteen days – apart from national holidays – from the date of completion of the required documents, examine the documents submitted by the investor and consider the criteria and conditions set forth under Articles 5 and 6 of this Regulation. Applications together with a recommendation of an approval or denial are then submitted to the Governor or his authorized delegate for finalization.

ARTICLE 12

The Authority may accept documentation pertaining to requests specified under Article 9, or copies thereof, through mail or other communication means and shall examine these documents pursuant to Articles 10 and 11, however a decision to license shall be made only after receiving and examining the original documents.

ARTICLE 13

Decisions on submitted requests shall be made in accordance to the rules specified in this Regulation and resolutions by the Board of Directors. The Governor, or his assigned delegate, shall sign the license decisions within thirty days – apart from national holidays – from the date of the completion of the required documents.

ARTICLE 14

The Center shall notify the investor, either by direct delivery or by registered mail, on the final decisions issued with respect to his application. The Authority shall provide the investor with the facilities and information available to assist in completing the procedures and the steps required to be taken after the grant of license. The Authority should state its reasons for denial when a request is rejected.

ARTICLE 15

A decision to amend a license shall be made by the Governor upon a request by the project owners and a recommendation by the Center, provided that such amendment falls within the licensed activity. However, amendments involving a change of activity shall be treated as a new license request.

ARTICLE 16

The foreign investor whose request is denied, despite an appeal to the Board of Directors, shall have the right to contest the denial decision before the Grievance Board.

SIXTH: OBLIGATIONS OF THE INVESTOR

ARTICLE 17

The licensed investor shall commence the process and execute the steps required for executing of the project in accordance to the applicable laws in the Kingdom and subject to the time schedule the investor submits together with the license request to the Authority. The Authority may, if the investor shows reasonable cause that prevent taking steps to execute the project according the timetable, extend the period specified in the schedule for periods that shall not exceed one year in total. The said extension should not be extended beyond a year unless a decision to that effect is made by the Board of Directors. However, if the investor is found frivolous after the extension the Board of Directors may then cancel the license. The investor whose license is cancelled under this Article shall bear the consequences of cancellation.

ARTICLE 18

Licensed projects must abide by the conditions and the basic objectives contained in the investment request submitted by the owners and upon which they obtained the license. No modification shall be made on these projects unless approved by the Authority.

ARTICLE 19

Owners of the licensed projects shall adhere to the laws applicable in the Kingdom and shall adopt an approved accountancy system for their projects, and upon Authority's demand shall provide the Authority with statistics or information in respect to their projects.

SEVENTH: VIOLATIONS

ARTICLE 20

Authority officials, assigned by written authorization by the Governor or his delegate, shall have the right to monitor implementation of the provisions of the Act and its Regulation. For this purpose they have the right to examine records, and all the documents relating to its activity and shall check for violations and submit necessary reports to the Governor. The assigned officials shall maintain the confidentiality of information and documents they examine.

ARTICLE 21

The Authority shall notify the foreign investor in writing of violation of the provisions of the Act, its Regulation or license conditions and will allow a suitable period of time to remove the violation. If he fails to remove the violation he shall be subject to any of the sanctions provided for in Article 12 of the Act.

ARTICLE 22

The Board of Directors shall form a committee consisting of at least three members, one of them shall be a legal counselor, and shall make the rules and procedures required for performing its task. The duty of the said committee shall be to review violations and to hear the parties accused of these violations, consider their defenses and suggest suitable penalties. The Board of Directors shall render the penalty decision.

ARTICLE 23

The Center shall notify the owner of the project in violation about the decision of the Authority regarding the violation by registered mail, thus the date of the signed receipt or refusal to accept the registered mail shall be considered the date the decision was notified. The project in violation, which the Board of Directors denies its petition against the penalty decision, may appeal that decision before the Grievance Board.

EIGHTH: DISPUTE SETTLEMENT COMMITTEE

ARTICLE 24

The Authority shall establish a Committee identified as the Dispute Settlement Committee consisting of at least three members, one of them a legal counselor. The Committee shall act to reach amicable settlements for disputes that arise between parties referred to under Article 13 of the Act. The Board of Directors shall specify the required procedures for performing the task of this Committee.

[33] Additional details are taken from the Saudi Arabia Monetary Agency (SAMA), 37th Annual Report, Riyadh, September 2001, pp. 48-49.

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[35] Saudi Embassy in the US, press release /00 spa/04-15-econ.html.

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[37] Arab News, April 15, 2002, www.arabnew.com/article.asp?ID=14435.

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[41] Brad C. Bourland, The Saudi Economy in 2002, Riyadh, Saudi American Bank, February 2002, pp. 26-27.

[42] Bloomberg, April 18, 2001, 1151.

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