

## **Saudi Arabia and the Gulf Region in the World Economy and in World Politics**



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Summary Report  
Christoph Frei, University of St.Gallen

## Preface

The Fletcher School of Law and Diplomacy at Tufts University and the Master of International Affairs Program at the University of St.Gallen invite each year approximately 40 participants for a high-level dialogue around global issues of strong economic and political relevance. The first series addressed "The Evolving Economic and Political Architecture in Asia and Its Geostrategic Impact" (2006), "Energy, Resources, and Geopolitics: Implications for Corporate Strategy" (2007), "The Economics and Politics of the Eurasia Region" (2008), and "Saudi Arabia and the Gulf Region in the World Economy and World Politics" (2009). This summary report covers the 2009 meeting.

Every year, the discussions are supported by short presentations which provide factual background and raise critical issues for debate. Their clarity and thought-provoking inputs greatly contribute to the understanding of the complex issues and prove enormously helpful for the deliberations. I thank the presenters 2009 in alphabetical order for their very helpful insights:

*Ali Aissaoui*, Head Economics & Research, Arab Petroleum Investments Corporation;

*Raad Alkadiri*, Senior Director, PFC Energy International;

*Omar Ahmed Bahlaiwa*, Secretary General, Committee for the Development of International Trade (CIT), Council of Saudi Chambers of Commerce and Industry;

*Christian Blickenstorfer*, Swiss Ambassador to Germany, former Ambassador to the Kingdom of Saudi Arabia and to the United States of America;

*Lucia van Geuns*, Deputy Director, Clingendael International Energy Programme, Netherlands Institute of International Relations;

*Heiko Hesse*, Economist, Middle East and Central Asia Department, International Monetary Fund;

*Majid Jafar*, Executive Director, Crescent Petroleum Group;

*Tim Niblock*, Professor, Institute for Arab and Islamic Studies, University of Exeter;

*Abdulaziz O. Sager*, Chairman of the Gulf Research Center, Dubai, and President of Sager Group Holding;

*Constantin Salameh*, Chief Operating Officer, Emirates International Investment Company;

*John Sfakianakis*, Chief Economist, Banque Saudi Fransi.

Our meetings respect the Chatham House Rule. Accordingly, participants can express their personal opinion without risk of public disclosure. Nevertheless, we find it helpful to make the main results of the discussion available to a wider public. Christoph Frei once again authored this summary report which gives a candid summary of the issues discussed and the areas of convergences of opinion. As compared to the actual experience of the participants during the day, the richness of individual arguments may partly be lost in such a synopsis, yet this is compensated by greater coherence of the main lines of discussion. I am convinced that participants and outside readers join me in thanking Christoph Frei for the great job he has done.

I also express my gratitude to persons and institutions that have made this seminar possible. Abdulaziz O. Sager and Giacomo Luciani from the Gulf Research Center as well as Vahan Zanoian from PFC Energy International have provided invaluable advice in formulating the program and in choosing and inviting our guests. The Ecoscientia Foundation and the Holcim Group have provided generous financial support. Tufts University offered their splendid European Center in Talloires on the shores of Lake Annecy. The hospitality of Gabriella Goldstein, Director of the Tufts European Center, and her staff makes the Center a place to remember far beyond its physical attraction.

Heinz Hauser

# **Saudi Arabia and the Gulf Region in the World Economy and in World Politics**

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## **Introduction**

Up until the 20<sup>th</sup> century, Western societies had precious little appreciation of the rich history and culture of the Islamic Middle East. Knowledge of the Arabian Peninsula, in particular, was almost nonexistent until oil was discovered there in 1938. With its offshore islands, the peninsula covers about 2.6 million square kilometers. Constituent countries are Bahrain, Kuwait, Oman, Qatar, United Arab Emirates, Yemen, and, the largest, Saudi Arabia. The area is covered almost entirely by the Arabian Desert, the economy is dominated by the production of petroleum and natural gas. As is well known, the world's largest proven reserves of petroleum are in the Arabian Peninsula.

Most of the states of the peninsula are monarchies whose legitimacy is largely founded on religious principles. Since World War II, their rulers have attempted to combine gradual change in political life with rapid economic and social advancement. Although the peninsula's available natural resources are not distributed equally among its states—those in the south and southwest derive far less wealth from oil, for example—comparable economic transformations have taken place, or are taking place, in all these societies.

As always, the broad topic of the seminar was structured into four sessions to give greater focus and thrust to our exchanges. The summary presented here does not make any claims to completeness. All it hopes to achieve is to concentrate on selected focal points, questions as well as answers, which may in turn serve as starting points for further exploration and discussion. Readers should keep in mind that the reported facts and figures reflect the situation as of fall 2009.

## **I. The Role of Saudi Arabia for Global Energy Security**

The first session was devoted to energy supply and, more specifically, to energy security. How should we respond to the finite nature and the alleged instability of fossil fuel supply? Should we anticipate another spike in prices any time soon? What role does Saudi Arabia play in this context? On the basis of acknowledged facts and figures, our panelists took as their point of departure that there is enough oil and gas for decades to come. They also expect, however, that global demand will resume in a not-too-distant future and that increased demand will not be met without huge investments in new supply capacities.

## Enough oil ?

Demand for oil will be driven by two main factors. On the one hand, there are demographic projections. Whereas world population was approximately one billion at the beginning of the industrial revolution, we currently count close to seven billion people, a number that will increase to nine billion by 2050. Rising demand for energy, then, owes much to population growth. This may not hold for most highly-industrialized OECD countries, but it certainly does for emerging countries such as China, India, or Brazil.

Besides demography and beyond the current economic downturn, broader economic development will keep boosting demand for energy. A major driving force in this context is transportation—a sector that is still almost exclusively based on fossil fuels, and one that is growing rapidly. The number of petroleum-fueled vehicles on the planet is expected to rise from 900 million vehicles at this time to roughly two billion vehicles in 2040. Again, this incremental growth will be generated in emerging economies rather than in OECD countries.

What about supply? Approximately 60 percent of global oil reserves are located in the Greater Middle East. For many years, every important energy supply model tended to assume that Saudi Arabian oil in itself was so plentiful and could be produced so inexpensively that its supply alone was sufficiently expandable to meet any realistic global increase in demand at least through the year 2030. To its undisputed credit, Saudi Arabia has always made good on its commitments to provide the oil needed to prevent supply shortages in the markets. Based on past behavior, there would, therefore, seem to be good reason to believe Saudi assurances about the future availability of its oil.

Then, about five years ago, Matthew Simmons presented a well-documented argument in which he questioned the notion of ample Saudi reserves. In his best-selling book *Twilight in the Desert*, Simmons contended that Saudi Arabian production in fact was at or very near its peak sustainable volume already, and that it was likely to go into decline in the foreseeable future. While hardly anyone beyond oil company executives and environmentalists had paid much attention to the peak oil issue prior to Simmons' book, the topic has become of keen interest ever since, not least because of the dramatic rise in oil prices prior to 2008.

Given a remarkable diversity of estimates and interpretations, not everyone is willing to go along with Matthew Simmons. As a matter of fact, many respected energy economists (several of whom were present at the Globe Leadership Seminar) concur that Saudi oil production capacity is actually much below its potential in view of the country's large subsurface reserves. With regard to the prospects for global supply, they also concur that oil *could remain plentiful* for decades to come. As the wording indicates, however, such abundance cannot be taken for granted.

## **Investment is the name of the game**

The case of Saudi Arabia is telling. Ninety percent of the country's entire oil output has come from just a few giant fields. The three most important ones have been producing at high rates for over 50 years. All of them are growing old, yet they continue to provide a major part of current output. At Saudi Aramco, the Kingdom's national oil company, there is certainly no lack of expertise, let alone modern technology. Yet, little has been done in the way of exploring new fields and more efficient forms of productions.

What is the broader implication? Fossil fuel reserves are still available, in principle. Yet they are concentrated in just a few countries, all of which have been either unwilling or unable to invest in exploration and in building new capacities. In the cases of Iraq and Iran, for example, analysts deplore a "drastic underperformance" with regard to both exploration and production technologies over the past 15 years. Whereas Matthew Simmons doubts the very existence of sufficient reserves, his peers pinpoint a different problem: oil is there, but cannot be exploited yet.

"Thus, investment is the name of the game." Even if global demand for oil were to remain stable over the next 20 years, the industry would have to compensate for the depletion of a large number of today's oil fields in order to maintain the current level of 85 million barrels a day. The International Energy Agency —an institution established by oil importing countries in the wake of the 1973 oil embargo— calculates the global net decline of mature oil fields at around five percent per annum from 2008 to 2013. In order to compensate for that net decline, over 3.5 million barrels per day of new capacity would be needed every year. With a view of meeting demand over time, World Energy Outlook envisages necessary annual investment for oil to be around \$220 billion until 2030.

In the Arabian Peninsula much as in Russia, East Asia, and elsewhere, investment decisions hardly depend on economic incentives alone. In the 21<sup>st</sup> century, scarce resources are the stuff of geopolitics. While many other sectors across the board have been moving towards privatization and private sector investment, the oil sector has—governments willing and governments pushing—moved in the opposite direction. The track record of national oil companies (or NOCs, such as Saudi Aramco or Kuwait Petroleum Corporation) may not be impressive in every instance. Yet, NOCs matter. According to the U.S. Energy Information Administration, they accounted for 52 percent of global oil production in 2007 and controlled 88 percent of proven oil reserves in the same year. Today, the world's top ten oil companies are NOCs. In the Greater Middle East, these players control investment policies as well as mid- and long-term strategies. As they seek and strike bilateral agreements with other NOCs from around the globe, politics and business blend in new and peculiar ways—and leave many in the international business and energy communities bemoaning a lack of transparency in what used to be the marketplace.

While NOCs have kept growing in importance in recent years, life has become more complicated for traditional international oil companies (or IOCs, such as Royal Dutch Shell or Brit-

ish Petroleum). For them, the era of "easy oil" in the Middle East is definitely over. Some remain in the region and cooperate with NOCs to help, for example, increase efficiency or develop new capacities. Guided by necessity as much as by genuine preference, some IOCs have turned elsewhere and invest increasingly in more "difficult oil," that is, oil produced through non-conventional, highly sophisticated methods. Of course, more difficult oil is also more expensive oil. Eventually, IOCs may stop operating as extractors and processors of primary natural resources altogether and transform themselves into full-fledged energy companies offering a broad array of products even beyond fossil fuels.

### **Security of supply vs. security of demand**

Marked by strong market volatility and the financial crisis, 2008 and 2009 saw the first consecutive annual decline in liquid fuels consumption since the early 1980s. Whereas oil prices had soared to \$150 per barrel in the summer of 2008, they fell to under \$35 just a few months later. While the oil market had been very tight earlier on, there were spare capacities of up to six million barrels a day in 2009—a comfortable cushion that was widely expected to help reduce price volatility for the time being.

Rapid swings in oil prices, be they induced by real supply-demand-imbalances or by speculation, invariably evoke discussions about global *energy security*. The notion gained notoriety some 36 years ago when Saudi Arabia and other oil producers introduced a rather sophisticated, gradual embargo by further reducing production every month to support UN resolutions concerning Israeli occupation of Palestinian territories. Even though several oil ministers went around the world and declared that the measure was not directed against Western economies as such, public opinion in the West would soon depict the Organization of Petroleum Exporting Countries (OPEC) as the enemy.

As a heuristic tool, the concept of energy security has changed over the years. Coined originally in response to fear of dependence on foreign oil, energy security was first associated with "security of supply" on the part of energy importing countries. Over the course of time, the concept then broadened to include "security of demand," that is, the perspective and concerns of countries dependent on the exportation of oil. More recently, and in recognition of the growing interdependence between stakeholders, a new paradigm on global energy security has emerged—a broad paradigm in which 'security' relates to dimensions such as improving the energy investment climate; addressing environmental challenges posed by different energy supply mixes; and enhancing the producer-consumer dialogue in order to bring about more transparency and stability in the markets.

## Fair pricing ?

The aforementioned producer-consumer dialogue found its institutional underpinning in the International Energy Forum in Riyadh. In this context, talking about one's own oil price preference used to be taboo. With oil-importing countries inevitably focusing on reliable and *affordable* supply, however, and oil producers focusing on stable and *remunerative* demand, the issue of energy prices was hard to keep under the table—especially so in a time of unstable markets. Obviously, both sides shared a strong interest in promoting price stability through appropriate measures.

Who was going to reveal their own preference first? Empirical evidence suggests that oil consumer countries are better prepared to cope with price volatility. This may explain why, as a group, they tended to remain rather vague about their preference. The producers, by contrast, were more straightforward. The underlying reason is easy to grasp. For the (mostly Western) member states of the International Energy Agency, energy imports represented just about 21 percent of total energy consumption in 2008, while the share of energy trade (both imports and exports) was only some seven percent of aggregate GDP. By contrast, petroleum exports represented about 85 percent of total exports and petroleum trade accounted for 64 percent of aggregate GDP in OPEC countries. Moreover, petroleum taxes represent 90 percent of all budget revenues in OPEC countries—which is another way of stating that the fiscal value of oil is precious indeed.

The aforementioned slump in oil prices prompted Saudi Arabia to announce \$75 per barrel as its preferred price (dubbed "fair price") at the end of 2008. This unprecedented move was immediately and positively echoed by most OPEC member states and was greeted just as favorably at the World Economic Forum in January 2009. All sides called for a price in the range of \$60 to \$80 per barrel to sustain investment.

Obviously, the markets lack an inherent capacity to reveal such preferences. Why is it, then, that producers and consumers readily concur on a price range of \$60 to \$80 dollars per barrel? An evaluation presented at the seminar combined the economic cost of production on the one hand and the fiscal value of petroleum assets on the other. In this model, the fiscal value of petroleum was derived by applying Milton Friedman's permanent income expectation hypothesis. On the other hand, the investment cost of producing one barrel of crude oil was determined by assessing the economic viability of different exploration and development projects under relevant risk conditions. Along these lines, nearly 1.1 trillion barrels of crude oil have been produced so far at an economic cost below \$30 (2008 dollars) per barrel. The cost of exploiting the remaining conventional oil is estimated at below \$30 per barrel in the Middle East and North Africa, and up to \$40 per barrel in other regions. Production cost falls between \$30 and \$70 per barrel for oil sands, while the cost of oil from enhanced recovery projects is between \$30 and \$80 per barrel. Oil shales are the most expensive to exploit with costs ranging from \$50 to \$110 per barrel, and the cost of gas-to-liquids and coal-to-liquids is equally high.

A dual non-market perspective of this kind establishes that a Saudi price preference of \$75 per barrel lies in fact within a range that is at the confluence of the economic cost and the fiscal value of a barrel of oil. Is this Saudi Arabian price preference, then, relevant for global energy security? One short answer would be yes—yes to the extent that it can help bridge the divide on price issues between oil producers and oil consumers.

What will the oil price do once the current downturn is behind us? Against the backdrop of commonly recognized economic conditions and parameters, energy economists around the table agreed that there was no justification whatsoever for oil prices at 150\$ per barrel - "unless the Goldman Sachs of this world come back and talk the market up again."

As long as uncertainty with respect to the price of oil continues, it will undeniably remain a major disincentive to the formation of investment in new capacities. In light of this impediment, one experienced practitioner called for a wide-ranging accord between producers and consumers, "even though such a covenant would probably require some re-interpretation of classical economics." An accord of this kind would have to be set in motion by the consumer side rather than by the producer side. "We in the West would have to reconcile ourselves to the fact that there is a price below which it is not in our own, enlightened interest as consumers to see oil sold at." Without such a far-reaching accord and price stability, it is going to be very difficult for the oil industry to assure the world that the flows of investment will be sufficient to meet rising demand.

### **Saudi Arabia, central bank of oil**

As the world's biggest oil producer and regular holder of the largest spare capacity, Saudi Arabia has what may be dubbed a "cushioning role" in the oil market as this spare capacity is perceived as ample enough to influence market expectations. Several participants made a point of acknowledging not only the special role, but also the responsible demeanor of the Saudi leadership in this context. Since the 1990s, the Kingdom has indeed played a crucial role in working towards what is commonly called a "fair price for consumers and producers," i.e., one that would respect the budgetary needs in oil exporting countries without inhibiting economic activity and growth in the oil importing countries.

Not that there had been no volatility at all. But overall, and this is not least a testimony to the skills of Ali Al-Naimi, the country's long-standing oil minister, the Kingdom has managed more often than not to maintain a precarious balance between divergent interests. More specifically, they have been willing "to do something that no other country would be willing or able to do. In fact, they spent billions of dollars to keep a precious resource in the ground just in case it might be needed. At this time, over 30 percent of Saudi production capacity is sitting idle." Should disruptions occur for political or other reasons in one or even two OPEC member countries, the Saudis can step in and secure the *courant normal* in supply. Over the

years, Saudi Arabia has thus positioned itself as a producer of last resort, as a central bank for oil.

While the international business community is obviously aware of the Saudi record, that record is hardly ever publicly acknowledged in Western countries. "When you are dependent on a resource to the degree that the Saudis depend on oil, then keeping it in the ground rather than selling it and collect the rent does convey a message. Western politicians and media tend to focus almost exclusively on the burning issues of the day. By contrast, the Saudis have maintained a policy that is truly and remarkably long-term. They have earned for themselves the geopolitical role of serving as the central bankers for oil, and as capable managers of oil prices in the interest of both producers and consumers. A willingness to act accordingly has defined the position and policies of Saudi-Arabia more than anything else."

In this context, it is also worth considering how the Saudis chose to contribute towards the global stimulus package in the midst of the recent economic downturn. They would hold on to the dollar rather than move out of it. They would keep most of their assets outside the country rather than reallocate them. Last but not least, they would stick to their preferred oil price "Even at \$100 per barrel the Saudis would say that there was a \$30 cushion for speculation, and that \$70 was indeed a fair price."

### **Wait a minute !**

By the end of the first session, it was abundantly clear that many of the younger audience were not happy with the general direction of our discussion. Throughout a four-day student seminar that had preceded the colloquium, they had been contending with climate change—and they had agreed that "what is needed most urgently is a major decarbonization of the world's energy system, a swift transition away from fossil fuels to alternative, renewable sources of energy." If that message was to be taken seriously, why worry over investment in oil (gas and carbon, for that matter)? Should we not ask instead how the oil industry can adapt to a scenario in which they produce less in the future?

At this point, the gap between *what ought to be* and *what actually is* in the context of dealing with climate change became most painfully clear. Even passionate representatives of the oil industry would not question the soundness ("in theory") of the students' argument. The practitioners did, however, point to facts and forces in the real world: Yes, the diversity of energy sources must increase, and it will eventually increase. However, all energy choices need time and commitment to build. "At present, we are well-advised to talk about oil, carbon, and gas. For whether we like it or not, today's global energy mix is dominated by carbon. That includes not only oil and gas, but also coal in many places. Fossil fuels will remain the dominant source of energy for decades to come. It is a hydrocarbon world that we are living in, and that ineluctable fact defines the geopolitics surrounding the issue."

This said, much will depend on sound, i.e., comprehensive energy policies—and little indicates that such policies are waiting around the corner. In fact, when climate and energy policies are still governed by two different departments, as is the case in most of the countries across the world, it is hard to move in the right direction.

Not even hardened realists, however, would deny that change is under way. Had we convened 20 years ago, climate change would not even have been an issue. Today, it is part of mainstream political discourse in many parts of the world and on the agenda of just about every public administration. That in itself is a transformation. As pressure mounts, the rhythm of change is going to adjust. Climate change will increasingly re-direct money into research and development. Faced with increased pressure to adjust, governments across the Arabian Peninsula have started to take destiny in their own hands, for example by developing and integrating the downstream sector. In addition to that, the region is in a perfect position to engage in carbon-capture and sequestration, that is, sophisticated techniques to mitigate the contribution of fossil fuel emissions to global warming.

A factor that is going to alter the economic and political equation in the foreseeable future is growth of local demand. Even now, the Gulf region is among the fastest-growing markets for oil products in the world. How will local governments balance increased internal demand for energy and petrochemical products with revenues from selling oil? Energy channelled into domestic use does, after all, not yield any rent at present. Moreover, there is little value creation outside the energy sector and what little value is created will not be captured since raising taxes is still a taboo. For the time being, government revenues come from exports, and from exports alone.

## **II. Regional and International Security Considerations**

During the second session, security-related questions were at the centre of our discussion. Seen from a Western perspective, the Arabian Peninsula remained more or less out of the limelight even after oil was discovered in the late 1930s. By the early 1970s, however, Saudi Arabia was suddenly thrust into assuming a major role when the world's need for ever more oil catapulted the Kingdom onto centre stage and suddenly made it wealthy beyond historic precedent.

Yet, Saudi Arabia was by no means a modern state in the early 1970s. Whether it is one today depends on the choice of criteria. The Basic Law of Government adopted in 1992 declared that Saudi Arabia was a monarchy ruled by the sons and grandsons of the first king, Abd Al Aziz Al Saud. The Law proclaims that the Qur'an is the constitution of the country, which is governed on the basis of the Shari'a. Throughout recent history, the country has been ruled by King Ibn Saud and his hereditary successors. There are no recognized political parties and elections are limited to the local level. The King's powers are theoretically limited within the bounds of Shari'a and other Saudi traditions. He also must retain a consensus of the Saudi

royal family, religious leaders (*ulema*), and other important elements in Saudi society. According to *The Economist's* Democracy Index for 2008, the Saudi government is the seventh-most authoritarian regime from among the 167 countries rated.

This being said, it is also fair to say that the Royal Family have repeatedly and increasingly shown willingness in the way of a devolution of political power. In 1993, King Fahd fortified the foundations of "counseling" by issuing the legislation for the *Majlis Ash-Shura*. This Consultative Assembly consists of 150 persons who are appointed by the King. It has limited legislative rights. At present, six members are women.

A critical issue in every monarchy is, of course, succession to the throne. In Saudi Arabia, the order of succession is determined by, and within, the House of Saud. Though some observers put the family's members as high as 25,000, most estimates place numbers in the region of 7,000, with most power and influence being wielded by approximately 200 descendants of King Abdullah. Over time, succession followed agnatic seniority, but a prince may be bypassed, or another elevated. In order to guard against uncertainty, current King Abdullah appointed his half-brother Sultan as the Crown Prince early on. At least three brothers are older than Sultan, but these have either stepped aside or have been sidelined for health reasons, by family consensus, or by their own unwillingness to participate in governing. Moreover, King Abdullah announced the creation of a *Bay'ah* Council to be made up of the sons and senior grandsons of Abd Al Aziz. The Council's function is to ensure the smooth transition of power in the event of incapacitation or death of both the King and the Crown Prince, and the selection of an heir. This, along with an earlier decree by King Fahd, has opened the possibility of considering Abdul Aziz Ibn Saud's grandsons as viable candidates. As one Saudi panelist put it, "right now, there is no problem because we already know who will be next. Also, it is important to recognize that the second generation [the one following Abd Al Aziz' sons] is taking over office and functions. You see that in several ministries. They have been trained on positions and they are very much involved in all that."

### **Not so rich after all**

Comprising well over two million square kilometers, Saudi Arabia accounts for approximately 80 percent of the Arabian Peninsula in terms of land area. The country is about as large as Texas and four times as large as Metropolitan France. Ever since oil was discovered in 1938, the precious stuff has remained the backbone of the Saudi economy. Roughly 80 percent of budget revenues come from the oil industry which in turn accounts for half of Saudi Arabia's gross domestic product (GDP), compared with 40 percent from the private sector. In 2008, GDP was close to \$500 billion, per capita income is around \$20,000. Such numbers indicate that Saudi Arabia is still significantly wealthier than the other large countries in the Middle East. And as one discussant put it, "there still is a perception in many people's mind that Saudi Arabia is a rich country."

Such a perception must be put in proportion. To be sure, the Saudi economy was flush with vast amounts of excess liquidity in the 1980s. With this wealth, the government was able to provide many public goods either free or at heavily subsidized prices. Today, however, the economic situation bears no resemblance to the wealth and opulence the Kingdom enjoyed 30 years ago. - Why? "The average oil price in 2008 was \$95 per barrel. In 1981, it was \$40. In

real terms per capita, however, today's \$95 revenue is worth less than the \$40 thirty years ago. What has happened? Population has exploded, and the cost of production has multiplied by five."

In 1970, Saudi Arabia's population was estimated at 7 million. By 1990, that number had doubled to 14 million; by 2008, population had soared to 27 million, including 8 million foreign residents. According to recent studies, the country's population will surpass 30 million by 2011 and reach 50 million by the year 2030.

An appreciation of the various consequences of this demographic explosion is crucial to an understanding of the issues that confront the Kingdom in the 21<sup>st</sup> century. On the economic side, the challenges are staggering. Only just creating a reliable electricity grid and building new desalination plants to ensure potable water for another 10 to 20 million citizens will absorb huge financial resources. On top of it, "many tend to forget that the government spent next to nothing on infrastructure between 1983 and 2001. Therefore, the demand for infrastructure is enormous, and the country's size does of course not help. We produce 37,000 kilowatt electricity per day, but will need 75,000 in the next seven years. Thus government will have to spend roughly \$10 billion dollars a year on power plants"

### **The biggest security concern**

The creation of jobs, of course, will pose another challenge. The majority of the Saudi Arabian population is younger than 30 years. While illiteracy is no longer an issue, the official unemployment rate is 16 percent on the male and 27 percent on the female side. The petrochemical business, like the oil industry as such, is not a labor-intensive field of activity. At present, the government still is the biggest employer by far. Around 900,000 people work in the civil service, approximately 700,000 in the military and security services. Through a variety of policies and programs, the government is trying to promote growth in the non-oil sectors by privatizing industries such as power and telecommunications. In order to further diversify the economy, a number of "economic cities" have been launched.

For the time being, the problem of "young men looking for jobs and lacking perspectives" will not go away. A highly uneven distribution of wealth does not help, either—and none of these issues is restricted to Saudi Arabia. Addressing the broader picture, one discussant from the region put it as follows. "The number one security threat to the Middle East is not Iran today, nor is it the Israeli-Palestinian issue, nor is it al-Qaeda. It is the demographic time bomb we face, and the challenge of meaningful job creation. We have to create a hundred million jobs over the next couple of decades, which is more than we achieved in the last century. There is no plan for doing so. The public sector definitely cannot continue to absorb these young people. If they are not absorbed productively, however, political instability is guaranteed. And while this may not be a direct cause of terrorism, it does prepare a fertile ground. As we know, most terrorists are not from the poorest of the poor. More often than not, they are well educated and frustrated young men. What can be done? I see too little in the way of economic and regulatory reform to really encourage the private sector and absorb all these young people. Of course, this is a problem across the Middle East, but it is especially worrying in the more populous states such as Egypt, Saudi Arabia, Iran, and Iraq."

What can be done? - With hindsight, it looks as if 9/11 and the 2003 terrorist attacks in Riyadh and elsewhere in Saudi Arabia had indeed shaken the ruling elites out of complacency. Yet, to each reform there is resistance. Provided that the King himself wants to pass progressive legislation, he has to convince the Wahhabi religious establishment in every instance that the policies in question are absolutely necessary for the survival of the country. He also has to overcome opposition from within the inner core of the Royal Family.

If reform is to succeed, and this holds true for all member states of the Gulf Cooperation Council, reform must come from within. Secondly, reform needs to be gradual rather than abrupt. "We need time to adjust. To hire a Western company to come to Riyadh and bring modern ballot boxes and tell us how to use these computers for the municipal elections - that cannot work." Last but not least, reforms will have to be tolerable in light of traditional value systems and beliefs. These, of course, may evolve over time.

### **Turning to regional security**

Saudi foreign policy is said to have traditionally been characterised by "prudence in the way of a continuous desire not to get involved, not to be forced to take sides, and not to be drawn into action." Under an American security umbrella, this policy was largely successful throughout the 1980s and early 1990s. In strongly opposing Iran, the Saudi government followed the U.S. policy of "dual containment" (i.e., isolating both Iran and Iraq), in which the United States sought to depict Iran as a "rogue" state that supported terrorism.

A big, if unexpected blow to good U.S.-Saudi relations came from within the kingdom, that is, from the participation of Saudi citizens in the September 11 attacks and other acts of terrorism against the United States. The perception of many Americans was that the Royal Family, through its long and close relations with the Wahhabi religious establishment, had laid the groundwork for the growth of militant groups like al-Qaeda and that after the attacks they had done little to help track the militants or ward off future atrocities. That viewpoint was reinforced when in 2003 the Saudi government refused to support, let alone to participate in the war between U.S.-led forces and Iraq, an action seen by some as an attempt by the Royal Family to placate the Kingdom's Islamist radicals. That same year Saudi and U.S. government officials agreed to withdraw all U.S. military forces from Saudi soil.

Today, King Abdullah is said to be keen on maintaining a good relationship with the United States, based on a renewed strategic alliance along the lines of "oil against security." In fact, "security and stability" both at home and in the regional arena seem to be the King's central preoccupation at this time.

## **A Saudi perspective on Iran**

In a historical perspective, the Saudi-Persian relationship has never been an easy one as a result of divergent Sunni and Shia interpretations of Islam. Another obstacle is political rivalry, as both countries have continued to strive for a leadership in the region.

Prior to 1979, direct relations between Iran and Saudi-Arabia were governed by the principle of non-intervention. Ever since the Islamic Revolution led by Ayatollah Ruhollah Khomeini, however, Saudi leaders have been worrying about Iran's alleged policy of exporting the revolution to other countries in the region with significant Shiite minorities, such as Iraq, Lebanon, Bahrain, Yemen, and Saudi Arabia. "They support the Hezbollah in Lebanon, they support Hamas in Palestine, to give but two examples. They try to use the religious dimension of security issues to expand Iran's influence in the region. This is interference, of course, and this is of great concern to us."

Another "great concern" to Saudi Arabia is the Iranian nuclear program. As is abundantly well known, Iran keeps insisting that its nuclear pursuits are intended for peaceful purposes, whereas the international community keeps advocating efforts to suspend them. President Ahmadinejad, a staunch defender of the program, embodies the country's apparent intent to continue its nuclear activities in spite of official opposition in many parts of the world.

In Saudi Arabia, there is widespread disappointment over "a clear lack of pressure" vis-à-vis Iran on the part of the international community in general and Western governments in particular. At the same time, the Saudis insist that the United States live up to their pledge to keep the Kingdom under its nuclear umbrella ("a promise is a promise, we need delivery now"). In the course of our discussion, several scenarios were taken up for consideration.

The first scenario was based on Iran's acquiring nuclear weapons. Confronted with this possibility, more than one Saudi discussant was surprisingly blunt: "If that happens and the U.S. American umbrella is not 120 percent credible, then we are going to acquire nuclear capabilities of our own, be it with external help, be it by starting a peaceful program and then taking advantage of its dual-use properties. We would hardly be the only ones in the region to walk down that road. Do not forget that there are other good reasons, energy-related reasons, for starting peaceful programs. Our neighbours in the United Arab Emirates have already signed agreements with France, with South Korea, with the United States of America." Statements such as this not only illustrate the terrible capacity of nuclear weapons to disrupt stability and create security dilemmas but also draw attention to one of the biggest problems in the current non-proliferation regime: by permitting the peaceful use of nuclear energy, it does not function as an absolute deterrent to nuclear weapons programs.

A second scenario built on the assumption that the international community in general and the UN Security Council in particular manage to put increased political and economic pressure on Iran by means of broadening the existing embargo to include the insurance sector, for instance, or even blocking harbors. In this second case, Iran's trading partners would ob-

vously pay a significant price as well. 25 percent of Iranian imports—or the equivalent of \$8 billion a year—come from Dubai.

Under a third scenario, either the United States or Israel would resort to striking Iran's nuclear facilities a military blow and delay the program at least for some time. Over the course of the ensuing years, the international community would have to work on a multi-layered, effective approach with a view to altering the political configuration within Iran. Such an approach would include the carrot and the stick, that is, the provision of strong incentives for moderate political groups on the one hand and continuous pressure on the other. Inevitably, scenario three would entail some kind of retaliation on the part of Iran. In the region, many seem to prefer that possibility and its unpleasant eventualities over an Iranian government with nuclear bombs at its disposal. "Yes, there would be big holes in the floor, buildings would be knocked down and people would die. But it would not last, and temporary retaliation would not wipe out Dubai, Abu-Dhabi or Saudi Arabia."

A fourth scenario was briefly discussed, but basically dismissed as too far-fetched. Why would governments not make more serious and sustained efforts at creating a nuclear-weapon-free zone and thereby bring about stability for everyone in the region? Would it not be possible to draw, lure or pressure both Israel and Iran into such a grand bargain? Sadly, we were told that the answer was no — not in the present climate, not under present conditions.

As regards the first scenario, not everyone was convinced of dreadful consequences should Iran end up with military nuclear capabilities. "So what? Could a bomb be anything else than a nuclear deterrent? Would a rational actor ever put it to use? In Pakistan, you may find players willing to do exactly that if they manage to lay their hands on nukes. I do not see that happening in Iran."

Others, however, warned against such nonchalance by pointing to the wider implications for a non-proliferation regime that was already dealt a terrible blow by the North-Korean precedent. "It is not just the fact that you have one more nuclear weapon state; rather, it is the fact that you then create security dilemmas around you. Proliferation in the number of nuclear weapon states is profoundly destabilising. Thus throwing up our hands in despair and letting this happen cannot ever be a viable option."

### **Iraq and Yemen, two neighbors in jeopardy**

With the U.S.-led coalition about to end its military presence in Iraq, the intermediate result of a multi-year intervention and unprecedented effort at regime change was not considered impressive, to say the least. While no one present seemed happy with the situation, several participants from the Arabian Peninsula did not even try to withhold their reservations and misgivings. "The Americans did not manage to build institutions. They did not manage to stabilize the political environment. What is more, they kept telling the Gulf Cooperation

Council and its members not to get involved while they were there. Now they go, leaving chaos behind.”

One question is whether these neighbors will be willing to go beyond deploring a lack of tact on the part of the United States. Are they ready to step up and make a more specific and direct contribution themselves? While it appears that they would have every interest in a stable, secure, and viable Iraq, our discussion revealed that a serious commitment, let alone a sustained engagement on the part of the Gulf Cooperation Council was far from certain. In spite of huge financial muscle (its member states held more U.S. treasury bonds than China in 2009), the GCC seems to lack not only a shared vision with regard to Iraq, but political cohesion altogether. The result is a strangely passive, defensive foreign policy that appears to aim at equidistance from political hot spots rather than at engagement, let alone intervention. Thus, apart from sheltering roughly 250,000 Iraqi refugees, there has been little in the way of a direct contribution in Iraq. “Clearly, the GCC is not active enough in regional security and foreign policy issues and keeps punching way below its weight. With small exceptions such as efforts at reconciliation in Lebanon or mediation between Palestinian factions, it has basically remained passive.” In turn, Iran appears to have made the most of that attitude and vastly increased its influence in Iraq.

By some accounts, the territorial and political integrity of the Republic of Yemen is even more imperilled than that of Iraq. Ever since the unification of the country in 1990, the central government has worked towards the integration of two relatively disparate economic systems, but has seen its efforts hampered time and again. Apart from poverty, tribal unrest, and recurrent insurgencies, rampant corruption is a notorious obstacle to development, limiting local investment and driving away regional and international capital. Foreign investments remain heavily concentrated around the country's hydrocarbon industry. Yemen's oil reserves are expected to be depleted within ten years, but there are proven reserves of natural gas. Due to the country's poverty, large population, and republican system of government, there is strong resistance to full Yemeni membership in the GCC.

Since 2004, another civil war is being fought to the north of the country between forces of the central government and Shiite Houthi rebels. In light of a common borderline that stretches over 1,600 kilometers, it is not surprising that the conflict continues to spill over onto Saudi Arabian territory and is about to become a serious threat. On the one hand, the Houthis can apparently count on external support on the part of Iran and Shiite groups in Lebanon. On the other, thousands of Yemeni refugees cross the northern border in search of shelter and protection. In order to avoid “a Darfur right next door,” the Saudi government supports the Yemeni central government as best it can. The security environment, however, remains dismal in many parts of Yemen, and an increasing amount of evidence suggests that radical Islamist networks are about to transform the country into a new incubator for terrorism. With regard to Yemen, then, there is not much ground for optimism.

## **Security wherefrom ?**

After assembling the different pieces of the puzzle, we find that Saudi Arabia and the other Gulf states face a daunting situation: a fragile Iraq to the North; to the East, a Shiite regime on the verge of crossing the nuclear threshold; and to the South, a poverty-stricken and fragmented Yemen that threatens to become a platform for Islamist terrorism. Where does the Arabian Peninsula turn to when it comes to the provision of the most precious of all public goods, that is, security? In military terms, Saudi Arabia and the smaller monarchies on the Persian Gulf are far from having the capabilities to protect themselves on their own.

"Traditionally, our security has come from the West." If that is how it used to be, what about the future? After all, trading routes to the East are becoming more and more important. Close to 70 percent of Saudi oil exports go to Japan at this time. 92 percent of Japanese energy resources come from the Persian Gulf. China is becoming an increasingly important partner not only in terms of energy demand, but also in the context of investments into downstream diversification in Saudi Arabia and elsewhere. Are we going to see modifications of security alliances along the lines of trade and commerce? - Most likely not. "Our relationship with Russia, with China and Japan is merely one of buying and selling. Do we talk about security with these partners? No, we don't. If the Japanese are willing to put up \$20 billion in the aftermath of Iraq's invasion of Kuwait in support of the UN coalition, then that kind of contribution is due to American influence and pressure rather than a direct security commitment by Japan. Again, our security comes from the Western countries in general, and from the United States in particular."

Another question is whether the Chinese, too, will be willing to stay on the trade and commercial side and leave it at that. Thus far, China has readily acknowledged that the GCC region with all its resources is essentially within the American sphere of influence. In geostrategic terms, it has not challenged American pre-eminence in the Gulf region in any way. More particularly, it has not played the oil and investments links with Saudi Arabia as a geopolitical card. Is that about to change as the Chinese are obliged to seek increasing supplies, and as the Gulf and Saudi Arabia increasingly look eastward?

### **III. Development and Internationalization of Private Business in Saudi Arabia and the Gulf Countries**

Whereas questions of energy supply and regional security predominated in the first two sessions, emphasis then shifted to business and the political economy.

In terms of business environment, one recent turning point was the introduction of the Foreign Investment Law and the establishment of the Foreign Investment Authority of Saudi

Arabia in 2000. Prior to that reform, foreigners were not allowed to own more than 49 percent of any investment or business in Saudi Arabia. Based on the new legislation, foreigners can now invest in just about any business and own these enterprises fully. If it is an industrial project, investors can get up to 40 or 50 percent of the total amount as loans from the Saudi Industrial Development Fund (SIDF). Other recent legislation allows foreigners to own land and invest in agriculture. Also, the minimum requirement for investments has been reduced. Whereas it used to be 5 million Riyal or the equivalent of \$1.8 million for industrial projects, the minimum is now 500,000 Riyal or about \$180,000. Remaining restrictions and limitations concern trading, but even there things have become easier, for example in service industries. Upon conclusion of bilateral market access negotiations with all interested member states, Saudi Arabia became a full member of the World Trade Organization in December 2005.

Today, the Kingdom features state of the art infrastructure, a good banking system, and good shipping facilities. Most of the factories in the country have brought their machinery up to date over the last 20 years. Under an ambitious project called "Vision 2010," the government has set out to become one of the ten most attractive countries for investment worldwide. A realistic target, it seems, as one study ranked Saudi Arabia 13<sup>th</sup> in 2009 in precisely this category.

### **Challenges: education and gender**

At present, there are 21 public and 9 private universities in Saudi Arabia. Those familiar with the issue agree that big strides have been made in higher education; more particularly, new research institutions have been set up not only in Saudi Arabia, but in most of the other monarchies in the region. At the same time, reform at the level of primary and secondary education has been all but nonexistent. Some fear, therefore, that public-sector education will fail to bring forth students who can benefit from higher education and meet the needs of the private sector.

Saudi high schools produce about 250,000 graduates each year. Some of them go on to university, others enter the labour market right away. As mentioned above, however, jobs are scarce. "As the government can no longer afford to pay for jobs, we need to try to encourage young people to start their own business. Under one official program, more than 50,000 Saudis have been sent overseas for higher education over the past few years. Our hope is that many of them will come back and set up something on their own."

A more specific problem is gender-related. Women account for 57 percent of the 250,000 graduates leaving high school each year. "They lack perspectives. We need to engage women in economic processes beyond the private realm and beyond social institutions." In 2009, Foreign Minister Prince Saud Al Faisal announced that government agencies were going to push job opportunities for women beyond the realm of public education, where women already account for 52 percent of employees. On its part, the Council for Saudi Chambers of Commerce launched programs to encourage remote work at home. In the context of a Millennium Fund in support of small businesses, most of the applications came from Saudi women.

"But it takes time. Take the issue of independent IDs for women, for example. Some men refused to have the pictures of their wives or mothers printed on an ID. King Abdullah is pushing forward, but he cannot advance faster. It was so difficult to bring women onto the Board of directors in the Riyadh Chamber of Commerce. So we started in Jeddah. Then, Riyadh became a little jealous and soon we had four women as candidates for the Board of the Riyadh Chamber of Commerce."

### **Saudization vs. internationalization**

Again, moving beyond traditional ways will take time. Technical jobs in the petrochemical industries, to offer another example, are "too low" in the eyes of many conservative families. "Parents want their children to become government employees or nothing." Whereas optimists tend to downplay such cultural patterns and peculiarities, skeptics deplore their continuing vitality and force. "In most of the GCC countries, there is an engrained expectation with the people that the public sector will offer employment if need be."

Small wonder, then, that there are about eight million non-Saudis living and working in the country. Most of them come from South and South East Asia. The term Saudization refers to Saudi public policies to encourage employment of Saudi nationals in the private sector. Successful examples include the (state-owned) national oil company Saudi Aramco. "Today, Saudis account for 80 percent of Aramco's employees, and they are certainly as highly-qualified, disciplined, and efficient as their foreign predecessors." In banking, 35,000 out of 37,000 employees are Saudis at this time. "15 years ago, the ratio was the other way around."

Overall, however, Saudization programs have met with little success. In fact, as one businessman from the region reported, "every Saudi development plan since the third one introduced in 1980 has had as one of its targets the reduction of foreign labour in the country. In every period, the number has actually gone up with the exception of a brief period in the early 1990s. Besides that, the number of foreigners has steadily gone up and continues to do so." If that assessment is valid, one interesting question relates to the impact of the ongoing process of internationalization: will it be strong enough to absorb Saudi labor?

With a view to the process of internationalization of private business, the WTO framework is certainly crucial. As mentioned above, Saudi Arabia became a full member in 2005, and the related agreements secured Saudi access to world markets in the very sector that mattered most, namely petrochemicals. As far as this sector is concerned, prospects are very good indeed. "In petrochemicals, the industry does not have to worry too much about labor questions as it is not labor-intensive in the first place. Moreover, existing structures are mostly efficient and well managed. The necessary infrastructure seems to be there. Finally, recent regulatory changes on foreign investment have helped in many ways. Saudi companies will be able to bring in foreign partners; they are doing it already very effectively."

## **Labor too dear, energy not dear enough**

For other sectors of the Saudi economy, the outlook is less promising. Against the backdrop of increased international competition, the notorious disparity in the cost of labor between Saudis and foreigners will be hard to defend. Today, Saudi labor is simply not competitive. Is Saudization an illusion, then? Who will do the work in future? In the medium and long term, the most unpopular option can hardly be avoided: if Saudis want jobs, they will have to work at lower, competitive levels. Yet, how should the Saudi elite go about that kind of reform without risking social unrest of even worse? "People would probably be willing to swallow the bitter pill within the framework of a new kind of social compact." Under such a scheme, the elements of a welfare state in Saudi-Arabia would have to be strengthened further, so that Saudis feel confident that their education, health care, housing, transportation etc. are effectively provided by the state.

While Saudi labor is too dear, another factor of production is still too cheap. "The cost of energy to industry is far too low. In fact, it is below production cost in many instances. If we look at Saudi Arabia, gas, which is the main feedstock for industry, is priced at 70 cents, which is close to nothing. Thus Saudi industrialists will return their investment in nine month or less, and there is infinite demand for gas." On the other hand, a higher gas price would not only increase revenues for the state, but would also put resource allocation on a sustainable base.

In 2004 and 2005, during negotiations with the World Trade Organization, low energy to industry cost was seen as a direct subsidy, but Saudi Arabia managed to get away with it. Energy pricing—in terms both of gas and electricity—is a big issue around the entire region. "There is, of course, another negative impact of keeping gas at 70 cents. People will like it and the whole setup discourages transformation. You have cheap labour, cheap energy, and of course no taxes at all. Great! All of this may grant you a competitive advantage. At the same time, however, all of this will prevent the diversification we need so urgently. And it prevents the development of your own national human resources. These are challenges that governments across the region are wrestling with."

## **Private business across the region**

It is fair to say that, historically, GCC economies have been driven and empowered by the private sector. In fact, most private business groups in the region predate the states in which they are located. These groups and their infrastructure are family-owned or family-controlled, and many of them seem more qualified for (or more professional at) providing a semblance of governance than public agencies.

While internationally competitive firms are still in their infancy, traditional family business is clearly dominant. "Worldwide, families own or control around 80 percent of all businesses. In

the Gulf region, that percentage is even higher and may reach 90 percent." In the past, these groups used to be diversified. "Their focus was on trade and contracting. Pretty low value-added and protected in many cases by sole-agency relationships. You had family business groups doing everything from contracting to selling watches to owning hotels." Many doubt that this model will last, as the sheer ability of these diversified conglomerates to compete effectively within the region (let alone internationally) is increasingly under question. There is evidence that the better-performing companies are the ones with, and focusing on, a clear core competence.

At the very moment when family business groups are under pressure to adjust, another challenge is succession. "In Saudi Arabia, for example, many a group are going into the third generation, in the wider GCC area at least into the second generation." While managing succession will entail many new problems, the process will also hold new opportunities in that "a new generation of young executives who studied abroad or worked for multinational corporations will quite naturally infuse a new ethos and level of professionalism into business at home." What is more, chances are that new generations will try to make their family groups public in order to gain access to new capital. Doing so will require adjustments of the legal framework, however, as current legislation was drafted under the premise of governments privatizing companies rather than existing private companies going public. All in all, those familiar with the issue were moderately optimistic as far as family business groups in the Gulf region were concerned. "They will manage to adjust."

A bigger and more daunting challenge is easy to identify. In most developed countries around the world, a solid base of small and medium-sized enterprises (SMEs) form the very backbone both of employment and GDP. That backbone is sorely lacking in the Gulf area. What should be done in that regard? While quick answers come cheap, all discussants agreed that the problem will be hard to tackle as it touches, once again, upon fundamentals. "You need education, of course. You need regulation. But far beyond that, value systems need to evolve. Today, an ethos that would promote hard work in the private sector in exchange for reward is still absent in GCC societies."

### **Looking at the business environment**

With a view to the region as a whole, our discussion failed to yield a unanimous result. To optimists, the sheer notion of a particular, specific business environment on the Arabian Peninsula is misleading, as "this region has become an integral part of international business." Most GCC states have joined the WTO and abide by its rules and regulations. Doing business in the region "is not nearly as difficult as it used to be." Of course, one will always have to identify the appropriate partners who are familiar with local conditions, but the bottom line is clear: a large number of exciting business opportunities clearly outweigh remaining challenges. Language is not an issue, either, as everybody's second language is English. "Today, this truly is one of the most promising business environments in the world. By now, even visas are easy to get. Write me an electronic mail, I'll get you a visa."

At a more specific level, one positive trend concerns a significant increase in intra-regional trade and investment, both within GCC states and from the GCC area to the near abroad. The signal, then, is strong and clear. "Years ago, these countries held practically no investments in the region. But then, why should European companies come and invest if local companies did not? Fortunately, that has changed."

What is more, capital markets have matured in recent years. "Equity markets, debt markets, the growth of Islamic banking, all of these are rather new topics. But the ability to fund expansion from within the region for private business groups is stronger now than ever before." Islamic banking, in particular, seems to develop into a serious alternative to traditional banking. As many in the GCC business communities abide by religious forms and duties, they prefer to find an alternative to interest. Islamic banking was introduced in the late 1970s, but had to wait for legalization. "Now it is legal, and many banks are branching out on it. It is working beautifully." At present, many European banks are starting to develop branches for Islamic banking.

Whereas the skeptics would concede that progress has been real in some regards, they point to persistent problems and imbalances. Some of these stem from the enduring dependence on oil. At the aggregate level, the economic output of GCC states is relatively small. Once the oil sector is not included, output is in fact minuscule and trade is negligible. Another imbalance is that these states dispose of huge amounts of liquidity. This is expected to continue as oil prices are likely to remain high by historical standards.

To the skeptics, a crucial concern is the quality of regulation, "the failure on the part of governance and regulatory regimes across the region to catch up with today's business needs." By and large, governments acknowledge that economic reform is needed, but fail (sometimes "miserably," we were told) to translate that need into a legal framework that supports business rather than impeding it.

More generally speaking, it appears that governments and administrations still have to learn how best to support the private sector—be it at home or abroad. "In the West, diplomacy is as much about promoting your national economic interest as it is about security. I do not see this in our part of the world. Yes, there are some trade missions here and there, but governmental support for the private sector has not yet emerged. At the bureaucratic level, there is strong resistance. In fact, bureaucracies still tend to compete with their own private sector rather than regulate and support it." Other skeptics helped complement the picture by contending that internationalization is, in fact, not even an objective for governments in the region. "They are inward-looking. The vision that guides economic diversification policies is exclusively geared towards employment. The only involvement abroad is either to secure markets for oil and petrochemical products or for sovereign wealth funds to diversify their investments."

#### **IV. Saudi Arabia and the Gulf Countries as Global Investors**

When speaking of the Gulf countries as global investors, the first thing that comes to mind is sovereign wealth funds. SWFs are state-owned investment funds composed of financial assets such as stocks, bonds, property, precious metals, or other financial instruments. They are typically created when governments have budgetary surpluses on the one hand and little or no international debt on the other. It is not always possible or desirable to hold this excess liquidity. This is typically the case when a country depends on raw material exports like oil or gas, copper, or diamonds. In such countries, the main reason for creating a SWF lies in the nature of revenue source: unpredictability of resource extraction, volatility of resource price, and exhaustibility of resources themselves.

As Norway's Government Pension Fund, Singapore's Temasek Holdings or China's SAFE Investment Company indicate, sovereign wealth funds are by no means confined to the Arabian Peninsula. Early examples from that region include the Kuwait Investment Authority (KIA), a commodity fund created in 1953 from oil revenues even before Kuwait gained independence from the United Kingdom. According to recent estimates, this fund is now worth approximately \$250 billion. Other SWFs from the region are the Abu Dhabi Investment Authority (ADIA, \$500-700 billion), or the Qatar Investment Authority (QIA, \$70 billion). While many of these agencies invest globally, new entrants such as the Mubadala Development Company from the United Arab Emirates tend to focus on domestic (and selected prestige) investments across a range of sectors.

Globally, assets under management of SWFs are estimated at between \$2.5 and \$3.5 trillion. This is about twice the size of hedge funds, but only half the size of global foreign exchange reserves, only 17 percent of global pension funds, and only 3 percent of global bank assets. Against the background of global finance, then, SWFs play a limited role. As their asset pool continues to expand in size and importance, however, their impact on various markets is bound to increase. Private sector analysts project that by 2015 total valuation of SWFs could range in size from \$9 trillion to \$16 trillion.

As SWFs have grown in size and number, analysts have voiced concerns about the lack of transparency in most of these funds. Moreover, politicians in America and Europe have objected to the countries developing these funds—oil-exporting states and more or less authoritarian regimes in the Pacific Rim. In 2007 and 2008, the IMF facilitated the establishment of the so-called Santiago principles for Sovereign Wealth Funds, a set of 24 voluntary guidelines that assign best practices for the operations of SWFs. Examples are transparency, sound governance, compliance in recipient countries, and stable financial investment. So far, 23 nations have signed onto these guidelines.

Since 2006 and more particularly since the global financial crisis, SWFs have become major players as they have acquired significant equity stakes in high-profile firms or injected capital in major financial institutions. In some countries, especially in the Middle East, SWFs were instructed by their respective governments to invest into domestic financial institutions and the overall stock market. There, they have recently suffered unrealized losses due to the crisis. These unrealized losses were higher for SWFs that had a higher share of equities in their investment portfolio or large illiquid positions in private equity or hedge funds. Given that

SWFs typically have a fairly long investment horizon, however, they are likely to sit out these unrealized losses.

In the long run, prospects are clearly positive, as oil and gas prices are expected to rise rather than fall in the decades to come. Potential growth is sensitive to risks of two kinds. On the one hand, there are broader macro-economic conditions such as exchange rates and flows in commodities, trade, and capital. On the other hand, there is global politics and, more particularly, protectionism.

### **Gauging the impact of Sovereign Wealth Funds: conceptual reasoning and empirical evidence**

Research on the financial stability implications of SWF's has been slow in emerging. Due to the scarcity of reliable data (particularly on SWF asset allocation), it is hard to investigate this topic. On the conceptual side, it is certainly safe to say that SWFs can play a stabilizing role in global financial markets. After all, they are long-term investors with mainly unleveraged positions and no imminent call on their assets. Thus they are able to sit out longer market downturns or even purchase against the market trend. Also, they are interested in pursuing portfolio reallocation very gradually to avoid price effects. Their investment might enhance both the depth and the breadth of markets. Finally, by adding diversity to the global investor base, such as private equity funds or hedge funds, they could contribute to greater efficiency and lower volatility.

On the other hand, it is not difficult to imagine circumstances in which SWFs could cause volatility in financial markets. Actual or rumored transactions may affect relative valuations in particular sectors and result in herding behavior and increased volatility. Deeper markets, such as currency markets, could also be affected, at least temporarily, by rumors or announcements about changes in currency allocation by Central Banks or Sovereign Wealth Funds. Opacity about broad allocation and risk preferences of a major investment class, including SWFs, may lead to inaccurate pricing and excess volatility.

These were considerations on the conceptual side. What about empirical evidence? With regard to the recent crisis, since November 2007 SWFs have injected more than \$50 billion into financial institutions that were in need in Western industrialized countries. The announcements of capital injections from SWFs have significantly assisted in stabilizing share prices over the short run at least. In most cases, the initial share price reaction was positive, with announcements of asset write-downs offset by hand-in-hand capital injections by SWFs. While other factors are not taken into account, this initial evidence supports the view that SWFs could indeed have a volatility-reducing impact on markets. At any rate, there is no evidence for a destabilizing effect of SWFs on equity markets.

Other findings or recent research indicate that the share prices' combined responses to SWFs' investments and divestments in developed economies are significant, while those in emerg-

ing economies are not. Furthermore, SWF investments and divestments in the financial sector have a larger impact on share prices than in the non-financial sector. Such differences in responses may be due to the relatively more transparent equity markets in developed economies as well as in the financial sector with higher signalling and information flow.

From what we know about the asset allocation and risk management framework of Sovereign Wealth Funds, they do have specific investment objectives in place; they do adopt an asset approach in determining their asset allocation strategy; they do utilize common risk measures (e.g., credit ratings, value-at-risk models, tracking errors, duration and currency weights) for their risk management; and finally, they do have explicit limits in their investment classes and instruments. Therefore and in spite of all the concern expressed by politicians with respect to opaque business conduct and a lack of transparency, SWFs in the Middle East and Asia seem to work and proceed rather like other investment groups.

### **Investment groups: one example from Abu Dhabi**

Emirates International Investment Company (EIIC) is a private, Abu-Dhabi-based investment group present in about ten countries throughout the Middle East and North Africa. It may be considered fairly large in that it holds in the billions of dollars worth of assets. The group belongs to members of the ruling families in Abu Dhabi.

One of the group entities focuses on financial investments, both passive and strategic. One example of a strategic investment is EIIC's majority shareholding position in the Abu Dhabi Islamic Bank, or in Citadel Equity Fund, which is a private equity fund in Egypt. Another entity is focused on direct investments in real estate, in oil and gas industries as well as in general trade and services. Its structure is similar to the structure of an increasing number of groups within the region, be it in Abu Dhabi, in the UAE or elsewhere. What is also similar is the 'entrepreneurship-nature' of these entities, that is, their way of preparing and making decisions.

The core expertise of EIIC is access to investment opportunities, access to creative funding sources, and finally access to human capital. The investment model itself is focusing on emerging economies with high barriers to market entry, such as in Iraq, Libya, or Algeria. Clearly, these are countries that are not considered as traditional investment places. "If you get there early, however, and find the right partners at both the political and the business level, you have put yourself in an excellent position to gain important positions in the market."

As regards investment priorities, EIIC has evolved over time. Early on, the focus was on classic investment, that is traditional, passive investment portfolios in money markets, fixed income or equity hedge funds. Subsequently, the Group started engaging in strategic investments, e.g., investments that include above five percent in terms of equity share and typically entail a seat or even a chair on the board. Finally, a third pillar complemented the Group's investment portfolio. Here, EIIC invests directly into companies that they own and develop. "Here, we have industrial companies, cement, cables, all one hundred percent owned by the

group." From what can be said today, this third pillar indicates the direction for tomorrow's priorities. "We want to contribute increasingly to the local Abu Dhabi economy by expanding these direct investments. This clearly is the trend – moving from passive to strategic to direct investments."

### **Saudi Arabia—a different approach**

If Saudi Arabia does not qualify in terms of operating sovereign wealth funds on a large scale, this is mainly due to demands that the authorities have imposed on surplus funds in the wake of lessons learned the hard way. Throughout the 1970s and early 1980s, oil-related revenues were spent light-heartedly and exuberantly. When facing more difficult times in the 1990s, Saudi Arabia quickly turned from a surplus to a deficit economy. In 1999, the country's debt-to-GDP ratio was 103 percent. At the time, the country lacked counter-cyclical fiscal capacity and had to borrow massive amounts of money.

When the country finally saw surplus numbers again, the Saudi Arabian Monetary Agency (SAMA) invested the money in low-risk, low-return, long-term assets, predominantly in the United States. "We had to learn that Saudi Arabia simply could no longer afford buying fancy trophy assets. We need the money to invest in our own economy, to develop the country's infrastructure, and so forth. Let me argue by comparison. Qatar is an economy of 130,000 Qataris with another 750,000 people serving the 130,000 Qataris. Saudi-Arabia is a country of roughly 30 million people. Over the next ten years, we need to build 1,000 new schools every year. Who is going to pay? The Saudis' expectation is that the state should go ahead and do much more."

Wiser from experience and faced with manifold economic and social challenges (as described *supra* in more detail), the Saudi elite thus opted for prudence rather than exuberance. In 2007, GE Plastics was acquired for \$11 billion — not a trophy asset by any means, but well within Saudi core competence, which are petrochemicals. To some extent at least, the government seems to follow the example of the private sector: settled, discreet, low key. "In the 1970s and 1980s, Saudis were seen frequenting posh parts of London. Nowadays, you would rather see Qataris and people from the Emirates there. This is typical when you make money for the first time. But many have learned their lesson and go about business in more subtle ways. This is all the more important as the fourth wave of the oil boom is going to be much more sustained in terms of high oil prices."

## Are SWFs here to stay ?

Several discussants pointed to marked differences among the GCC member states. By their account, governments in Saudi-Arabia and Qatar have pursued a clear development strategy over the years with the primary objective of developing the national economy and transforming it in a very fundamental way. "When you have that kind of vision, you are not terribly interested in sovereign wealth funds. Kuwait might have had a vision and a strategy in the 1990s, but lost it on its way. Abu Dhabi never intended to develop one; it intended to be a nice, civilized, and pleasant place, but not an industrial power. The fact that Abu Dhabi has accumulated a large sovereign wealth fund is a consequence of not knowing how to employ that money domestically. Dubai did not have the money, so what they did, they did on the basis of heavy leveraging. Now they face the consequences of that."

If such an assessment proves to be correct, SWFs will hardly survive the next 20 years and the road to the future is shown by Saudi Arabia rather than by Abu Dhabi. Other SWFs might well follow the Saudi example and evolve into fiscal risk management tools in the hands of governments. To accomplish such a transformation, they would have to restructure their Funds to ensure that there is a liquidity tranche that can be used for fiscal purposes. At present, this model seems to work reasonably well for Saudi Arabia. Concerns that placements in the United States would be hard to withdraw ("park your money forever") do not withstand the empirical record over the past few years.

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Let us restate a few central findings in conclusion. With regard to energy supply, our panelists expect that oil and gas reserves will be adequate for decades to come. They also expect, however, that global demand will keep rising and that increased demand will not be met without huge investments in new supply capacities. Over the years, Saudi Arabia has managed to position itself as a producer of last resort, as a central bank for oil.

In light of climate change, student participants called for a thorough decarbonization of the world's energy system, i.e., a swift transition to alternative, renewable sources of energy. Practitioners insisted that fossil fuels will remain the dominant source of energy for decades to come. "It is a hydrocarbon world that we are living in." Clearly, however, change is under way. Had we convened 20 years ago, climate change would not even have been an issue. Today, it is part of mainstream political discourse in many parts of the world and on the agenda of just about every public body. That in itself is a transformation.

In terms of regional security, Saudi Arabia and the other Gulf states face a daunting situation: to the North a fragile Iraq; to the East a Shiite regime on the verge of crossing the nuclear

threshold, and, to the South, a poverty-stricken and fragmented Yemen that threatens to become a platform for Islamist terrorism. Yet, the number one security threat to the region might well lie elsewhere today, namely, in "the demographic time bomb we face, and the challenge of meaningful job creation. We have to create a hundred million jobs over the next couple of decades, which is more than we achieved in the last century." With a view to Saudi Arabia in particular, an appreciation of the various consequences of its demographic explosion is crucial to an understanding of the issues that confront the Kingdom in the 21<sup>st</sup> century.

Even skeptics concede that the Gulf countries have made giant strides in the way of reform. At the same time, there are some entrenched features of the economy that are universally popular in the Gulf countries today even though they do, in fact, portend more harm than good. "Cheap labor from elsewhere, cheap energy at home, and no taxes at all" may grant a competitive advantage for the time being. Yet these cherished advantages not only impede much needed diversification of the Gulf countries' economies, but also development of their own human resources.

Looking back at the sessions, some of us were struck as much about the things we did not touch upon as by the things we did talk about. With regard to security issues, for example, there was a conspicuous absence of discussion about the role of Israel in the geopolitics of the region. Neither did we take up the evolution of the political situation inside Iran. Finally, it is worth mentioning that no one would question what seemed to be an underlying assumption throughout the various discussions, namely, that the United States of America was somehow going to "always be there" and play an active role in the Greater Middle East.



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