Saudi recession must catalyse reform

Greater liberalisation and modernisation essential

by Julian Frazer in London

Tue 7 Nov 2017

Saudi Arabia's move into recession is the clearest sign yet of potential upheaval and the need for reform. The arrests this weekend of numerous senior officials on corruption charges are a foretaste of further radical change in the Arab world's largest economy.

The likelihood that oil demand will peak in the next 10 years, as well as increasing competition from US shale producers and renewable energy, makes economic diversification not merely an ambition but a necessity for the kingdom with an ailing private sector, rising unemployment and average age of less than 30. Latest data show that GDP shrank for the second straight quarter between April and June.

The initial public offering of Saudi Aramco, the state-owned oil giant, on an international exchange was intended to offer something of a remedy. A listing in either London or New York of only a small portion of Aramco's business was expected to raise more than $100bn. But comments made last week by the Saudi ministry of finance confirm that the only certainty, for the time being at least, is a domestic listing.

For Mohammed bin Salman, the deputy crown prince and head of the anti-corruption commission, the IPO was central to funding Vision 2030, the country's ambitious economic reform programme. Though an international listing is still a possibility, other initiatives must come to the fore to buttress the private sector.

Uncertainty around the Aramco IPO raises questions about how the crown prince's plans will be financed. The oil price isn't expected to recover imminently to its 2012 highs. Even if it did climb, it is far from inevitable that a boost to state coffers would go towards underwriting the reform programme – there are few examples from resource-rich countries of such effective forward planning.

The kingdom is courting private investors and the international banking community. Between 24-26 October Riyadh hosted its Future Investment Initiative conference, referred to by some as 'Davos in the desert'. Christine Lagarde, managing director of the International Monetary Fund, and Steven Mnuchin, US Treasury secretary, were among the major figures in attendance. The future of the Public Investment Fund, Saudi Arabia's sovereign fund, was a key point of discussion. Blackstone, the world's largest alternative investment firm, and the PIF have already agreed to collaborate on a $40bn investment vehicle. Japanese telecommunications company SoftBank and the PIF are likewise partnering on a $45bn technology fund.

The most talked about issue, however, was the announcement of a $500bn investment zone called Neom. In his address, the crown prince described the zone as a hyper-advanced city and innovation hub which will be powered entirely by renewable energy. Plans show it will be built in the northwest of Saudi Arabia, near to Egypt and Jordan. It is as close practically as the project can be to both Africa and Europe, at 'a strategic crossroads in trade'.

Greater liberalisation and modernisation of the sort espoused by the crown prince will play a key role in attracting investors. In September the ban on women driving in the county was lifted and will come into effect from June 2018. While some in the West may view this as a superficial improvement, it is a substantial step forward for the traditionally ultraconservative country. Moreover, it is a sign that the state understands the significance of upholding and improving the quality of its social contract with citizens.

Although their size and gravity did not meet that of other Arab Spring revolts, Saudi Arabia contended in 2011-12 with protests relating to infrastructure improvement, women's suffrage and labour rights. The cutting back of generous welfare programmes in a country where 'cradle-to-grave' subsidies are treated by many as a birthright may engender further protest and encourage political leaders to enact popular reforms quickly. The introduction of a 5% value added tax from January 2018 in Saudi Arabia and across the other five Gulf Co-operation Council states is another potentially unpopular, though economically sensible, move.

More difficult decisions of this sort will have to be made if Saudi Arabia is to unburden itself of its oil dependency and deliver robust growth for its young population. The popular, charismatic and reformist 32-year-old crown prince appears to be the ideal exponent to deliver that message.

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