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THE RISE OF THE GULF: SAUDI ARABIA AS A GLOBAL PLAYER

Nicolás M. Depetris Chauvin

Until two decades ago, Egypt was the main referent of the Arab world in the global arena. However, with the end of the Cold War world and a shift in emphasis from geopolitics to geo-economics, the role of Egypt as a leader in the Middle East and North Africa (MENA) region greatly declined. A clear example of this was the failed attempt of the Egyptian diplomacy to participate in the G20 meeting of London in April 2009 where the policy responses to the global financial crisis were discussed. On the other hand, the Saudi economy’s strength and influence in the world marketplace have grown exponentially during the past few decades. The Saudi economy is the largest in the Middle East and, in their “Doing Business” annual report issued last year, the International Finance Corporation rated Saudi Arabia as the 13th most economically-competitive country in the world. Saudi Arabia is today the only Middle East Country, the only Arab country and the only OPEC member among the constituents of the G20. This is a recognition of the rising importance of Saudi Arabia both in the MENA region and in the global economy

Saudi Arabia is the largest economy of an emerging regional block, the Gulf Cooperation Council (GCC) formed by Bahrain, Kuwait, Oman, Qatar, the United Arab Emirates and the Saudis. The Kingdom of Saudi Arabia contributes with 49% of the total GDP of the economic bloc and 67% of the total population. Despite the recent setback product of the international financial crisis, the GCC has seen very important economic developments in the recent decade. Banking on high oil prices since 2003, the region has tackled one of the long standing policy challenges, the diversification of their economies away from oil. As a result, the non-oil activities have expanded faster than the energy sector and the region has become one of the global economic growth poles attracting both foreign workers and foreign direct investment (FDI). Regardless of the fiscal expansion and rapid import growth, the region has maintained healthy fiscal accounts allowing for the accumulation of important fiscal surpluses. As a consequence, the Gulf countries are today home to some of the largest Sovereign Wealth Funds (SWF). While clear information is lacking, market speculations estimate that the value of assets under management between the two largest GCC SWFs (the Abu Dhabi Investment Authority and the Saudi Arabian Monetary Agency Foreign Holding) in 2009 was well over one trillion US dollars. All these recent developments have increased the international profile of the GCC countries and of Saudi Arabia in particular as the main economy in the bloc. They are not longer only regarded as the main exporters of oil but have became also a dynamic growing region that is a net supplier of capital in global markets, has increasing commercial tights with the rest of the world, and controls key global assets through their Sovereign Wealth Funds. As a result, the GCC countries have become part of the international debate on global imbalances and financial stability.

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The objective of this paper is to analyze the evolution of the Kingdom of Saudi Arabia from an open economy but closed social and political system with little involvement in the world economy to its first steps towards becoming a true global player. In the next section we briefly document some of the economic and political transformations of the last two decades in the KSA, discussing as well some of the key pressing issues that may have an important effect on the Saudi policy agenda in the years to come. The subsequent section reviews the participation of the Kingdom of Saudi Arabia in international organizations and its involvement in the Arab world. The paper concludes with an assessment of the effects of the recent market volatility episodes on the foreign policy agenda of the country and its participation in the G20 Summits as a major, stable, credible economic power in the international stage.

OIL, ECONOMIC DIVERSIFICATION, AND POLICY CHALLENGES

The development of the Saudi economy is closely linked to the establishment and expansion of the Saudi state during the last sixty years. The oil revenues financed the development of a bureaucracy that worked to unify an economically diverse country. The developing of the oil sector was crucial to domestic policy stability and a guarantee of foreign protection during the several regional conflicts. Between 1962 and 1979, Saudi Arabia became a powerful centralized state legitimated by the state provision of benefits directly to the population, and by extensive economic and social development financed by the sharp increase in oil prices. This bonanza was short lived as prices collapsed in 1982 what required Saudi officials to change their emphasis from managing large surpluses to coping with growing budgetary and balance of payments shortfalls. A more commercial approach to oil exports and better OPEC discipline boosted oil revenues from 1986 but the invasion of Kuwait by Iraq cost the Saudi government $60 billon, depleting the last reserves accumulated during the oil-boom days. This greatly constrained the ability of the ruling family to finance the three priority programs of the 1990s: the oil sector capacity expansion plan, the increase in defense and arms purchases, and the maintenance of public investment to sustain the domestic standard of living. Rising unemployment and social discontent among the youth create the ideal conditions for Islamist challenges to the monarchy regime during this period. As a response to the crisis, Saudi Arabia embarked in the late 1990s on

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an ambitious reform campaign to remedy its long-term economic stagnation, pushing for further economic diversification and searching for innovative institutional development to reduce the presence of a "rentier state".

The formidable increase in the price of oil that started in 2003 gave the House of Saud a new opportunity to push for further economic reforms. The oil revenue helped the regime to buy off and shore control over Wahhabi clerics and to reduce the level of discontent among the poorer section of the society. Learning from previous mistakes, the government of Saudi Arabia drastically reduced the amount of oil revenues used for current consumption, directing these resources to long-term capacity building and human resources development rather than hardware acquisition and spending on showcase projects. In the last few years, there have been also talks on how to reduce the economic dependence on the government through programs to regenerate the indigenous private sector in the non-oil sector.

However Saudi Arabia is in a very different position from contries like China and India as it is a energy-exporting country, it has already high per-capita emissions, it is wealthy and it has relatively high adaptive capacity. Even more, Saudi Arabia is potentially vulnerable to trade barriers against their high-carbon industries such as aluminium, steel, oil refining, petrochemicals, gas-to-liquids, etc. what makes the potential impact difficult to predict for the government.

Despite the significant revenue windfall of the last years and better fiscal management, public services like education, health care, sewage systems, and water distribution have not improved for many of the inhabitants of the country. Looking forward the country faces enormous policy challenges. In the face of a growing young population, one the most important challenges for the Kingdom is human resource development. This implies the construction of new schools and universities but also curriculum reform to fill the existing gaps and mismatches in the job market. Like other GCC countries the government will need to address structural problems in the labor market that today are segmented with both low and high-skilled expatriates combined with high unemployment among the Saudi youth. A growing population and ambitious plans for industrial development mean that the domestic demand for power and water will continue to grow at roughly 8% per year. Meeting this demand will require investments in installed capacity for more than $250 billon through 2025. Tight credit conditions and private sector de-leveraging implies that the State will have to assume most of the financial burden on these projects. As we will refer in detail in the last section of this paper, the country will also need to secure a diverse source of food imports. Another policy challenge for the government is to forecast the likely impact climate change policy will have in the development of the fossil fuel sector. The Gulf shares some climate issues with developing countries such as vulnerability to climate change and reluctance to have economic growth slowed by CO_2 limits. However Saudi Arabia is in a very different position from contries like China and India as it is a energy-exporting country, it has already high per-capita emissions, it is wealthy and it has relatively high adaptive capacity. Even more, Saudi Arabia is potentially vulnerable to trade barriers against their high-carbon industries such as aluminium, steel, oil refining, petrochemicals, gas-to-liquids, etc. what makes the potential impact difficult to predict for the government. Yet another challenge is the limits to State-led growth and the need for further diversification strategy that affects most sectors and not only those associated with the energy sector. On top all these issues the question of internal and external security remains always latent. We expect that all these economic and social policy challenges will shape both the domestic and international agenda of the Saudi government in the years to come.

REGIONAL AND GLOBAL ENGAGEMENTS OF THE KINGDOM OF SAUDI ARABIA

Historically, Arab policymakers have been reluctant to deeply integrate their economies with the outside world. Saudi Arabia has not been an exception to this. Integration with the global economy has been a divisive issue, with most members of the House of Saud and the merchant elite in favor of economic liberalization and the majority of the population and the religious leaders opposing the opening of the country. Saudi officials have had to deal with the disjunctive of modernizing the economy while maintaining traditional values and safeguarding the power structures. On the external front, the government has had also to deal with international pressure to open their domestic markets, reduce government interference in the markets, and deal with several geopolitical issues such as the fight of insurgent groups, the support of the different US interventions in the region, and as a mediator in the different regional conflicts.

Given the domestic policy constraint and the international pressures, Saudi policy makers have selectively used external anchors such as affiliation to international organizations to promote internal policy reform, reinforce credibility, and lock in commitments without necessarily buying into the full globalization logic. Saudi Arabia is member of both the World Bank and the IMF. It joined the Bank in 1957, a few years later than other non resource rich Middle East countries, as the main incentive for membership, the access to development finance and technical advice, was not a pressing issue for oil rich Saudi Arabia. The country acceded to IMF Article VIII in 1961, accepting to not impose capital controls on current account transactions both outward and inward. These memberships signaled the commitment of the Kingdom to some economic openness. For the country, the peg of the riyal to the US dollar, and the free convertibility of the currency have been major stabilizing factors as oil prices are denominated in dollars. Despite these measures, the Saudi economy is not totally opened as there are some limitations to foreign investment in particular economic sectors such as oil, telecommunications, and financial services.

The decision of the government to adopt the external demands wholesale significantly reduced the room for inter-agency politics. A series of trade deals with the European Union and the United States, and further regulatory changes finally permitted the accession of Saudi Arabia to the WTO in November 2005. As a result, the country had to give substantial concessions such as allowing 60% foreign ownership in banking and insurance, and 75% foreign ownership of distribution within three years.

Under the mercantilist logic of quid pro quo that characterized most international trade negotiations, there was initially little incentive for Saudi Arabia to join the World Trade Organization (WTO) as no country imposes tariffs on oil and there were internal concerns that WTO rules would be at odds with local interpretations of Sharia law regarding the proscription of certain goods and services deemed as un-Islamic. However, as Saudi Arabia started to produce petrochemicals and diversify its economy away from oil, it became evident that membership in the WTO could bring substantial benefits to the country in form of lower tariff for its exports and cheaper imported good. Negotiations started in 1996 but rapidly got stuck as the Kingdom was not willing to make concessions that would affect some local interest groups and the proposed binding tariff rates were seen as too high by the international organization. Saudi Arabia complained of unfair treatment as other Arab countries, notably Egypt, were admitted without too much hesitation despite having more restrictive policy than those of the Kingdom. The accession process got jammed until 2003 when a limited cabinet reshuffle and a decision of the leadership, that realized that external conditionality would become only harsher with time, to move the WTO issue to the top in the policy agenda gave new impetus to the negotiation. The decision of the government to adopt the external demands wholesale significantly reduced the room for inter-agency politics. A series of trade deals with the European Union and the United States, and further regulatory changes finally permitted the accession of Saudi Arabia to the WTO in November 2005. As a result, the country had to give substantial concessions such as allowing 60% foreign ownership in banking and insurance, and 75% foreign ownership of distribution within three years.

Like any other open economy, Saudi Arabia has increasingly been exposed to both the positive and negative economic effects of globalization. The recent crisis has proved that regional hegemony is not always a valid alternative to global integration and that the Saudi economy is part of a larger system. In recent years, Saudi Arabia has been greatly affected by the remarkable volatility in oil, food commodities, and international finance.

Saudi Arabia has also explored the possibility of economic integration with other Arab countries as an alternative to full integration in the global economy. On the diplomatic side, Saudi Arabia has been an active member of the Arab League since its foundation in 1945. The Kingdom has acted as broker in several peace initiatives and has provided financial resources to Arab countries in difficulties. On the economic side, the Arab Free Trade Area (AFTA) or Great Arab Free Trade Area (GAFTA) was agreed in 1998 by 18 out of 22 members of the Arab League. Saudi Arabia was part of this group of countries. The treaty became a reality on January 1st 2005 when tariffs on intra-Arab trade were eliminated. The commitment covered only trade of goods, not service, investment or factor mobility. The treaty did not reduce nontariff trade barriers either. The analysis of trade flows data shows low intensity of intraregional trade (Middle East share in Saudi total trade is around 5%) and therefore there is little expectation that the GAFTA, even if fully implemented, will have a large economic impact. A careful look to the data shows however that there are some positive trends since the implementation of the treaty such as the fact businesses are playing a more important role than the government and there has been an important increase in intra-MENA FDI flows (mainly by Gulf countries).

Saudi Arabia is also behind the initiative of creating a common market with the other five Arab countries of the Gulf. The GCC was created in 1981. The free trade area was established in 1983 and the custom union was eventually established in 2003 with a common external tariff of 5%. The next step, the creation of a single market and monetary union has been delayed as not all GCC countries fulfilled the five criteria of convergence that have been agreed on (budget balance, foreign reserves, public debt, interest rates on deposits and inflation) and because of the recent conflict over the location of the Central Bank that led the United Arab Emirates to pull off from the single currency agreement in protest to the Saudi hegemony. Even if this political controversy is resolved, there are compelling reasons to think that there is a very limited scope for the GCC integration. The GCC countries are rich in energy but relatively poor in other natural resources, they have a restricted set of opportunities for engagement with the world economy and little chance of following a manufacturing export route to economic development or, given the small population, the development of larger consumption markets like in the case of Europe. Even more, GCC countries have recently choose to diversify their economies in similar areas: tourism, banking, real estate, and logistics. For all these reasons the GCC is at most a way for Saudi Arabia to integrate in the world economy from a strengthen position. As we will discuss in the next session, the recent instability in world markets have shown Saudi Arabia that the answer to some of the thread to the Saudi economy lay far beyond the Gulf or the Arab world in general.

THE RECENT MARKET VOLATILITY EPISODES AND THE ROLE OF SAUDI ARABIA IN THE G20

Like any other open economy, Saudi Arabia has increasingly been exposed to both the positive and negative economic effects of globalization. The recent crisis has proved that regional hegemony is not always a valid alternative to global integration and that the Saudi economy is part of a larger system. In recent years, Saudi Arabia has been greatly affected by the remarkable volatility in oil, food commodities, and international finance. As a small open economy, the country realizes that the events leading to these wide fluctuations are beyond their control and have been searching for ways to have its voice heard in international forums without compromising the control over their domestic policy agenda.

Despite some successful diversifications initiatives, the Saudi economy is still highly dependent on its oil revenues. In 2006 for instance, oil income generated 89% of government revenues, 87% of export earnings, and represented 54% of the Gross Domestic Product of the country. Saudi officials have constantly claimed that a fair price for oil should be between $75 and $80 per barrel. The government budget for 2009 has a break-even price of $54 per barrel (Bahrain has the highest in the GCC with $84, and the UAE and Qatar the lowest at $24). The observed recent volatility in oil prices and the push for new sources of renewable sources of energy are a source of great concern for policy makers in Saudi Arabia. Saudis claim that the promotion of a rapid growth in renewable fuels may trigger a "nightmare scenario" where oil suppliers cut back their investment in new fields and installed processing capacity and the new sources of energy do not growth fast enough to cover a raising demand for energy. Some sectors in Saudi Arabia have been very vocal against climate change policy from the really beginning of the debate and to any change in the status quo. Other sectors instead, do not see climate change policy as a thread but as an opportunity to switch to more value-added production in the petrochemical sector. Given these two opposite views in the Kingdom, it is unclear whether the government is pushing for a smooth transition to a low carbon world economy or just trying other countries to scrap their alternative energy plans. As we will see below, the G20 has been an important platform for the Saudi government to encourage same compromise from the largest economies to secure stable high oil prices.

The Saudi policy agenda during its participation in the recent G20 meetings is a reflection of the main concerns for the Saudi economy that we reviewed above. As it is the tradition in Saudi politics, they have kept a low profile during the Summits but making sure that the final documents reflected their inputs in what they consider the key issues for the Saudi economy.

Other source of concern for Saudi officials is the developments in international food markets. The food price boom of 2007-2008 triggered alarm in the policy circles of the Kingdom. For a country with little fertile land and insufficient water reserves, ensuring alternative means of long-term food supply is essential. As a response of the food embargos of the 1970s and using part of the revenues accumulated during the first oil boom, the Kingdom embarked itself in an extensive program to become self-sufficient in the production of food. The execution of the program between 1980 and 1999 led to the consumption of two-thirds of the country's non-renewable water sources. Given the unsustainable implementation of this policy, the government decided in 2008 to phase out food production. That left the country to the options of been exposed to dramatic commodity prices swings or to invest directly on food production abroad. The numerous attempts of the Saudi government to secure agriculture lands in Africa (for example the Hail Agricultural Development Company deal in Sudan for vast swaths of lands and the talks with the Tanzanian government for a 500,000 hectares lease deal) raised concerns in the international community, labeling the initiatives as a form of new colonialism. As a response, the Saudi government has decided to get more involved in the multilateral organizations and specific agencies dealing with food security issues. An example of this was the donation of $500 million to the World Food Programme and the sponsorship of the World Food Summit on Food Security in the Headquarters of Food and Agriculture Organization in November 2009.

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A third source of concern for the Saudi government in dealing with an increasing global economy is the volatility in financial markets. Saudi banks were not as affected by the international crisis because they are not widely integrated into the financial system, but the value of government assets' holding depends very much on the health of the US dollar and the international financial markets. This concern is rather new for Saudi policymakers, as the collapsed of oil prices in the late 1990's led to serious problem of debt sustainability and public budget financing in Saudi Arabia. The combination of prudent fiscal policy and the astronomic increase in the price of oil from 2003 allowed for a remarkable transition of the country from net debtor to net creditor. The accumulation of a sizeable Sovereign Wealth Fund managed by the Saudi Arabia Monetary Agency (SAMA) means that the country is also concern by developments in the financial markets. The policy of SAMA has been mostly to invest on low-yield, low-risk U.S. treasury bonds. Despite of this, the leadership is aware of the limitations of this investment policy. They recognize the risk associated with the evolution of the dollar as an international reserve currency, given that their currency is pegged to the dollar and most of their assets are dollar denominated. They also understand that, despite their sound monetary policy and prudent investment policy, they are not except from the financial market volatility observed since the second semester of 2008.

The Saudi policy agenda during its participation in the recent G20 meetings is a reflection of the main concerns for the Saudi economy that we reviewed above. As it is the tradition in Saudi politics, they have kept a low profile during the Summits but making sure that the final documents reflected their inputs in what they consider the key issues for the Saudi economy. Despite the relatively minor impact of the crisis on their economy, Saudi Arabia boosted spending in infrastructure, education and health care looking to underpin economic growth. According to an IMF study the Saudi fiscal stimulus, valued in $400 billon for five years, was the largest in terms of GDP among the members of the G20. The Saudis have also promoted the idea during the G20 Summits that these efforts should be country specific and should be kept for some time even after seeing growth rates recovers. Besides this push for fiscal measures in member countries, the Saudis have been reluctant to directly contribute to other countries' stimulus packages, refusing to increase their contribution to the IMF when it was suggested in the early stages of the crisis. This is probably related to another recent debate in which the Kingdom of Saudi Arabia has been part. That is, the controversy over the members' voting power in international organizations. Emerging economies such as China, Russia, Brazil and India have long argued for an increase in their voting power in key financial institutions like the IMF and the World Bank to accurately reflect their growing weight in the global economy. Saudi Arabia supported the emerging market countries' demand for better representation in the financial institutions, not at the expenses of other emerging and developing countries but from the share of developed countries that are overrepresented. This statement was in response to European G20 sources that said that they would prefer to see the shift come from overrepresented nations to all underrepresented nations, no matter whether the member is a developed or a developing country. The sources named Saudi Arabia as the example of a developing country that is overrepresented in the IMF. According to the Ministry of Finance of the KSA, Ibrahim Al-Assaf, Saudi Arabia should retain its weight in the IMF because of its position as a major player in international oil markets and the impacts this market has on the world economy at large.

The stimulus measures were the immediate priority during 2008 and 2009 G20 Summits. Past this first instance, the focus switched to the question on how to regulate the financial markets to avoid a repetition of the collapse we experienced in 2008. In light of the severity of the crisis, this is one of the main concerns for both the Saudi economy and the entire world. While there was little dispute among the G20 leaders that a global failure of regulators helped cause the financial and economic crisis, there has not been a global agreement on how this regulation should be implemented worldwide. Excessive borrowing by banks, the explosive growth of hedge funds and a bonus culture that offered big rewards for short-term profits have all been singled out for blame. Going into the September 2009 meeting all the countries agree on the problems, however it was not clear what solution should be adopted to avoid a similar collapse in the future. Basically there were four alternatives. The first one was to create a new global regulator. This was the first option proposed by some European leaders, including French president Nicolas Sarkozy. However, this option was somehow hard to implement as too many differences remained between the G20 members over what this would require. For instance, some nations, including Saudi Arabia, fear that their domestic financial firms would be subject to foreign audits, supervision and public scrutiny. The second option was a college of regulators. This would take the form of a forum of international banks that would share data and issue guidance on best practices among the G20. However, it would have no enforcement powers. The third option was the self-regulation of the financial industry. This would involve establishing an independent third party to monitor financial services institutions. Using a principle-based framework, the monitoring body would set broad outlines for sovereign regulatory systems but have no enforcement powers. The last option was the continuation of status quo what implied a broad declarations of cooperation among members, but not fundamental change in the patchwork regulatory system that exists. The Saudi delegation favored the last options as they have been relatively successful steering monetary policy in Saudi Arabia and in safeguarding the safety and soundness of the Saudi financial system despite the difficulties experienced by two important family groups (the Saad and Gosaibi) that led to severe liquidity constraints in the financial sector during 2009. They recognized the need for more effective regulation and support a global coordination on this regard but without affecting their autonomy on domestic financial issues. This particular point of view was also shared by most of the countries Saudi Arabia seems to represent, the GCC and the larger Arab financial and economic community. The US and UK had a similar vision and therefore the outcome of the Summit was in line with what the Saudi government expected. The G20 formalized in Pittsburgh a number of commitments for future regulation of the financial industry, including: increased capital standards; implementing international compensation standards; increasing regulation of the over-the-counter derivatives market; and creating more powerful tools to account for financial risks. For each of these, it set timelines to make the recommendations specific in detail and measurement to help ensure these changes can and will be delivered. The next G20 Summit may provide further details on these matters.

Another area that was important for the Saudi government and that was covered during the Pittsburgh Summit was the issue of energy security and climate change. The declaration of Pittsburgh stated that “Inefficient markets and excessive volatility negatively affect both producers and consumers” and that the G20 countries individually and collectively commit to: "Increase energy market transparency and market stability by publishing complete, accurate, and timely data on oil production, consumption, refining and stock levels, as appropriate, on a regular basis, ideally monthly, beginning by January 2010. We note the Joint Oil Data Initiative as managed by the International Energy Forum (IEF) and welcome their efforts to examine the expansion of their data collection to natural gas" and "improve regulatory oversight of energy markets by implementing the International Organization of Securities Commissions (IOSCO) recommendations on commodity futures markets and calling on relevant regulators to collect data on large concentrations of trader positions on oil in our national commodities futures markets". This declaration has probably the direct input of the Saudi delegation as the country felt strongly that a lot of the instability in the energy markets was due to speculation from hedge funds and large banks. The statement also mentioned the Joint Old Data Initiative, an organization based in Riyadh that according to Saudi officials has not received enough attention from both consumer and producer countries. During the Summit there was also a principle of agreement on an issue of particular interest to the Kingdom, the process of switching to other sources of energy. The Summit called for access to diverse, reliable, affordable and clean energy and asked the Ministers to provide their strategies by the next G20 meeting on how to "phase out and rationalize the medium term inefficient fossil fuel subsidies". As it was mentioned before, some sectors in the country worry if there was a major effort to cut oil subsidies and emissions worldwide that would mean less crude oil consumption with a negative impact in the Saudi economy. On the other hand, some sectors inside the Kingdom are hoping to use more oil for their own economic development instead for the export markets. If the major economies can agree on a predictable path to reduce oil dependency, that could help set the domestic agenda in Saudi Arabia in favor of the development of their downstream industries what would have a positive effect in the long run.

Summing up, despite their low profile and conservative policy agenda, the outcome of the recent G20 meetings has been favorable for Saudi Arabia. The participation of the Kingdom reflects not only its systemic role in the global production of energy but also its substantial financial assets holdings and its leadership over a very dynamic economic region.

Summing up, despite their low profile and conservative policy agenda, the outcome of the recent G20 meetings has been favorable for Saudi Arabia. The participation of the Kingdom reflects not only its systemic role in the global production of energy but also its substantial financial assets holdings and its leadership over a very dynamic economic region. The future prospects looks even better for the Saudi diplomacy as one of the first major announcements to come out of the Pittsburgh meeting was that the group will become the new permanent council for international economic cooperation. This means that the much larger G20 meeting will essentially replace the smaller G8. This decision will help to include not only major developing nations such as China, India and Brazil which were originally not included in the G8, but also Saudi Arabia. This permanent participation will allow the Saudis to have their voice heard when global leaders meet in the future to discuss issues related to financial markets regulation, energy security, climate change policy, and food security, all very important matters for the future of Saudi Arabia. Even more, their participation in these global forums may work as a catalyst for further change in their domestic policy.