commentary

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SAUDI ARABIA'S OIL DEPENDENCE: CHALLENGES AHEAD

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Oil is the main pillar of Saudi Arabia's economy and the cornerstone of its development. According to the IMF's latest data[1], oil receipts accounted for around 85% of exports and almost 90% of fiscal revenue, while the oil sector comprises over 40% of overall GDP. The oil price boom from 2003to 2014 provided Saudi Arabia with strong growth, allowing the economy to grow[2] by an annualized 5% and the kingdom's gross domestic product (GDP) more than tripled in size. As a result, the Saudi economy moved up from being the 27th largest in the world in 2003 to become the 19th largest in 2014.

To be sure, Saudi Arabia is the largest economy in the region (excluding Turkey) and its economy represents around a quarter of the combined GDP of the Middle East-North Africa (MENA) region according to the latest IMF data, making it the logical choice to be a member of the world's top economies or G20. Importantly, Saudi Arabia is the world's largest producer and exporter of oil and has by far the world's largest sustainable production capacity[3] at about 12.3 million barrels-per-day and it also has the world's largest spare capacity (Vs February 2016 supply) currently estimated at over 2 million barrels-per-day or around 70% of OPEC's unused capacity.

Rising "threats"

However, nearly two years after the start of the collapse in global oil prices, Saudi Arabia's economy has clearly deteriorated and the outlook remains uncertain. The county's fiscal deficit hit[4] almost $100 billion or 15% of GDP last year. Saudi Arabia also recorded a deficit in the current account balance, which for the first time since 1999 reached $41 billion, or 6.4% of GDPin 2015. This deficit is expected to rise in 2016 to more than $63 billion, or 10.2% of GDP.

1 http://www.imf.org/external/pubs/cat/longres.aspx?sk=43343.01.

2 http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx

3 https://www.iea.org/oilmarketreport/omrpublic/

4 http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx

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According to the IMF's latest World Economic Outlook[5] report, Saudi Arabia's economic growth will slow considerably in the next five years. The Saudi economy is set to grow by 1.2% in 2016, the lowest in seven years, and real GDP growth is forecast to average less than 2% a year between 2016 and 2021. The Economist Intelligence Unit "expects the deficit to average 10% of GDP in 2016-20, as spending cuts fail to fully offset persistently weak oil prices." In this context, the US-based Fitch Ratings on April 12, 2016[6] downgraded Saudi Arabia's long-term ratings due to lower estimates for oil prices.

Meanwhile, Saudi foreign reserves are declining at an alarming rate. The latest figures from the Saudi Arabian Monetary Agency (SAMA) show its net foreign assets falling to $ 593 billion at the end of February, down $ 19 billion in the end-2015 figures and $ 121 billion (17%) from the previous year's level[7]. However, aware of the need to protect its reserve stocks, the Saudi government will increasingly rely on debt issuance to finance its deficits. As a result, the IMF expects[8] general government gross debt to soar from a negligible 5.8% of GDP at end-2015 to 51% of GDP by 2021.Another threat to stability and growth in Saudi Arabia has emerged from pressure on the long-standing riyal's peg to the US dollar. However, it's unlikely in the near future that SAMA will abandon its currency's peg.

To add to complications, geopolitical risks are also high as tensions have risen between the kingdom and Iran. Additionally, official Saudi deficit figures do not even include some of the military expenses incurred by the war in Yemen or payments made to the armed opposition in Syria. Saudi Arabia continues to spend a bigger portion of its economy on defense than any other nation (13.7% of GDP, vs. 3.3% in the U.S.). According to the SIPRI Fact Sheet[9] Saudi Arabia overtook Russia to become the third-largest military spender in 2015.

Above all, Saudi Arabia's oil dependence has also led to structural inefficiencies such as rising unemployment among Saudi citizens and a heavily subsidized welfare system. Last year, the kingdom's oil demand hit 3.29 or over 32% of the total crude supply. The IEA's latest data estimates[10] that fossil-fuel consumption subsidies in Saudi Arabia amounted to 9.5% of its GDP or $71.3 billion in 2014.

The Developing Saudi Response

Despite the uncertain outlook, the economic situation seems manageable in the short and medium term, although Saudi Arabia must embark on deep structural reforms to tackle the rising challenges in the long term. There are three lines of response which Saudi Arabia is currently developing in answer to these challenges. First, Saudi Arabia's government is reacting to the decline in its revenues with a mixture of policies, drawing down reserves and taking on debt on the one hand, and imposing austerity measures, cuts in energy subsidies, tax increases and higher fees on the other. In the long term, Saudi Arabia is seeking to diversify its economy and the government is expected to release (before the end of this month) its National Transformation Plan (NTP) designed to restructure the economy away from its oil dependence for the country's sustainable development.

Secondly, Saudi Arabia's policy of maintaining its oil market share is expected to continue for the foreseeable future, unless other major producers such as Russia and Iran agree to joint action. Julian Lee, an oil strategist for Bloomberg First Word, warned recently[11]: "There's an oil supply crunch looming and Saudi Arabia and its local allies are positioning themselves to take advantage.

[5] http://www.imf.org/external/pubs/ft/weo/2016/01/

[6] https://www.fitchratings.com/site/fitch-home/pressrelease?id=1002337

[7] MEES: April 1, 2016

[8] http://www.imf.org/external/pubs/ft/weo/2016/01/

[9] www.sipri.org/media/pressreleases/2016/milex-apr-2016

[10] www.worldenergyoutlook.org/resources/energysubsidies/fossilfuelsubsidydatabase

[11] http://www.bloomberg.com/gadfly/articles/2016-04-10/saudi-arabia-oil-gambit-moves-to-phase-two

In what would be the second phase of the kingdom's strategy to defend its market share against rival producers, [the kingdom] is planning to raise output capacity to fill the hole left by the lack of investment in new projects elsewhere". The IEA estimates that global capital expenditure (Capex) dropped 24% in 2015, and this year we expect a further decline of 17%. Certainly Saudi Arabia is among the few countries to keep its upstream activity at near record levels so far this year. According to the oilfield service firm Baker Hughes, the Saudi rig count fell to 127 in March, just two below its December 2015 record of 129.

Most importantly, Saudi Arabia is seriously considering the introduction of renewable energy as an option to counter the challenge as well as to diversify its industrial structure for the country's sustainable development. As Saudi Oil Minister Ali al-Naimi rightly pointed out[12], "I don't think there is a more ideal country for renewables than Saudi Arabia".

Against this strategic backdrop, diversifying the Saudi economy away from oil dependencewill not be an easy job, but a long and painful process. Economic reforms potentially carry social risks and could provoke resentment among several segments of society such as the young unemployed, harder-hit businesses and influential religious groups. These developments in Saudi Arabia are watched closely by the whole world as the success or failure in the kingdom will have serious repercussions regionally and internationally.

[12] http://www.bloomberg.com/news/articles/2016-03-17/saudi-arabia-s-oil-chief-prepares-for-a-world-after-fossil-fuels