Saudi Arabia

Saudi Arabia at a glance: 2006-07

OVERVIEW
The Economist Intelligence Unit expects the king, Abdullah bin Abdel-Aziz al-Saud, to continue to seek to consolidate his authority by balancing the accommodation of rival members of the ruling family with the advancement of allies where possible. This necessarily collegiate style of government, not least given the vested interests involved, will constrain the pace of political and economic reform. A concerted strategy to overcome the political and economic roots of opposition is not expected to materialise over the forecast period. Cautious, piecemeal political changes, such as the introduction of an elected component to regional government, following the 2005 municipal elections, are likely. Widespread dissatisfaction with the rule of the Al Saud will persist, and periodic attacks by Islamist hardliners on Western and other targets are likely, despite the efforts of the security forces. Driven by high oil prices and rising production, economic growth will stay strong in 2006 and 2007, as oil revenue, though declining, remains firm. The kingdom will also generate large trade-driven current-account surpluses. Inflation will remain low and there will be no pressure on the riyal’s peg to the US dollar.

Key changes from last month

Political outlook
• Our political outlook is unchanged. Although the position of second deputy prime minister (and probable second-in-line to the throne) remains unfilled, this is unlikely to prevent key decision-making.

Economic policy outlook
• Our economic policy outlook is unchanged. The government is expected to persist with its relatively modest programme of economic reform, which will focus on measures to open up parts of the non-oil economy to the private sector in order to boost employment.

Economic forecast
• Our economic forecast is unchanged. Our oil price forecast for 2006 has slightly altered, down to US$55/b from US$56/b.

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**Outlook for 2006-07**

**Political outlook**

The king, Abdullah bin Abdel-Aziz al-Saud, has been moving to consolidate his authority. He appears keen to ensure that, where possible, the powerful “Sudairis” (the sons of the founder of the kingdom, Abdel-Aziz Ibn Saud, by his favoured wife, Hassa bint Ahmed al-Sudairi), while accommodated, do not overly constrain his cautious reform ambitions, as they sometimes did during his de facto rule from the mid-1990s onwards. This relates to the question of who will become crown prince after the demise of either the king or the current crown prince, Sultan bin Abdel-Aziz al-Saud, which is likely to remain a source of tension within the elite, and will quite possibly not be resolved in the foreseeable future. While this will not be a fundamental block on decision-making, it does reflect the cautious pace of political reform. Though not automatic, whoever the king eventually chooses to fill the vacant post of second deputy prime minister is likely to become the next in line to the throne. It is envisaged that the successful appointee will be one of the surviving sons of Ibn Saud. The evolving informal competition looks likely to be a three-way contest between two of the most senior Sudairi members, the governor of Riyadh, Prince Salman bin Abdel-Aziz al-Saud, and the interior minister, Prince Nayef bin Abdel-Aziz al-Saud, and an older non-Sudairi, Prince Mitaab bin Abdel-Aziz al-Saud, who is currently municipal and rural affairs minister and an ally of the king. Whereas appointing Prince Mitaab could strengthen the reform option, nominating a Sudairi—especially Prince Nayef, whose star appears to be waning a little—could constrain an inherently cautious process even further.

The king's authority within the wider family is assisted by an informal alliance with the “Al Faisal”, the sons of a former king, Faisal bin Abdel-Aziz al-Saud, who include the long-standing foreign minister, Prince Saud al-Faisal bin Abdel-Aziz al-Saud, and the Saudi ambassador to the US, Prince Turki al-Faisal. In addition, the king is respected by many of the ulema (clerics), where his reputation for not being corrupt and for personal piety is an asset. The ulema have provided the traditional prop of legitimation for the rule of the Al Saud, although this has been dented by radical challenges and socioeconomic discontent in recent years. The king also retains control of the National Guard, a symbolically, as well as practically, powerful fief that, in addition, provides institutional authority for his three sons.

Frustrations with the Al Saud have been building for years against a backdrop of falling living standards and rising unemployment, particularly among the kingdom's large population of young adults. These conditions have not only broken the implicit social compact that granted the family political authority in return for economic wellbeing, but have also created an impression of a government that is both incompetent and corrupt, with the contrast between the wealth enjoyed by the kingdom's many princes and the poverty of the bulk of its subjects increasingly clear. Rising discontent over the Al Saud's traditionally close relationship with the US has been articulated since the early 1990s by younger, more politically radical clerics whom the senior and co-opted ulema
have been largely unable to rein in. These factors have created a situation in the past few years where hardline Islamist groups have been able organise against the regime.

However, these opposition groups are unlikely to emerge as a fundamental threat to the Al Saud's hold on power. Even during a period of transition within the elite, the Economist Intelligence Unit does not believe that radical leaders would be capable of mobilising a concerted mass opposition movement able to destabilise the ruling order. Although disenchantment is widespread, active support for armed opposition remains limited, and there is no plausible alternative focus of national leadership within or outside the country. The security services are also well armed and well funded, and capable not only of defending the interests of the regime but also of striking back. The number of violent attacks in the kingdom fell significantly in 2005. However, there are still a number of militants at large who are strongly opposed to Al Saud rule and who can also be influenced by events and leaders outside the kingdom, not least in Iraq. As a result, security is likely to remain a constant challenge for the authorities for some time to come.

Formulating a longer-term strategy that could begin to reverse the negative dynamic within the domestic political scene, from which militancy can garner support (or at least a degree of popular acquiescence), would be far harder to achieve. Structural economic reforms could eventually ensure an economy capable of providing sufficient employment opportunities and income to meet demographic challenges. Such a plan would also necessitate a political strategy that engaged more actively with those Islamists who have radical, but reforming, agendas, and who have long sought influence inside the system. Achieving this would necessitate reducing the financial support from the public purse of the vast numbers of members of the extended ruling family and reining back personal excess.

Of less pressing, but still significant, concern is the attitude of the Shia minority concentrated in oil-rich Eastern Province, who remain on the margins of the political system. Although they are for the most part reformist in orientation, there is some impatience among elements of the educated Shia middle class with the cautious approach of the Shia religious leadership. King Abdullah is conscious of the need for greater accommodation of those outside the political mainstream, but was hamstrung by the ruling family's traditional alliance with the highly conservative Sunni clerical leadership. Al Saud caution is likely to continue, especially towards the Shia, compounded in the wake of government concerns about the growing influence of Iran in Shia-led Iraq.

King Abdullah is also well aware of the deleterious effect on political consent for the Al Saud of declining economic standards nationally. However, the process of economic reform is necessarily piecemeal, given the vested interests involved, and the political reform agenda appears limited beyond the gradual introduction of partially elected authorities and an ongoing National Dialogue that is increasingly cynically viewed in many quarters. The added authority that King Abdullah has acquired since his accession will give him the opportunity, should he wish, to approach these issues in a more forthright fashion. However, he is likely to continue to be constrained by his own
caution, given the fear of unleashing overt political pressures or even creating long-term challenges to the survival of the Al Saud. Even relatively small measures require a consensus within the elite. As a result, it appears likely that reform will continue to be slow, with the state's political structure and culture discouraging the government from tackling the causes of unrest and wider discontent more strongly.

**International relations**

Saudi Arabia is under less pressure from the US for internal political change as a result of piecemeal steps already taken and the US administration's regional reform agenda being handled more circumspectly in the wake of ongoing challenges in Iraq. However, the role of Saudi nationals in the Iraqi insurgency and threats to foreign interests in the kingdom could lead to deterioration in relations with the US. The unwillingness of the kingdom to play too public a role in trying to persuade Iraqi Sunni Arabs to fully embrace the political process may complicate ties too. Relations with Iraq and Iran are likely to continue to be difficult. Saudi Arabia will remain pivotal to Syria’s attempt to shore up its position in the Arab world.

**Economic policy outlook**

**Policy trends**

The authorities will continue with their cautious programme of economic reform, laying particular emphasis on boosting the pace of growth in the non-oil sector, both to create employment opportunities and to ease the country's reliance on energy export earnings. With oil prices set to remain high, increased recurrent and capital spending will be central to this drive, although we also expect the government to move forward with efforts to broaden and deepen private-sector activity outside the oil sector. This will include opening up additional parts of the economy currently dominated by state monopolies to private-sector competition, in line with successful measures taken recently to overhaul the telecommunications industry. We also anticipate further steps being taken to improve financing, including the development of a more effective capital market and a further easing of restrictions on foreign financial intermediaries. The government will also provide additional openings for foreign investment, partly to meet the demands caused by its new membership of the World Trade Organisation. The scope and value of foreign direct investment inflows are likely to remain below their potential levels, however—a reflection of investor concerns over the political and legal environment, as well as a reluctance on the part of the government to cede control to the private sector, which might threaten vested interests.

There will remain a general institutional and political resistance to more widespread structural changes, which will hinder the pace and depth of reform, particularly as several years of high oil revenue have eased some of the pressure felt within the government. This will be especially apparent in the government's approach to public finances, with few, if any, practical steps likely to be taken to enhance non-oil earnings (other than the potential indirect benefit of reform leading to rises in foreign company tax revenue) or reduce spending. High oil prices and sustained growth in global oil demand have allowed Saudi Arabia to reverse the cuts imposed on its oil output. Given the
outlook for the oil market, we expect that Saudi output will rise over the forecast period, albeit modestly.

**Fiscal policy**

Total fiscal revenue reached SR555bn (US$148bn) in 2005, an increase of 42.5% on 2004’s outturn, driven by rising oil output and high prices. This exceptional level of earnings is not only an all-time high, but is more than double the five-year average, and four times higher than revenue reported as recently as 1998. Fiscal revenue is forecast to reach SR574.7bn in 2006 as oil production increases slightly and prices remain exceptionally high, but will ease in 2007 as oil prices fall. However, with prices still far ahead of their long-term average, production rising and non-oil earnings showing growth, overall revenue will remain strong by historical standards at SR510bn, the equivalent of 44% of GDP. With the revenue position so strong, we expect the government to continue to accede to political pressures and allow spending to rise strongly throughout the forecast period. A significant element of the increase will be directed towards capital projects, but recurrent spending is also likely to continue to climb significantly.

Despite these gains in expenditure, we expect the central government balance to show a very healthy surplus of SR185bn in 2006, easing to a still-substantial SR87bn in 2007, the equivalent of 7.5% of GDP. The surpluses are likely to be used both to retire elements of the local-currency debt built up over the past two decades and to add to reserves. However, weaknesses beset the public finances in years other than when oil revenue is high. Public financing is unlikely to be the subject of meaningful reform over the near term, and, as a result, these frailties will re-emerge when prices decline.

**Monetary policy**

With the Saudi Arabian Monetary Agency (the central bank) certain to remain committed to the riyal’s peg to the US dollar, interest rates will continue to track those set by the US Federal Reserve (the central bank) closely. This should lead to further increases in 2006, before rates stabilise in 2007. We expect little widening in the interest rate differential over the forecast period, as Saudi Arabia is unlikely to face inflationary or currency pressures.
Economic forecast

International assumptions summary (% unless otherwise indicated)

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Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

We estimate that global growth (measured using purchasing power parity exchange rates) averaged 4.4% in 2005—a performance that stands slightly above the long-term average, but that marks a deceleration on the 5% recorded in 2004. We expect global growth to ease further but remain relatively strong in 2006 and 2007 at around 4%. US interest rates will continue to rise in 2006, before stabilising in 2007—an important consideration for Saudi Arabia, which is all but certain to retain the riyal’s peg to the US dollar.

We estimate that the benchmark dated Brent Blend averaged US$55/barrel in 2005. This exceptional performance reflects the difficulty of expanding supply quickly enough to keep pace with demand. With most producers currently operating at close to their maximum, the market has little spare capacity, putting prices under sustained upward pressure. The market is expected to remain very tight in 2006, keeping average prices unchanged. The market should loosen in the second half of the year, however, as supply growth outstrips increases in demand. The trend will persist into 2007 when prices are expected to average just under US$47/b—still more than double the ten-year average (1995-2004).

Economic growth

We estimate that real GDP growth reached around 6.5% in 2005, on the back of further rises in oil production. Strengthening oil export revenue also fed through into the domestic economy, most directly through sharp increases in public spending. High oil prices have bolstered confidence, lifting private consumption and boosting investment. Interest rates, though rising, are low by medium-term norms, and, with the banks remaining highly liquid, credit expansion is likely to continue to be robust, further boosting growth. Foreign investment will continue to strengthen, and the initiation of the development of the country’s upstream gas sector and downstream power and water
supplies will also continue to add to overall capital spending. These trends will persist throughout the forecast period, although the pace at which the economy grows in real terms will ease to around 4.6% in 2006 and 3.7% in 2007, as oil production rises more slowly.

**Inflation**

The continuation of price subsidies over the forecast period and beyond is likely to mean that the weakness of the US dollar (and consequent increase in the local-currency cost of a range of imported goods) will not prove a strong stimulus to price rises. As a result, despite the inflationary potential of relatively high levels of liquidity, we assume that consumer price inflation in the kingdom will remain very low, at around 0.5%, throughout the forecast period.

**Exchange rates**

Given the robust outlook for the kingdom’s external accounts, the prudent approach to monetary policy adopted by the central bank and our assumption that there will be no serious disruption to political stability, there is very little prospect of the riyal’s peg to the US dollar coming under strain. In the unlikely event that pressure did emerge, the authorities would be well-placed to mount a robust defence of the peg, given their command over interest rates and the large stocks of foreign assets under public control. As long as crude oil continues to be priced in dollars, we do not expect any break in the peg.

**External sector**

We forecast that export earnings will reach US$162.2bn in 2006. Marginally up on the estimated end-2005 figure, this represents the highest level of receipts the kingdom has generated by a wide margin and is around 80% above the five-year average. As average oil prices fall in 2007, export earnings will decline. However, with prices still strong by historical standards, production trending upwards and non-oil exports strengthening, overall revenue will remain robust at nearly US$143bn. Import spending will rise strongly in 2006, by 8%, before increasing less markedly by 4% in 2007. (The weak US dollar will compound the expected increase in the cost of non-industrial goods imports.) However, this will still leave Saudi Arabia with a trade surplus of over US$113bn in 2006, easing to a still very large US$91bn in 2007.

The trade surpluses will be eroded by large net non-merchandise outflows. Services payments will be driven upwards by the higher transport and insurance costs associated with the increase in the import bill, and by a likely pick-up in defence spending (recorded under this line rather than as a merchandise import). Income outflows will remain high, as expanding foreign investment in the fast-growing domestic economy together with strong international oil prices boost profit repatriation. Despite continuing efforts to nationalise the workforce, expatriate remittances will rise. Services earnings are likely to show only modest growth, but there should be a marked pick-up in income credits in 2006 as global interest rates rise and the large external-account surpluses allow a further build-up in the country’s stock of foreign assets. Overall, we expect this to leave the kingdom with very large current-account surpluses in 2006 and 2007, albeit smaller than in 2005, at around US$76.6bn and US$4.6bn respectively, the equivalent of an average of around 21% of GDP over the two-year period.
### Forecast summary

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<th>2004&lt;sup&gt;a&lt;/sup&gt;</th>
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<sup>a</sup> Actual.  <sup>b</sup> Economist Intelligence Unit estimates.  <sup>c</sup> Economist Intelligence Unit forecasts.