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Report

Saudi Vision 2030 and the Consequences Of the Gulf Crisis

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Vision 2030 consists of a programme that aims to direct the Saudi economy away from oil dependence by rationalising expenditure, developing sources of non-oil revenue, diversifying the economy and most importantly raising the private sector's contribution to GDP to about two thirds [Getty Images]

Introduction

Oil is a key pillar of Saudi Arabia's economy, the cornerstone of its internal development and the primary source of its revenue. Recent statements by the International Monetary Fund (IMF) indicate that oil revenue represents about 75 per cent of the country's exports and 72 per cent of its financial income; further, the oil sector's share of the kingdom's GDP is more than 40 per cent.(1) The fall in the world oil price in 2014 revealed the kingdom's over dependence on oil. Export revenue dropped dramatically, Saudi Arabia's economy deteriorated rapidly, and its future became uncertain.

These changes forced Riyadh to adopt austerity measures, which peaked in April 2016 when Saudi Arabia's deputy crown prince at the time, Mohammad bin Salman (the current crown prince), announced Vision 2030. The vision consists of a programme that aims to direct the Saudi economy away from oil dependence by rationalising expenditure; developing sources of non-oil revenue; diversifying the economy and, most importantly, raising the private sector's contribution to GDP to about two thirds.

The latest changes to Saudi Arabia's power structure have removed – at least for now – any doubts pertaining to the succession of the Saudi throne. With Mohammad bin Salman's rising popularity, it is only reasonable to conclude that Riyadh will proceed in its implementation of Vision 2030. However, the kingdom's experiences in the past year reveal significant challenges that should not be underestimated and that are likely to complicate the achievement of the vision's objectives in the coming years.

Key features of Vision 2030

The strategic objectives of Vision 2030 can be divided into three key categories: economic diversification and business environment improvement, financial reforms and social reforms. As such, the programme aims to increase the private sector's contribution to GDP from 40 per cent to 65 per cent. The plan also intends to increase non-oil government revenue by six times to reach 1 trillion Saudi Riyals (SAR; equivalent to 267 billion US dollars [USD]) through the increase of taxes, fines and public fees; the imposition of new taxes, like a value-added tax (VAT); and the development of non-oil sectors, like mining and tourism.(2)

In addition, the programme aims to increase the sources of national wealth, diversify the country's investment portfolio abroad and raise the value of public investment fund assets from 600 billion SAR (156 billion USD) to over 7 trillion SAR (1.8 trillion USD).(3) The key pillar of Vision 2030 may be the transformation of Saudi Arabia's public investment fund into a sovereign wealth fund with financial assets reaching up to 2 trillion USD, according to Saudi government estimates. The assets are to be funded through the initial public offering (IPO) of 5 per cent of Aramco and selling some governmental assets and land.

The Saudi government is also planning to invest about 50 per cent of the sovereign wealth fund into internal and external investments amidst optimistic expectations that the fund's revenue will end the kingdom's oil dependency by the year 2020.

Primary economic measures

Saudi Arabia's budget for 2017 reveals plans to completely remove subsidies on fuel prices within four years as well as introduce VAT in 2018 and impose additional charges on expatriates. The budget also includes plans to provide cash transfers to low- and medium-income families to help them weather the drop in government support.(4)
In this regard, three financial positions can be identified in the short and medium term:(5)

- Government revenue will remain lower than it was before the fall in global oil prices in 2014.
- Government spending will decrease and the civil service workforce will be reduced by 20 per cent. The Saudi government also plans to decrease subsidies on water and electricity to save about 200 billion SAR (53 billion USD) by 2020.
- The government will increasingly attempt to cover its fiscal deficit by drawing on reserves and issuing domestic and external bonds.(6)

Although many international institutions – including the International Monetary Fund, the World Bank and credit rating agencies – have welcomed the economic reforms in Saudi Arabia, everyone agrees that the path is long and bumpy with many obstacles that may hinder or stall its success due to internal challenges or unexpected developments. Some pessimists even predict that Vision 2030 will not succeed at all.

The foundation of Vision 2030

Eyes are on the public offering of Saudi Aramco, which is expected to take place next year in 2018. This process is considered the main axis of Vision 2030 as Riyadh expects that Aramco will be valued at 2 trillion USD. Thus, selling 5 per cent of the company's shares after listing it on at least one foreign exchange should bring in 100 billion USD. To this end, the Saudi government decreased Aramco's tax liability in March 2017, from 85 per cent to 50 per cent, in hopes of increasing the company's attractiveness to foreign investors.(7) The government is also preparing to announce additional measures towards achieving its goal.

In the same vein, Mohammad bin Salman confirmed that Aramco would be listed in 2018, and that the shares that are to be sold will not exceed 5 per cent. He stressed that revenue from the sale will help develop other industries in the kingdom, and the sum will be invested in a public investment fund, which will spend over 500 billion SAR (133.3 billion USD) within three years of the Aramco IPO.(8)

Aramco is expected to announce the foreign exchange on which the shares will be listed. US geopolitical intelligence platform Stratfor reported that Mohammad bin Salman preferred the listing to be on the New York Stock Exchange not only to fund Vision 2030 but also to strengthen the country's political ties with the United States.(9)

The sale of part of Aramco's shares is certainly receiving international attention. Foreign investors are closely and fervently observing the entire process. Therefore, any delay in the listing (especially due to weak foreign involvement) may create a state of uncertainty, which may in turn negatively affect the kingdom's privatisation programmes as a whole and harm the credibility of the Saudi crown prince who has frequently promoted them. However, the notable success achieved by Saudi Arabia's recent issue of 17.5 billion USD in sovereign bonds in the biggest bond sale to date from an emerging economy to date may reinforce hopes for a successful Aramco IPO and a new IPO record.(10)

Nevertheless, some questions remain, including the company's disclosure through independent and internationally approved evaluations of the production costs, profit margins, taxes, expected prices, actual recoverable reserves and nature of the oil fields in addition to all matters related to listing companies in financial markets. The Financial Times published warnings attributed to consultants for the Saudi government and Aramco that the company needs to change its structure and the nature of its activities to resemble those of international oil and gas companies and end all activities aloof of the energy field. Otherwise, international investors' concerns might damage the company's evaluation.(11) These issues have led many international economic institutions to question the likelihood of Aramco's value being 2 trillion USD.

In other words, what is really important for the market is the revenue and cash profit that Aramco generates rather than its activities or its oil and gas reserves. Certainly, the profits will largely depend on two main factors: the global price of oil and low taxes.(12) Notably, Aramco is involved in many economic, health-related, educational and social activities in the kingdom; thus, abandoning – or even minimising – these activities may negatively affect the employment of Saudi citizens and may even have political consequences.

The Wall Street Journal recently revealed that disagreement between members of the royal family in Saudi Arabia and senior executives in Aramco might delay the intended initial offering of the company in 2018.(13) The newspaper also quoted informed sources that said officials in Aramco had encouraged the Saudi king, Salman bin Abdulaziz, and Crown Prince Mohammad bin Salman to list the company on the London exchange. The paper added that Aramco officials believed that listing the company in the United States might pose a significant legal risk.(14) Further, international lawyers warned Riyadh that the legal system in the United States is the most dangerous in the world, especially since new anti-terrorism legislation – the Justice Against Sponsors of Terrorism Act (also known as "the JASTA law") – may permit the families of 9/11 victims to sue Saudi Arabia. Aramco may also face litigation if it does not strictly abide by the rules of US regulatory agencies regarding reserves and data disclosure.(15)

Economic challenges

Concerns are not limited to Aramco but also relate to the performance of the Saudi economy in general. The current slowdown could lead to weak economic growth and challenging macro-economic conditions (e.g. shrinking public expenditure, rising energy costs, cash deficits and pressures on private sector profit margins) that could complicate attempts to increase employment and raise Saudi living standards.

In addition, official Saudi data showed a reduction in the kingdom's GDP in the first quarter of 2017, the first time since the global financial crisis. Adjusted for inflation, the GDP growth rate decreased by 0.5 per cent on an annual basis in the time period from January to March, marking the first fall since 2009.(16) Long-term economic expectations remain unclear. According to IMF data, real GDP growth is likely to drop to less than 1 per cent in 2017 (which is the lowest rate in eight years). However, it is also expected to recover slightly to 1.3 per cent in 2018 and stabilise at 1.9 per cent in the medium term (2019–2022).(17)

At the same time, Saudi Arabia's fiscal surpluses are regressing at alarming rates. According to Reuters, the kingdom's foreign exchange reserves declined to approximately 493 billion USD at the end of April 2017, or around one third of the peak level of 737 billion USD reached at the end of August 2014.(18) Riyadh, however, still has room to manoeuvre as it has considerable reserves. Further, if Aramco shares are actually sold, the sale could eventually provide additional resources in addition to loans, especially given the low rate of foreign debt.

Still, the reserves are being spent at an unsustainable rate, or an average of 100 billion USD per annum. It is important to note that Saudi Arabia maintains a fixed exchange rate with the US dollar. Meaning, based on some estimates, the kingdom may need to provide a minimum of 200 to 300 billion USD in reserves to maintain economic confidence and avoid the risk of increasing financial pressure on the Saudi riyal.(19)

Reducing the high unemployment rate (which is currently more than 12 per cent) among Saudis, especially youth, is a major challenge facing the Saudi government. The percentage of Saudis under the age of twenty-five is expected to reach 50 per cent by 2030. This section represents a significant asset if gainfully employed and a time bomb if the unemployment rate remains the same.(20) Therefore, as the government continues to reduce public sector employment, the private sector is unlikely to create enough job opportunities for Saudi youth who enter the labour market each year and whose number is estimated to be around 30 000 individuals.(21) This number requires an annual economic growth rate of 7 to 8 per cent, which is unlikely to be achieved within the coming years.(22)

In addition, the economic reforms may slow down or be hindered due to fluctuations in the global price of oil. If the current oversupply in the markets continues, Saudi Arabia will have to choose from one of two difficult options: admitting the failure of OPEC's efforts and returning to the previous policy of maintaining market share, or risking deep cuts in production rates, staked on price hikes to offset losses in export revenue.
However, any further reductions could bring the kingdom back to square one: a recovery in the production of shale oil in the United States accompanied by a loss of market share for producers inside and outside OPEC.(23)

Political challenges

In Saudi Arabia, the path of economic reform remains fraught with political risks and major social impacts, which could result in negative reactions that could slow down or stall the reforms. In fact, Vision 2030 completely ignored the political dimension. Experiences of economic reforms in various parts of the world – from East Asia to Africa to Latin America – demonstrate that economic reforms can only proceed under existing political structures. Several political factors that could negatively affect the implementation of economic reforms in the kingdom include:

- **Cohesion of the ruling family:** So far, there is no sign of violent power struggles within the ruling family in Saudi Arabia that may pose an existential threat. However, the reform programmes led by Mohammad bin Salman may face resistance in the future. The Financial Times quoted western diplomats in Riyadh as saying that opposition to the crown prince may grow within the ruling family if he makes a serious mistake in Yemen or if public discontent rises as a result of the failure of economic reforms.(24)

- **Popular discontent:** The Saudi government will not hesitate to slow down, delay or cancel reforms if they provoke negative reactions among Saudis, which could undermine many of the goals of Vision 2030.(25) In this context, it may be recalled that in May 2017, the Saudi government decided to restore the allowances of state and military employees after they were reduced in September 2016 due to improved financial performance and in order to stimulate economic growth.(26)

- **The religious establishment:** Economic and social reforms may generate tension within the conservative forces in the country. Over the next decade, the Saudi government is looking to increase foreign investment, promote the leisure and entertainment sector and develop non-religious tourism. If this happens, it may erode the authority of the religious establishment or push some of its prominent figures towards further criticism or opposition, which could negatively affect political stability in the country.(27)

- **Political reforms:** Although Saudi Arabia has already begun economic reforms without the announcement of any political reforms, and despite the lack of real and effective political mechanisms to monitor government performance transparently, especially regarding the fight against corruption and meeting people's demands, popular support could be undermined in the medium and long term, forcing the government to abandon important aspects of reforms – especially in the event of mounting popular opposition. Of course, political reforms (elected parliament, independent judiciary, parties, unions, etc.) and measures such as increased accountability are far from the Saudi government's agenda or discussions.

- **The danger of jihadist groups and unrest in the Eastern Province:** Saudi Arabia may still see further attacks by organisations such as al-Qaeda and the Islamic State. Although they do not pose an existential threat, their escalation or continuation could negatively influence economic and investment prospects. Other issues include human right issues raised by international organisations and ongoing unrest in the Eastern Province where Saudi Shiites are demanding political rights, which in turn send negative signals to the outside world.

- **Privatisation:** Inside Saudi Arabia, there are reservations and opposition to the privatisation of state-owned assets, especially in light of the decline in the global price of oil. Those assets may be estimated at a much lower value than their actual worth. In addition, there are real fears about how privatisation could encourage 'crony capitalism' by selling state assets to senior investors associated with the regime or powerful families. Meanwhile, others argue that the official reform programmes in Saudi Arabia do not aim to support the private sector in a way that allows for the emergence of a real middle class, which could ultimately defy the economic hegemony of the ruling family or influential families.(28)

- The volatile regional situation: The regional and security political issues difficult challenges that could place more pressure on the kingdom's economy, ranging from the war in Yemen; the situations in Syria and Iraq; ongoing support for stability in Egypt, Morocco, Jordan and Bahrain; and fears of an increase in Iran's power as well as the current Gulf crisis.

Consequences of the current Gulf crisis

These challenges are accompanied by an escalation in the current Gulf crisis, which, if it continues for a long time, is expected to negatively affect the economic situation in Saudi Arabia. The volatile regional situation in the Gulf and Saudi's involvement in political and military conflicts on multiple fronts remind oil consuming countries of the instability in the Middle East and could also force some of the kingdom's important partners, such as China and India, to expand the process of diversifying sources of oil imports from regions outside the Middle East such as Russia, Africa and Latin America.
On the other hand, the Saudi government is expected to resort to borrowing or issuing more bonds on international markets to finance the fiscal deficit. However, current regional circumstances could increase the cost of borrowing through risk premiums due to the political instability in the Middle East and the Gulf.

Further, the Saudi government is seeking to attract 18 billion USD in FDI by 2020 in comparison to 8 billion USD in 2015.(29) If prolonged, the Gulf crisis is expected to affect investment in Saudi Arabia and could possibly decrease the size of investments in the kingdom. The size of FDI flows has been falling since 2009, when it reached its peak of 36.5 billion USD, reaching only 7.4 billion USD last year.(30)

The suspension of Saudi exports to Qatar could hurt many Saudi exporters whose exports to Qatar amounted to about 1.3 billion USD last year. Although such exports only represented a small portion of total Saudi exports, which amounted to 169.7 billion USD in 2016, most of them were non-oil exports and related to private companies in desperate need of increased economic activity, especially in light of the recession in the Saudi economy.(31)

Conclusion

In the context of this analysis, Vision 2030 is clearly an ambitious project and its implementation could take many years. However, obstacles to its implementation must not be underestimated; the risks are high and there is potential for failure. Apart from political challenges and regional conflicts, the logistical challenges of implementing such wide-ranging reforms in an environment with a history of resisting change cannot be underestimated.

Although Riyadh has the economic and financial tools to adapt to the challenges in the short to medium term, the economic diversification programme's success requires deep and genuine internal economic and political reforms and resolution of the regional situation in order to ensure the long-term stability of the kingdom.

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