Middle East Youth Initiative

The Middle East and the New Global Economy: The Drive for Competitiveness, Skills and Innovation

Introduction to the Series

As leaders from the Group of Twenty (G-20) nations prepare to gather in Pittsburgh to take stock of the global economy, the countries of the Middle East will not be represented in great numbers. Nonetheless, economic performance in the region is increasingly connected to global trends and policies. The region has experienced the economic slowdown through a variety of channels, including commodity price and export market volatility and declining tourism and investment. While specific policy priorities during the global recovery will vary across the Middle East, nearly every country in the region must meet the challenge of diversifying its economy to stimulate new, innovative markets and sources of growth. As this entails moving toward greater competition in new global markets, it is certain that the Middle East will play an increasingly significant role in future global economic stability.

Following from our successful online interview series which began last fall – "Food, Fuel, and Finance: How Will the Middle East Weather the Global Economic Crisis?" – the Middle East Youth Initiative (MEYI) turns once again to our network of scholars to ask how the region is faring. Have chronic unemployment challenges in the region been exacerbated by the economic slowdown? Has the global crisis forced a rethinking of development strategies in the region? Have ambitious programs been put on hold due to declining revenues from commodities, investment, exports and tourism?

Part 2: Diversification and Development in Saudi Arabia

An edited transcript of a discussion between the Middle East Youth Initiative and Hassan Hakimian on the economic situation in Saudi Arabia follows. Hakimian is a specialist in development economics with a special focus on the Middle East and Gulf countries. He is the incoming director of the London Middle East Institute at SOAS, University of London.

Saudi Arabia and the G-20

Middle East Youth Initiative (MEYI): The leaders of the Group of Twenty (G-20) nations are convening at a summit in Pittsburgh September 24 and 25. Saudi Arabia is the only Arab country represented in the G-20. What issues do you think are at the top of the agenda for the Saudi government going into this summit?

Hassan Hakimian: Saudi Arabia's presence at the G-20 economic summit indicates how the balance of economic and financial power has been gradually moving eastward: toward China, India, and also the major Gulf oil-producers. Saudi Arabia has been important for a number of years: it is the largest oil-exporting country in the world, it is the largest OPEC [Organization of the Petroleum Exporting Countries] member, and naturally it is a country which has immense regional – and increasing international – significance. The economic performance of Saudi Arabia is also an important factor in any possible global recovery.

From the point of view of Saudi Arabia, attending the G-20 economic summit is important in at least two respects, both indicating Saudi Arabia's inexorably rising ties with the international economy. First, of course, is oil prices – the prospect for oil price recovery is tied with the prospect for global growth and international economic recovery. Second, considering that Saudi Arabia's currency is pegged to the dollar, the position of the dollar as an international reserve currency is of considerable importance to Saudi Arabia and its monetary stability. We should also remember that a significant part of the Kingdom's vast foreign assets, topping about $500 billion, is denominated in low yield but safer U.S. Treasury bills. So, for at least these two reasons, what goes on in the wider international community will be of immediate interest to Saudi Arabia.

MEYI: Oil prices have been hovering around $70 per barrel in recent weeks. Does the Saudi Arabian government consider this to be a decent price, given the importance of oil prices to the Saudi economy?

Hakimian: Well, oil prices around $70 per barrel are a lot better than the lows around $30 per barrel that we saw at the beginning of the year, but it is still quite some distance from the peaks achieved in the summer of 2008. Officially, the Saudi government considers a fair oil price to be around $75 per barrel. There are conflicting estimates about what could be considered as a break-even oil price for the Saudi budget; I think this is probably somewhere between $55 to $65 per barrel. The current budget for 2009 is based on an estimate of oil prices around $44 per barrel. So, a partial recovery of oil prices from the lows, and from the price assumed in the budget, obviously is good news on the fiscal side, especially recalling that the current budget was projecting a deficit of about 16 to 17 percent of income. Of course, oil prices depend very much on how sustainable the international economic recovery is going to be. There is some concern about whether this recession is likely to be a "double-dip" recession or not. That is an area that Saudi Arabia, like many other oil producers, will be watching.

MEYI: Have Saudi fears of the dollar depreciating been assuaged at all by the U.S. and its fiscal and monetary responses to the downturn? As you know, U.S. Treasury Secretary Timothy Geithner was in Saudi Arabia this summer and addressed this issue in his remarks in Jeddah, reassuring Saudi Arabia that the U.S. dollar will remain strong.

Hakimian: The fragility of the U.S. dollar is obviously a sensitive issue for oil producers, like those in the Gulf Cooperation Council (GCC) countries, whose currencies are pegged to the dollar. This is partly due to the adverse implications for their accumulated foreign assets, and also partly because a severe depreciation of the value of the dollar can also lead to imported inflation. That means that the GCC's substantial imports from the Euro zone, for instance, will cost a lot more in the face of a weak dollar – effectively implying a lower real price for their main export, which is oil. This has been an additional concern in the last few years.

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The Saudi Stimulus Budget and Current Economic Outlook

MEYI: We have talked a bit about the relative strengths, weaknesses and vulnerabilities that Saudi Arabia faces in the context of the economic slowdown and recovery. Overall, what is your assessment of where the Saudi economy is today and how well it has fared approximately one year since the beginning of the downturn?

Hakimian: As expected, I think the first six months of this year have been difficult in Saudi Arabia, as with other countries in the region. All indications are that economic activity has slowed down. This is particularly true in the private sector, for reasons that I will come to in a moment, but also because of lower oil prices.

If you look at some indicators, such as imports, for the first six months of 2009, they were down by 18 percent. Imports of construction materials were down by 29 percent:

this is an indication of how the construction sector has been affected. On the other hand, although Saudi Arabia has not quite experienced a mass exodus of expatriate workers, as some of the other Gulf states have experienced, there has nevertheless been a decline in new entries. As far as the private, non-oil sector is concerned there have been notable weaknesses, there is no doubt about it.

We should not forget that recent months have demonstrated the fragility of the economy not just in terms of exposure to external shocks, but also with regards to internal factors. The difficulties experienced by two important family groups this year – the Saad and Gosaibi groups – has led to severe liquidity constraints in the financial sector and, as a result, the banks have been very reluctant to lend to the private sector. In a sense, the Saudi banks were not as affected by the international crisis because they are not widely integrated into the international financial system, but the prevalence of family businesses in Saudi Arabia and the so-called system of "name lending" (where a bank will lend with a personal guarantee from the borrower as the only collateral), shows how exposed the financial system can be to domestic factors. Both these liquidity constraints and the resulting debt default have had a depressing effect on liquidity and bank lending in Saudi Arabia in the first half of 2009.

The bright spot, I might add, has been the government sector: had it not been for the expansionary fiscal policy pursued in the 2009 budget – the largest budget in the Kingdom's history, then we could have seen much weaker economic performance.

MEYI: Let us discuss the 2009 stimulus budget, which amounts to a $17.6 billion increase in spending from the previous year, or 3.3 percent of 2008 GDP.[1] What is your assessment of how the Saudi government has managed the stimulus package? What has been its impact, or is it too early to tell?

Hakimian: The stimulus package does a few things. First, it signals to the market the intent and seriousness of the state, the biggest actor or player in the economy, to rein in the recession. In that sense, it is important to see a proactive fiscal stance, as we have generally seen in a number of other countries in the G-20. As for its particular impact, it is a little bit too early to tell. These stimulus packages can take a while to demonstrate their impact, particularly those parts which are comprised of expenditure on infrastructure projects with longer gestation periods. Had it not been for a very active government stance, both for its signalling impact and the direction it has taken, I think that the current economic climate and macroeconomic performance in Saudi Arabia

[1] IMF, Group of Twenty Meeting of the Deputies, February 2009. http://www.imf.org/external/np/g20/pdf/020509.pdf. The total amount of Saudi Arabia's proposed 2009 budget is SAR475 billion (approximately $126 billion).

would have been even weaker. In fact expectations are that, on the whole, the Saudi economy will contract by about 1 percent in 2009, although partial recovery is expected to start in the latter part of this year.

Development of Saudi Arabia's Human Resources

MEYI: A significant portion of the stimulus budget is devoted to education and human capital development. What are some of the more critical issues for the education component of the stimulus to address?

Hakimian: Education and, more broadly, human resources development is now an important priority for the Kingdom. Approximately one-quarter of the current budget is devoted to education and development of human resources, and the government has adopted a number of large-scale and ambitious educational programs. Basically there are two types of projects and programs. First, there are those that are devoted to improving and raising the quality of the physical infrastructure – the hardware capacity, so to speak. This involves the construction of about 1,500 new schools; renovation and completion of several thousand existing schools, both at the primary and secondary levels; and also the construction of new universities, such as the new women's university, Princess Norah University in Riyadh, and the Medical City for King Saud University.

It is understandable why a young country such as Saudi Arabia, where almost two-thirds of the population is below the age of 30 years old, is required to improve its capacity to educate and empower its population. However, if you look at some of the gaps and mismatches in the job market, we encounter some daunting challenges. For instance, Saudi engineering graduates meet only one-fifth of the country's needs. Sixty-eight percent of the science jobs in the Kingdom are filled by graduates from other countries. It is also said that the country needs tens of thousands of pharmacists every year and it is currently only producing one hundred.[2]

I do therefore think that education at all levels and human resources development, in a wider sense, is rightly at the top of the agenda. This is a long term structural issue, partly due to demographic issues. But we must also not forget the importance of institutions: educational capacity does not just consist of showcase buildings and campuses, it also includes developing the quality of the workforce, the staff and the curriculum. The

[2] Less than five percent of pharmacology jobs are reported to be filled by Saudi nationals. "More Saudi Pharmacists Needed," Arab News, August 18, 2007.

curriculum in particular in Saudi Arabia requires reform: this is one area in which there is a lot that needs to be done.

MEYI: What has been the impact of the crisis on the labor markets in Saudi Arabia? What is happening to job creation today, in light of the exogenous demand shock of the economic downturn coupled with the internal challenges of demography, labor market rigidity and a large public sector. Where do we stand?

Hakimian: As you know, there is a very large expatriate community of workers in Saudi Arabia: about 6.5 million. They have been there since well before the current economic crisis. As I said earlier, the economic crisis has not hit the expatriate workers in Saudi Arabia as hard as it has hit them elsewhere in the Gulf states.

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Saudi Arabia is acutely aware of the dual, or segmented, labor market it faces. It has had this situation for a long time: the combination of a large population of expatriate workers, both low-skilled construction workers and high-skill engineers and graduates from abroad, combined with an incidence of high unemployment among the Saudi youth. This is why there has been an active "Saudization" program in place to provide incentives for job generation for young Saudis, particularly the young male population. I think this is a long term challenge: first, the young Saudi population does not always have the skill sets that the expatriate workers have and, second, because of a much higher reservation wage, they are not attracted to certain jobs at the same level of salaries and wages as the incoming migrants. So, some of these issues are structural and they need to be addressed over a longer period.

Food Security in the Kingdom

MEYI: Transitioning now to another policy challenge for the Saudi economy: what is your view on Saudi policy toward food security, especially in terms of investing in land acquisition and food production abroad? How large is this challenge for Saudi Arabia, and what are some of the concerns and issues the international community should be looking out for as Saudi Arabia pursues its policy on food security?

Hakimian: Saudi Arabia's policy of investing in land acquisition and food production abroad is a thorny issue. On one hand, it reflects the Kingdom's sensitivity to, if not nervousness about, the state of its almost total food dependency on the rest of the world. In the summer 2008, with the spike in international food prices, and as more food exporters imposed restrictions on their exports to protect their own domestic consumers, the extent of that nervousness and anxiety became ever more manifest.

From Saudi Arabia's point of view, this is a challenge to be met and that means looking for ways in which its food security can be improved and sources of food imports diversified, given the particular climate that the peninsula has and its well-known water problems. From the point of view of other countries, the recipients of the investment, it is very likely that operations like these remain largely enclave investment outlets with limited backward linkages with the domestic market. These are therefore not the classic foreign direct investment (FDI) projects that may necessarily lead to much transfer of technology to recipient countries. If you look at the textbook advantages of FDI, it is hard to make a very strong case for the host country in a situation like this.

On top of this, if you look at the local context in which producing food for exports for overseas markets is intertwined with ongoing and contrasting domestic poverty, then the issue understandably acquires a political dimension too.

Prospects for the Future: State-Led Growth and the Need for Diversification

MEYI: As we wrap up, we want to ask: how do you see the future of the Saudi economy? Obviously, Saudi Arabia has been able to pursue a large stimulus package because it goes into this economic downturn with huge reserves. Looking two to four years ahead, do you think this generous public spending is sustainable? Do you think an increasing role of the government in the economy, while necessary during a crisis, may also be distorting incentives for young people and making them more dependent on the state?

Hakimian: Looking out to the medium term, there is no doubt that one of the main challenges for the Saudi government is to regenerate and resuscitate the indigenous private sector in the non-oil economy. The fiscal stimulus and government intervention necessitated by the current economic climate are necessary responses in the short term and should not cloud the long term horizon: the government needs to stick to its policy of encouraging long-term growth that is sustainable, indigenous, and based on private sector initiatives and entrepreneurship. I think the dependency on the oil sector is obviously going to continue, but more important is how the oil resources are utilized. Indications have been that in the current climate, as contrasted with the 1970s' oil boom, most oil producers in the Gulf, including Saudi Arabia, have learned lessons and they are implementing those lessons. Oil resources are, first of all, not principally used for current consumption and second, they are directed at long-term capacity building and human resources development rather than hardware acquisition and spending on showcase projects.

Thus, in terms of government intervention in the economy, important lessons have been learned. But, at the end of the day, the "proof of the pudding is in the eating." Big showcase projects cannot save the economy per se, and what remains to be seen is how effective and efficient such intervention in the economy proves to be.

MEYI: In a recent paper for the Carnegie Endowment, Ibrahim Saif argues that the Gulf states squandered the opportunity to make economic reforms during the last five years of high oil prices. Do you agree that Saudi Arabia has squandered the oil windfall to more aggressively pursue diversification in the past five years? What might it do next?

Hakimian: There is no denying that the Saudi economy needs to diversify, full stop. It needs to diversify not just in terms of energy, but generally in terms of achieving a sustainable and diversified economic structure affecting most sectors, including services and manufacturing. I think five years is probably too short to allow for such diversification to take place, but it is never too late. The Saudi reserves are the envy of most countries, and they can still be directed toward achieving that measure of diversification. As I said earlier, the expenditure on upgrading the quality of human resources is a case in point. This is in opposition to the 1970s, when much of the oil income was diverted toward acquisition of hardware, such as showcase roads and huge infrastructure projects; projects to "green" the desert; and the amassing of expensive and possibly useless military hardware. I think the upgrading of human resources is going to take quite a while, especially with a young population like in Saudi Arabia. The fruit of such investment will take a long time to materialize and results will extend well beyond a few years only.

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MEYI: In conclusion, what are your thoughts on political stability inside the country, in terms of the Kingdom's political institutions and future transitions?

Hakimian: Well, I am not a political scientist, but I do know that, as elsewhere, the ultimate success of economic policies will depend on how effectively they reach out to ordinary citizens, and their perception of how engaged they are in the process of wealth creation and wealth distribution. In other words, how *inclusive* economic policies are is at least as important as how technically sound and accurate they are. There is no doubt that policies in place will have to keep in mind, ultimately, the welfare and inclusion of the largest part of the population and, in the case of Saudi Arabia, this certainly means a dynamic, youthful population.