Reforms and Diversification

The meaning of word 'reform' means "to improve by alteration, correction of error, or removal of defects; put into a better form or condition; to abolish abuse or malpractice", as in reform the government. The word reform has almost invariably been used in its plural form and preceded by the word 'economic'. Economic reforms and diversification in Saudi Arabia means reducing the heavy dependency on the oil sector by developing the non-oil sectors of the economy. It also implicitly includes reducing the direct role of public sector, while increasing private sector activity and hence, its size and role in the economy. Further more economic reforms and diversification for Saudi Arabia means increasing non-oil exports, non-oil revenues, and increased Saudi labour force participation in all economic activities.

There are a number of indicators and measures in order to assess the progress of economic diversification efforts. These indicators include:— the contribution of oil verses non-oil revenues in total government revenues, the percentage of oil export verses non-oil exports in the total exports and composition of non-oil exports and imports. The

progress in total employment for Saudi versus non-Saudi by the various economic areas. Finally we can say that reforms and diversification of Saudi Arabia means the development in the relative importance of public versus private sector contribution to the Gross Domestic Product (GDP).

Oil continues to dominate the Saudi economy accounting for three quarter of the government revenues, and around 90 percent of exports earnings. Saudi Arabia focuses almost exclusively upon the hydrocarbon sector, to the detriment of the rest of the economy. The need for economic diversification was clear long ago, but little was achieved. For achieving this goal the government of Saudi Arabia established Supreme Economic Council. The Supreme Economic Council was established in 1999 under the chairmanship of the then Crown Prince Abdullah.

The Supreme Economic Council evaluates economic, industrial, agricultural, labour policies to assess effectiveness. It also studied the country’s economy, annual budget, the current and future five year plans, economic reforms requirements such as privatisation and partial market deregulation. The Supreme Economic Council also started projects to diversify the economic, monetary and fiscal policies. It has some executive powers, but only in getting its decision to be approved and issued by the Council of Ministers. It issues a regular report to the Council of Ministers on the state of the economy. The Supreme
Economic Council has eleven members. Their direct influence on the interest of citizens and the need to involve a wide circle of contributors in economic policy making in the changing scenario has been crucial.

This clears that the economic policy of the Saudi Arabia is based on the pillars of comprehensive social welfare, the concept of free economy, and a free market for capital goods, services and products in order to secure the following goals:—

1. The welfare of society
2. Provision of job and optimum use of man powers.
3. Diversification of economic base and increase in the sources of public revenue.
4. Development of saving and saving channels and framework for fresh investment.
5. Increase of investment of domestic capital and saving in the national economy.
6. Fair distribution of national income and opportunities for investment.
7. Increase in the contribution of the private sector, expansion of its contribution in the national economy, and contribution to the government programme for privatization.
8. Enhancement of the ability of the national economy to cope efficiently with international economic changes.

The other element of the reform strategy is to diversify the base of Saudi economy away from its sole dependence on oil. The government has encouraged the growth of value added industry in areas where the kingdom has comparative advantage. Saudi Arabia wants impressive growth in non-oil industry. The volume of export of these industries reached US $ 23 billion and has been achieving an average annual growth of 13 percent during past ten years.\(^2\) When Saudi Arabia became the member of WTO in December 2005, a substantial increase in the level of growth in the export of these industries was expected as has happened with the other newly acceding countries, to the WTO such as China, Jordan and Oman. Saudi Arabia is fully committed to increase private sector participation in economic growth. Privatization is a key element of Saudi Arabian economic liberalization and a host of sectors are being opened to the private sector. Telecommunication, electricity, mining, airlines, postal services, railways, port services and water utilities are some of the potential areas for investment. Privatization is an important issue that has been tackled by many researchers both in developed and developing countries. Literatures on privatization suggest

that it promotes economic growth, stimulates productive efficiency, expands the role of the private sector, reduces the size of the government sector, attracts foreign investment and helps in the development of capital market programmes specially in developing countries.\textsuperscript{3}

The Supreme Economic Council approved privatization in Saudi Arabia, having eight main objectives and each objective requires number of policies. The objectives are focused on improving the capacity of national economy and enhancing its competitive ability to meet the challenges of regional and international competition. The strategy is also aimed at encouraging private sector investment and effective participation in the economy, based on commercial principles. Expanding the ownership of productive assets by Saudis, encouraging local investment of domestic and foreign capital, increasing employment opportunities and optimizing the use of the national workforce. Privatization also ensures the continued equitable increase of individual income, providing services to citizens and investors in timely cost effective manner. Rationalizing public expenditure reduces the burden of the government budget. It gives the private sector opportunities to finance, increasing government revenues from: return on participation in activity to the transferred to the private sector as for example, from

granting concessions or the sale of government properties.\textsuperscript{4} The privatization strategy of Saudi Arabia defined a number of administrative and implementational procedures. Whereby the economic council will be responsible for supervising privatization programmes and monitoring their implementation. The privatization strategy for Saudi Arabia was prepared to ensure a continued increase in the share of private sector and its expanded participation in the national economy. The best means for achieving this included transferring certain type of economic activity to private sector. Its aim has been expanding the participation of the private sector in economic development and enabling it to carry out its investing and financing role in accordance with the national development plan. It is reported that the privatization is the process of transforming the ownership or management of public establishment, projects and services from the government sector to the private sector. The government of Saudi Arabia defined the objective of privatization and policy needs to achieve these objectives, as described below:—

1. Saudi Arabia’s privatization relates to improving the capacity of national economy and enhancing its competitive ability to meet the challenges of regional and international competition. The capacity of the economy can be

\footnote{Ibid.}
strengthened by subjecting projects to market forces. Enhancing competitiveness is closely linked to the general strategy of development of the private sector of Saudi Arabia. The developing of capital and labour markets will help achieve this objective.

2. Encouraging private sector investment and effective participation in national economy. A developed and strong private sector is essential for Saudi Arabia, as the private sector is able to achieve a comparative advantage. It also provides a better opportunity for diversifying the economic base, and moving away from the dependence on oil. The private sector and direct capital investments towards the more fruitful and commercially sustainable sector. The privatization programme must also include simplification of procedures to encourage investment in the private sector, and ensure that privatized projects are able to achieve significant growth. Policies necessary to achieve these two objectives are—

i. Privatization of public projects, enterprises and services that are appropriate for private sector participation and encouraging competition.
ii. To ensure that privatization results in increased direct investment that are self sustainable.

3. The third objective gives emphasis on expanding the ownership of productive assets by Saudi citizens. For this encouraging the large number of citizens to participate in various types of activities transferred to the private sector by using the privatization method.

4. The fourth objective of the privatization aims at encouraging local investment of domestic and foreign capital. Privatization reflects the government commitment to economic reform and projecting a positive image on attracting foreign investment. Privatization also helps to develop the capital market, create new mechanism for providing capital and attracting domestic capital.

5. The fifth objective of privatization gives emphasis in increasing employment opportunities, optimizing the use of national workforce, and ensuring the continued equitable increase of individual income. Developing the nation's human resources is a basic element of national development. Therefore, the privatization programme attaches particular importance to it, including Saudization. By developing appropriate regulations and incentives to
encourage the private sector to hire Saudi citizens. The privatization of certain projects revealed that the number of employees were larger than actually required. The privatized enterprise could agree to keep their employees until they studied their future expanded requirements to meet increased demand for their services, which would reveal their actual requirement for their employee.

6. The sixth objective of the privatization is stated to provide services to citizens and investors in a timely and cost efficient manner. However, privatization, particularly of projects that have monopoly concession rights, may lead to increase in prices and reduction in the quality of services. Because some enterprises received government subsidies prior to being privatized.

7. The seventh objective of the privatization strategy rationalizes public expenditure and tries to reduce the burden of the government budget, by giving the private sector opportunities to finance, operate and maintain certain services that they are able to provide. The government budget is expected to benefit from reduced allocation for operating expenditure resulting from the privatization of public establishments.
8. The last objective of privatization policy gives emphasis on increasing government revenues from returns on participation in activities to be transferred to the private sector. For example, granting concession or sale of government properties. The government aims at achieving positive financial result from privatization.

The Supreme Economic Council is responsible for supervising the privatization programme and monitoring its implication in coordination with the competent government agencies.

The Saudi government is pursuing various procedures for privatizing enterprises owned by the government. The main objectives of these procedures are to promote more effective contribution by the private sector to the provision of different goods and services, reduced dependence of oil as main source of income and further increase private investment.

**Saudi Arabia General Investment Authority (SAGIA)**

This organization was set up in 2000, to further promote foreign investment and serve the business community. Prince Abdullah Ibn Faisal Ibn Turki, nephew of King Fahad, became its governor as well as Chairman of its thirteen member board. The other members were the deputy ministers of interior, foreign affairs, finance and economy,
petroleum and mineral resources, industry and electricity, planning commerce, agriculture and water, labour and social affair, as well as deputy governor of Saudi Arabia monetary agency and two representative from the private sector. The new laws for investment enacted in allows foreign companies to obtain 100 percent ownership of local ventures and related estate in a wide range of fields, including gas, power generation and water desalination, petrochemical and oil refining. Foreign owned ventures now have access to loans from the Saudi Industrial Development Fund, which are almost interest free, and enjoy the same incentives and guarantees as the ones given to the nationals. With this having cleared the way for international oil companies to be attracted to the gas openings, planners hope the law and other reforms would attract into Saudi Arabia about $100 billion direct foreign investment. Saudi Arabia is a signatory to various regional agencies guaranteeing a level playing field to foreign investors. It is a member of the Multilateral Investment Guarantee Agency (MIGA) and WTO. Saudi Arabia, hence, has to ensure the same treatment, protection and incentives to foreign investment as accorded to the national capital. The pre-investment assistance provided by SAGIA and other government agencies includes helping foreign investors prepare

feasibility studies for industrial projects. They also provide information and statistics for investment projects within the scope of Saudi Arabia development plans. Land for setting up industrial units are available throughout the kingdom in several industrial units. The kingdom proposes to invest $200 billion in the oil, gas, electricity and desalination and petrochemical industries. Global oil companies are also considering investing $100 billion over a period of 20 years in the production of natural gas. It is also expected that $6 billion worth of domestic capital will be invested in the tourism sector. The Supreme Commission for Tourism was established in April 2000 to help the tourism sector grow and coordinate with the private sector, for further investment. Each year more than two million Muslims from all over the world visit Saudi Arabia to perform the Hajj, and many more come to perform the Umrah. Further, the kingdom also hosts the non-religious tourism. Saudi Arabia is rich in history and culture and a variety of tourist attractions to offer, including archeological sites. Expansion of King Abdul Aziz International Airport in Jeddah was implemented in 2003 at the cost of $1.5 billion to accommodate an additional 13 to 21 million passengers per year. Because of the huge inflow of religious and other tourists Saudi government invests huge amount in real estate. Over the past five years, Saudi Arabia’s private developers, buoyed by

8. Special Report, Oil and Gas, *Middle East Economic Digest*, April 11, 2000, p.12-16
high oil prices and a growing housing shortage, have launched a series of urban real estate projects targeting the kingdom's growing requirement for affordable accommodation.

Following decisions by the municipalities of Riyadh and Jeddah to relax the height restriction on tall planning, the skyline of the kingdom's major cities is also set to change rapidly as towers of up to 50 storeys replace traditional low-rise buildings. Taking advantage of the relaxation of Saudi Arabia building restrictions, local and international developers have launched a series of real estate developments. Emmar of economic city, a subsidiary of the UAE's Emmar Properties, is developing the $27 billion, 167 square kilo metre King Abdullah Economic City.9

This is the first of six such economic cities, which are designed to diversify the kingdom's oil dependent economy and provide for the next generation of the Saudi's. "Before the Saudi came up with the idea of the economic city, the real estate market was not exactly booming." Says Kenneth Lim, Business Development Manager with Singapore based Jurong International, which master plans urban development in the kingdom. "But right now, because of the economic cities, it has pushed the market to be more vibrant."10 The tower will form part of a wider real estate project planned by kingdom holdings, covering 5.3

10. Ibid.
square kilo metre. It will be split into a residential area of 1.5 square kilo metre, a business zone of 800,000 square kilo metre and a 470,000 square metre commercial area. There will also be an educational area of 150,000 square metre, along with leisure and tourism facilities and hotels. Local developer Dar al Arkam has launched the $1.6 billion Shams al Riyadh project, a 10 square kilo metre development of 8,000 residential units, which will be built to north of the city.

The holy city of Mecca is also undergoing a massive transformation as developers capitalise on one of the world's most expensive location for real estate. Emmar Middle East, a property development company owned by Emmar Properties that focuses on projects solely in the middle east region, has two major developments targeting growth area in Saudi Arabia. All these activities taking place are bound to benefit the tourism sector in Saudi Arabia. Since the kingdom is the cradle of Islam and homeland of the two holy mosques, it occupied a special status in both the Arab & Muslim countries. Arabia has vast geographical area, diverse climate and natural resources and open economy. It also has advance infrastructure as well as the existence of an efficient system of tourism facilities. For developing the tourism industry Saudi Arabia established Supreme Commission for Tourism, which was later known as General Commission for Tourism and Antiquities. Tourism sector contributes to the diversification and
growth process of national economy. It also increases employment and investment opportunities for citizens, realizes balanced regional developments, enhances the balance of payments, enriches heritage and knowledge and binds the citizens with their societies.

General Commission for Tourism and Antiquities prepared a three phased project for developing national tourism. The first phase has been to work out the general policy for developing and advancing national tourism over the next twenty years. The second phase has been to draw up implementation plans for the upcoming five years. And the last phase three is to set the detailed foundation for developing regional tourism and fulfilling the plans of promoting tourism location. The kingdom of Saudi Arabia has diverse natural and heritage resources, numerous tourism facilities and good infrastructure that can contribute to developing the tourism sector. According to the General Commission for Tourism and Antiquities, more than 12 thousand natural, historical and cultural sites have been located. Accordingly 40 tourism development areas have been identified, all of which can be developed in to an integrated tourism areas of the future. The General Commission for Tourism and Antiquities approved around 903 sites in 2002 as being feasible for tourism development.11

According to the data of the Ministry of Commerce and Industry, the number of hotels of various classes operating in the kingdom at the end of 2007 stood at 1,209 with a room capacity estimated at 185 thousands. The number of housing units licensed in the kingdom stood at 2,784 at the end of 2007. These units are spread over various cities in Saudi Arabia. Jeddah accounted for the largest number of such units, representing 22.4 percent (624 units) of the total followed by cities of the eastern region 14.4 percent (400 units), Riyadh 14.3 percent (398 units), Abha 9.7 percent (270 units) and Makkah with 8 percent (224 units). The General Commission for Tourism & Antiquities estimates indicate a rise in the value added by the tourism sector to Gross Domestic Product (GDP) during 2005-2007 from Reylals 36.5 billion to Reylals 37 billion while its ratios decline during the same period from 3.1 percent to 2.6 percent mainly due to the high growth in GDP due to improved oil prices. And hence, the share of tourism sector in GDP declined lastly it can be stated that tourism industry plays an important role for the economic reform and diversification process in the economy.

Private Sector in Economic Diversification

The new policy centres on economic diversification and reform widening the role of the private sector. Unlike in previous booms, the

government is driving a comprehensive strategy to move away from its hydrocarbon dominated economy of the past. The creation of Saudi Arabian General Investment Authority (SAGIA) was deemed to be important step in this regard. Set up to target foreign and private investors, it has grown in its sphere. The chairman of SAGIA Amr Dabbagh, is close to king Abdullah and considered a progressive thinker. It has set itself a target of placing the kingdom among the world’s top ten competitive investment destination by 2010.\(^{13}\) Under SAGIA’s auspices, the kingdom is pressing ahead will a bold initiative to create six economic cities as a means of beneficial foreign investment and repatriating Saudi money. In 2005-06, it launched four integrated cities:—

1. King Abdullah Economic City (KAEC) bear Rabigh.
2. Prince Abdul Aziz bin Mosaed Economic City (PABMEC) in Hail
3. Jizan Economic City (JEC)
4. Medina’s Knowledge Economic City (KEC)

A new one is proposed at Tabuk, while the sixth city was to be launched later on in the eastern province. The government was also considering a city in partnership with Yemen.\(^{14}\) Each city aims to develop a specific business sector. However industry will be focused in

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\(^{14}\) Ibid
Jizan. Recreation and tourism will be centred in Rabigh. Hail will enable logistic and agricultural, while Medina will develop knowledge-based industries. Saudi Arabia General Investment Authority estimates the entire programme's contribution to GDP to be about $150 billion by 2020, raising the country's GDP per capita to $33,500 million from $13,000 million.\(^{15}\) "It was an extraordinary response in the first 12 months." Said a senior SAGIA official. "As a result, we have received proposals from private developers so they can launch their own economic cities, but we have had to curb some of their enthusiasm."

These cities are also to be the cornerstone of the government's efforts to resolve the kingdom's worsening unemployment problem, which stands at between 12-20 percent. According to Dabbagh, Chairman of SAGIA, the new development will provide job opportunities for 1.3 million people. "Jizan is one of the largest areas in the kingdom and is among the least developed", says Abdullah Basodah, Chairman of the Board of Western Way for Industrial Development Company, which is building an aluminium smelter in Jizan Economic City (JEC). "It has the largest potential for Saudi people to gain employment so we can draw on that pool."

Likewise, it is hoped that the cities will fill the demand for good quality and modern accommodation. The country's youthful population-

60 percent are under the age of 20 and are increasingly demanding real estate development similar to the kingdom’s neighbours. The Managing Director of Jeddah based development firm Tamlik, Zuhair Hamid Fayez says, “It is good way of putting things in motion.” But while the rationale for the cities may be evident, it has not been plain sailing since King Abdullah Economic City was launched in 2005. Until now, very little construction has actually occurred. King Abdullah Economic City is the most advanced. However, other than ground leveling works, a sale centre and a few tenders for residential buildings, progress has been slow. Yet, the developer, Emaar Economic City, expanded the size of the development by nearly four times to cover over 168 million square kilo metre, making it the largest project ever undertaken in the Middle East. Despite initial enthusiasm, a growing number of private sector, businessmen are questioning whether the plans are realistic. Hashim Malaika, General Manager at Riyadh based Dar Al Riyadh says, “We have been hearing a lot about the economic cities.” But very little has happened. The opportunities for investment are huge, but the bureaucracy is so stifling that makes it difficult to take a step forward. There is still very little investment from overseas and Saudi investors would still rather invest abroad. This slow pace of reform is holding things back. Nowhere is this more evident than in issuing visas. In mid

16. Opcit. 13, p.2

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2006, it appeared that international tourist visas would be made available for the first time.

These cities would also provide a platform for social development. The king Abdullah bin Abdulaziz foundation for the development of housing owns the land. Under its agreement with Seera, it will receive a portion of the city’s returns, which will then be invested into providing housing across the kingdom. The economic cities are undoubtedly the boldest initiatives ever undertaken by Saudi Arabia. The authorities have made the promises. As of yet, quantifying success is too early. SAGIA has said that it is aiming to license investment projects of about $300 billion in 2009, of which it will hope a large portion enters the new cities.

Saudi Arabia’s privatization and economic diversification efforts have gained momentum since the creation of new Supreme Economic Council. The purpose behind the creation of the Supreme Economic Council has been to speed up economic reforms aimed at opening Saudi markets and ensure stability for investors. The Supreme Economic Council has been officially responsible for the kingdom’s privatization efforts since early 2001. It plays a supervisory role in the formulation of economic policy, managing the budget and coordinating the implementation of policies between government department and agencies. The Supreme Economic Council evaluates economic,
industrial, agricultural and labour policies to assess their effectiveness and impact on the national economy, diversification of the country’s economic base and the growth of its competitive economic strength.

**Capital Market**

Developing the financial markets is one of the most important objectives of reforms. It would help to achieve various goals of privatization process. This includes expanding the scope for participation by Saudis in the ownership of productive assets. Public enterprises projects are encouraging local investment of domestic and foreign capital. There is strong connection between privatization and financial market. Because privatization leads to development of financial markets by encouraging investors and investment companies to diversify their portfolios by investing in companies that are well managed, and in diverse sectors such as communication, electricity, cement, banking and transportation. Small investors are also attracted, which lead to creation of investment tools of a joint nature and balance in the liquidity position between banks and financial markets. Its also provides opportunities to invest in the funds of social security and financial establishments. The existence of a developed financial market helps ensure the success of the privatization process, when certain enterprises are privatized through public subscription in the financial
market. Since the first big increases in oil prices in the 1970's, there has been three major phase for capital development in Saudi Arabia. The first was a period of massive capital expansion. Where nearly all of the modern infrastructure was planned and built; the roads, airports, electricity and water systems, universities and so on. During the decade from 1975 to 1985, Saudi government budgets provided more than $250 billion in project spending with annual budget for project spending at times exceeding $40 billion. This was the time when ground work was laid for Saudi Industrial Development. From its own capital budgets, Aramco found resources to develop huge natural gas gathering and pipeline systems in order to meet the fuel and feed stock needs of the Saudi Basic Industries Corporation. The capital to built the SABIC Companies came through the public investment, as well as from more than a dozen joint venture partners. Some of the government's interest in the SABIC companies has been sold to the public. Public investment remained as the nominal shareholder for the portion that is retained by the government. Other than public investment funds were the Saudi Industrial Development Fund (SIDF), the funds for agriculture and real estates, and the Saudi Credit Bank. The Saudi Industrial Development Fund provided financing and advice to small and medium as well as

19. Ibid.

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large scale business, helping to meet up to 50 percent of the capital needs for activating. The funds for agricultural and real estates work with individuals, farmers and home-owners to help to meet capital needs in these areas. And the Saudi Credit Bank was structured to help meet the capital requirements of independent small business. Government’s capital contribution in these funds exceeded $50 billion during the early period through 1984.\textsuperscript{20} With ongoing repayments of earlier loans, these funds have continued to provide new capital for economic development and growth.

The post war phase of Saudi development, also saw a large expansion of the banking system. Between 1991 and 1995, the capitalization of Saudi banks doubled, from $4.5 billion to 9.0 billion.\textsuperscript{21} The Saudi budget of 1997 highlighted that the budget deficits were narrowing and substantial progress was reported at bringing government payments current. Due to continued private sector expansion and higher oil prices, the country enjoyed the robust growth in 1996 nearly 9 percent nominal terms, with the private sector holding its own at around 4 percent. The local monetary system was increasingly developing as reflected in increased reliance on banks and banking services. Major progress was reported for needed expansion of the electricity and telephone systems. Capital Market Authority spokesman Abdul Aziz

\textsuperscript{20} Kevin Taecker, “Saudi Capital Market in context-Retrospective and outlook”, \textit{MEES} Vol. XL No. 3, 13 Jan 1997, p.D1
\textsuperscript{21} Ibid., p.D2
said “They are licensed to do everything related to the stock market.”

Capital Market Authority also granted more limited brokerage licenses to two other firms; i.e. a Saudi company and a joint venture between Saudi investors and credit issues. “This is a big development in the financial sector. We have never had new companies winning brokerage license”, Al Zoom said. Saudi Arabia’s 11 domestic banks have so far a monopoly on brokerage activity on the Arab world’s biggest bourse. Which has doubled in value this year and seen daily turnover hit nearly $7 billion on busy days. The gulf and western banks have won approval from the central bank to operate and some already have branches in the kingdom. Last month French bank BNP Paribas became the first European bank to open up in Riyadh. Saudi Arabia has established a sound regulatory and financial standards and payment system equivalent to those in the major industrial countries. This has resulted in a strong banking sector that benefits from management, expertise and the most sophisticated technologies. The sector offers diverse financial services to the growing commercial sector. The reliability of this financial infrastructure and the size of the Saudi market make Saudi Arabia an attractive investment destination. The Kingdom’s financial sector

24. Ibid....
consists of the Central Bank (SAMA), the commercial banks, the specialized credit institutions and the stock market. Banking is regulated under the Banking Control Law issued by government of Saudi Arabia in 1986. The council of ministers issues license for the establishment of banks, based on recommendations from the ministry of finance and national economy after review by the central banks. The government stake in commercial banks is less than 10 percent. Sufficient liquidity enables financing at equitable rates. Foreigners can invest in the stock market through investment funds. The Saudi stock market has become the largest in the region. The Saudi Riyal has a strong record of stability and inflation rates in Saudi Arabia were very low.

Foreign Direct Investment and trade are often seen as important catalyst for economic growth in the developing countries. Foreign Direct Investment is also an important means of technology transfer from developed countries to developing countries. Foreign Direct Investment also estimates domestic investments and facilitates improvements in human capital and institutions in the host countries. International trade is also known to be an instrument of economic growth. Trade facilities more efficient production of goods and services by shifting production to countries that have comparative advantage in producing goods and services. Foreign Direct Investment in Saudi Arabia mostly assumes one of the three forms; (1) Joint Ventures, (2) Green Field Investment, and
(3) investment related to the offset programs. Joint venture has been predominant from prior to the new investment law and involved ventures jointly with Saudi government, institutions or firms. Greenfield investment in Saudi Arabia production and distribution facilitates is relatively new being spurred by the new investment law. Joint venture, the predominant form could theoretically be either equity joint venture or contractual joint venture. Of these two forms equity joint ventures seems to be the predominant in Saudi Arabia’s foreign direct investment, where the foreign side generally contributed equipment, industrial property rights, including technology and funds. While Saudi counterpart contributed land, plant, equipment and the local component of currency and funds. In addition to these forms, the kingdom of Saudi Arabia also instituted an offset program, with foreign partner. However, rather than merely reducing the cost of imports, Saudi Arabia evolved offset programs that focus more on developing and diversifying Saudi national economy to ensure long term growth. Foreign Direct Investment and trade has a positive impact on economic growth. The size of such impact may across countries depending up on the level of human capital, domestic investment, infrastructure, macro economic stability, and trade policies. Foreign Direct Investment plays an important role in economic growth of a country as well as the importance of economic and institutional development. It is clear that
Foreign Direct Investment, trade, human capital and domestic investment are important sources of economic growth for developing countries. Saudi Arabia is a signatory to various regional agencies guaranteeing a level playing field to the foreign investors.\textsuperscript{26} It is a member of the Multilateral Investment Guarantee Agency. The kingdom, hence, ensures the foreign investors same treatment, protection and incentives as accorded to the national capital. The pre-investment assistance provided by Saudi Arabian General Investment Authority and other government agencies includes helping foreign investors prepare feasibility studies for industrial projects. They also provide information and statistic for investment projects, within the scope of Saudi Arabia's development plans. Land for setting up industrial units are available throughout the kingdom in several industrial cities. The government makes electricity, water and fuels available for industrial projects at low prices. Industrial parks have public utilities like roads, desalinated water, telephones and postal services. Commodities entering the kingdom as input for industrial production and some basic foods are exempted from custom duties. Saudi Industrial Development Fund gives soft, medium and long term loans to industrial establishments for up to 50 percent of the total cost of the project.

\textsuperscript{26} Op cit, 18, p.D5
Foreign Investment and Energy Sector

Most of the crude oil producers have switched away from an exclusively state controlled energy sector to the gradual opening of foreign investment inflow. So, the Saudi move should be seen as part of a larger trend in the oil and gas industry. There are several reasons why government is reopening the door to foreign investment i.e. shortage of capital, modern and sophisticated technology and human resources.

First the need for capital stems from many factors. The most significant of which is the period of low and stable oil prices from 1987 to 1997, followed by a dramatic decline until early 1999. As a result many producing governments have found themselves without the necessary financial resources to maintain their current level of production.

Second, technological advances have drastically changed the oil and gas industry. Most notably, successful exploration have increased, and the cost of production and development of oilfields have fallen. Technological advances have made it cheaper and easier to find and develop hydrocarbon resources. Multinational oil companies have more access to state of the art technology in the industry than most national oil companies.

Third, human resources include not only management personnel, geologists and engineers, but also professionals with expertise in applying new technology and new market techniques.

In Saudi Arabia, these incentives apply only partially. Saudi Aramco, like other national and international oil companies, have few financial resources to expand its production capacity, when oil prices remain low. But since 1999 prices have recovered and stabilized at a high level than in 1990s. This means that Saudi Aramco is under less restraint to finance its exploration and development operations. Also the Saudi take over of Aramco was friendlier and less confrontational than is the case with most of other oil producing countries. Furthermore, Saudi Arabia has never been subjected to international economic sanctions. As a result Saudi Aramco has always had access to advanced western technology and expertise.

In short, Saudi Arabia has few incentives to invite foreign investment back to its upstream oil sector. Thus, despite some expectations, and hope and desire expressed by top executives of international oil companies, there has been no change in the kingdom’s policy. Rather, the door has been open for foreign investment in the exploration and development of natural gas.

Saudi Arabia is one of the world’s richest countries in hydrocarbon resources. However, its efforts has been focused on developing the massive oil reserves, with little attention to natural gas. Indeed, until the early 1980’s gas was flared. In the last few decades this policy of minimum utilization of the country’s gas resources has substantially changed. The creation of Master Gas System in the early 1980s show growing official interest in utilizing largely unutilized hydrocarbon potential. During the last two decades Saudi Aramco efforts in gas exploration and development operations have been successful. The kingdom’s proven reserves of natural gas have almost doubled. At the end of 1983 these were estimated at 3.5 trillion Cu ms and twenty years later (2003) they had risen to 6.68 trillion Cu ms. This expanding capacity was matched by rapid domestic gas consumption. During the same period (1983-2003) Saudi Arabia’s gas consumption rose at a remarkable rate of 7.2 percent annually and was projected to grow on an average by 3.7 percent per year during 2005-06, according to a Saudi Arab official. Natural gas is largely used in power generation, water desalination and to satisfy an impressive growth in the petrochemical industry. The development of gas resources serves two other important social and economic purposes. The expansion of gas related industries helps in generating thousands of jobs. For several

years the Saudi government has sought to create employment for the growing number of indigenous job seekers. Using natural gas instead of oil domestically will help free up additional crude for export. This has been particularly important given the relative high oil prices since the early 2000s.\(^{32}\)

Within this context the Saudi government since the late 1990s has engaged in intense negotiations with several international oil & gas companies to develop its gas resources. After meeting of Saudi king with top executives from US oil companies in 1998 preliminary negotiation were held. This led to the signing of an agreement in 2001 between Saudi government and eight international companies, most of them US based. According to this agreement, the companies would invest approximately $ 25 billion in the Saudi gas sector, and develop three “core ventures”. Core venture one is in South Ghawar, Core venture 2 is in Red Sea region, and core venture 3 is in the Empty Quarters (Rubi-al-Khali).\(^{33}\) The implementations of these agreements would have been the first major reopening of Saudi Arabia’s upstream hydrocarbon sector to foreign investment since 1970s. However, the two sides failed to meet several deadlines and in June 2003 Saudi oil Minister Ali Naimi officially terminated the negotiation with the companies. A major reason for the failure was disagreement over the

\(^{32}\) Opcit. 27, p.4

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production (company wanted to significantly higher one than the Saudis were willing to accept). However, this collapse has not put an end to the kingdom’s strategy of inviting foreign investment back to its gas sector. Saudi officials held a meeting in London in July 2003 with representatives of about 40 energy companies. Mr. Naimi confirmed his country’s commitment to create an environment that would be attractive to private investment. In line with this determination, Saudi Arabia reached a tentative agreement, which was officially signed in November 2003, with Royal Dutch/Shell, the Anglo Dutch energy group, and Total of France, to invest approximately $2 billion to develop non-associated gas in the Empty Quarter region.

The decision to invest in the Saudi Arabia’s energy sector is made by both the Saudis and the international oil companies for different reasons. Saudis were interested in stimulating their economy, generating jobs, expanding their petrochemical industry, satisfying a growing domestic demand, and freeing additional oil for export. International oil companies, on the other hand, have been interested in maximizing their profit and establishing a base in Saudi Arabia with the expectation that the door will be opened for investment in country’s lucrative oil sector.

The course of foreign investment in the Saudi energy sector in the

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foreseeable future is likely to be determined by a combination of domestic, regional and international developments. Saudi Arabia invites foreign investment to the energy sector only as a part of a broader strategy of economic reform. The high level of economic growth since the early 2000s is due mainly to high oil prices. The Saudi economy is heavily dependent on oil and suffers from structural imbalances. Saudi leaders have acknowledged the need for economic reform and since the late 1990s have repeatedly re-affirmed their contention that privatization is a “strategic choice”. In line with this connection the Saudi government has moved continuously and slowly towards subsidy cuts and tax increases. In 1999 The Supreme Economic Council was created and charged with boosting and promoting privatization. In January 2004, the Saudi cabinet approved a reduction in taxes on foreign investment to 20 percent in most sectors and 30 percent in natural gas sector. These efforts were promoted by the International Monetary Fund, which commanded the Saudi government for speeding up the implementation of structural and institutional reforms needed for a sustained increase in private investment, including foreign direct investment. All these created an atmosphere of improved efficiency, greater transparency, reduced governmental regulations, more opportunities for foreign investment and significant emphasis on the highest ethical and business

standards. This has resulted in major strides towards strong economic performance and enhanced ability to increase domestic and international investment.\(^{38}\)

The World Trade Organisation (WTO) gave approval on Friday 11 November 2005, for Saudi Arabia to join global body as a full fledged member. The decision flowed from over a decade's structural economic reform in the kingdom.\(^{39}\) The kingdom attained full membership as 149\(^{th}\) member of GATT's successor WTO in December 2005.\(^{40}\) It was a signal of radical change in market environment. Fawaz Al Alamy, Chief Technical Negotiator for WTO accession, said, "we have always believed in free trade, but we needed to open up further. We found out after previous boom and the last decline that oil is volatile commodity and we can not keep a country hostage to it."\(^{41}\) Like other developing countries, Saudi Arabia too embarked on the economic reforms under fiscal stress. It is premised on neoliberal understanding of liberalization, privatization and globalization of the economy. The WTO membership implies that the future path of Saudi Arabian economy is going to be determined by the new set of parameters redefining the social contract.


\(^{39}\) Hindustan Times, New Delhi, 12 November 2005, p.13


\(^{41}\) Moin Siddiqui, The Middle East, August/September 2007, Issue 381, p.52-53
The state which has been the prime mover on the strength of oil revenues is gradually recasting its place by working as facilitator in the reform process. It is opening up the economy for foreign direct investment, expanding the space for private initiatives. The Supreme Economic Council (1999) has been leading with the responsibility to drive the reform programme. According to the Saudi Commerce & Industry Minister, Hashim Yamani, “The access will further integrate Saudi economy into the world economy. It will also deepen the universality of the multilateral trading system. It will enhance the business environment in Saudi Arabia by adding more transparency and predictability. Thus we expect to lead to more investment and job creation.”

Opening of the closed economy under WTO meant reduction in tariff, access to service sector, greater foreign participation, transparency in trade issues and elimination of technical barriers to trade etc.

According to the WTO sources among the leading commitments and the obligations that the state has to fulfill include the following.

1. Elimination of export subsidies on agricultural products.
2. At the end of the ten year implementation period, average bound tariff level will decrease to 12.4 and 10.5 percent for

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agricultural and non-agricultural products respectively. The individual tariff rates for agricultural products will range from 5 to 200 percent, with the highest rate being applied to tobacco products and dates.

3. Foreign insurance company will be permitted to open and operate direct branches in Saudi Arabia. A three year transition period was to be given to existing foreign insurance providers to convert to either a Saudi cooperative insurance company or, to a direct branch of a foreign insurance company.

4. Within three years from accession, Saudi Arabia’s commitments would allow up to 70 percent foreign equity in the telecommunication sector.

Saudi Arabia’s acceptance by the World Trade Organization (WTO) has the potential to significantly increase commerce between Indian businesses and the gulf giant. “Saudi Arabia is a very important country, which has one fourth of the world’s oil reserves”, said Ujal Singh Bhatia, India’s WTO Ambassador. This move may bring increased stability to the global energy market. India has been importing more than 18 million tones of crude oil annually from Saudi Arabia. India can look forward to better deals from Saudi Arabia, and expanding the presence of our labour forces across the kingdom. Analysts say, it

44. The Asian Age, 14 November 2005, p.31
could be boom for Indian businesses. “India’s service industry especially related to IT sector, could have vast scope here”, said K.S. Ramkumar, a veteran Indian journalist based in Jeddah.45

The world bank’s 2007 doing business indicator ranked Saudi Arabia as 38th most competitive economy out of 175 – above such European Union economics, as Italy, Portugal and Spain. The Supreme Economic Council is obliged under the WTO guidelines to review sectors closed to FDI, including recruitment, employment and fisheries. But upstream oil sector will probably remain on the ‘negative’ list for the foreseeable future. Key to diversification efforts are an estimated $1 trillion worth of mega projects in the pipeline that requires public private partnership and massive increases in FDI.

The kingdom’s accession to the WTO has opened new markets for non-oil exports (notably petrochemicals). According to a Samba official, “The industry is a major beneficiary from the WTO entry, given that the kingdom made no commitment to change the pricing of feed stock an the chemical Tariff Harmonization Agreement substantially lowers tariffs globally on chemical imports, including all of the 64 chemical exported by Saudi Arabia Basic Industries Corporation.”46 SABIC (70% state owned) has an ambition of becoming the world’s third largest petrochemical manufacturers, with a capacity of 130 m tones/year by

45. The Asian Age, 14 November 2005, p.31
46. N. 40, p.55
2020. In other sector, the Saudi Iron & Steel Co. (Hadeed) is expanding its steel making to 10 m & 17 m tones/year by 2010 and 2020, compared to 5 m tones in 2006. To exploit substantial bauxite reserves and ample gas supplies, Maaden, in partnership with Canada’s Alcan, is building a $ 7 billion facility to produce 2.1 m tones/year of primary aliminium. The Jizan Economic City will host an alumina refinery with a capacity of 1.2 m tones/year and 650.000 tones/year aluminium smelter. The gulf countries in general and Saudi Arabia in particular, are looking at ways of reinvesting petrodollars in growth – enhancing projects like “economic cities” and value added downstream industries, rather than simply recycling external surpluses through western capital market. Underlying aims are building a less oil – reliant future that depends on private sector investments (including DFI) and provides more diverse source of revenues, as well as creating productive jobs for future generation.

To accelerate diversification successfully strategy must be based on both comparative and competitive advantages. Where comparative advantage is based on endowed factor resources, while competitive advantage has to be forged by increasing value added economic activity conducted within the kingdom’s firms industries, sectors and regions. Diversification is also known to provide for positive spill overs between different types of economic activity in the form of economies of scale
and scope, added inter and intra-linkage in industry and trade, diffusion of technology and the attainment of organizational and managerial skills. It also leads to greater factor market flexibility for labour and capital. Diversification in an economy entails measures that firms and government consciously adopt to foster, maintain and increase productivity on a sustainable basis. It relates to continual upgrading of human and physical resources, and encouraging and strengthening inter- and intra industry, sectoral, and international linkage. It requires inducing technological changes, innovation and open learning and knowledge sharing system, and change in the organizational structure and behaviours of firms, industry and government. Government has a principal role to play in facilitating this process by addressing systemic type of issues such as provision of efficient infrastructure, and other supportive business services. The measures undertaken to induce added diversification must be market oriented and aimed at various sectoral, regional and economy – wide levels. Competitive pressures in both domestic and international markets, play a critical role and at the same time cooperation between firms and industry should be encouraged to develop general purpose inputs, information, training programs etc.

To forge a viable diversification and competitive enhancement programme and attractive climate for private investment must be created. To do that, it is necessary to adopt a liberalization and reform package
which would include measures to allow the market place to function more properly, established sectoral policy and strategy and introduce competitive and stable fiscal rules. The package should also lay down an acceptable legal framework, provide supporting regulations, administered by an impartial regulator, ensure transparency, avoid discrimination among investors. For the economy as a whole and its constituent sectors the vision should be an open with an enabling environment and a level playing field where the same rules apply for all i.e. public vs. private, local vs. foreign, corporate vs. individual.

The global economy presents major opportunities in this regard for diversifying and upgrading the competitive position of firm and industries. Policies directed at deregulation, privatization, trade and investment liberalization are giving rise to increase FDI flows as more flexible production system, joint ventures, strategic alliances, and other cooperative arrangement in production and marketing. Mining is the great potential for Saudi Arabia economy. The vast country is home to the largest mineral resources in the gulf region, including precious and base minerals, as well as industrial minerals. Minerals discovered in the kingdom of Saudi Arabia include phosphate, bauxite, gold, magnesium, gypsum, marble, iron ore, bentonite, copper, garnet, granite, limestone, silver and others.
Saudi Arabia holds some of the largest phosphates deposit in the world. With private sector investment, Saudi Arabia can locally utilize the produced phosphates to consolidated its position as one of the leading exporters of fertilizers, where anticipations are that the country will capture 60 percent of the world phosphate market. The soil of Saudi Arabia is also rich in bauxite and has potential to supply the aluminium industry in the GCC region. Some estimates suggest that Saudi Arabia is home to 20 millions of tons of gold ore. The gold deposit have significantly contributed to meeting the needs of the thriving 2,000 ton domestic market, as well as that of foreign markets such as India, Europe and the US. Saudi Arabia has also several iron deposits. The holding reserves are 84 million tons at 42.5 percent iron, which are sufficient for 25 years of pellet production at 2.2 million tons per year.

Saudi Arabia has the world’s largest deposit of high grade magnesite. The soil of Saudi Arabia is also rich in gypsum and marble which have a growing domestic market owing, in part, to an active construction industry.

The development of mining sector occupies a prominent position in Saudi Arabia’s diversification program. Saudi Arabia’s mining sector is seen to present a high growth potential and the government views private investment as the mining sector’s engine of growth. An important catalyst for private investment in the mining sector was the
creation of the Saudi Arabian Mining Company (Maadan) in 1997 with an initial capital of more than $1 billion. Maadan is involved in the development of the mining sector through sole and joint ventures, and through its contribution to the development of the infrastructure of the mining sites, including water, electricity and telecommunication. Incentive to the private sector have contributed to making investment in the mining sector highly profitable both for local investors and their international partners.

The government of Saudi Arabia’s medium and long term objectives for the sector include establishing industries for extracting and processing the minerals and making the country a leading exporter in that regard. Plans to develop integrated downstream cluster industries in the sector are starting to materialize.

Challenges for the development of Saudi mining sector stem from the fact that the global mining industry has changed considerably in the 1990s. The role of market and private sector has become the driving force whereas the role of the state has changed from owner and operator to regulator and administrator. Challenges facing the sector encompass reforms in public sector agencies and the establishment of an enabling environment for long term private sector participation in minerals. In terms of the public sector, the goal is to establish competent and responsive institutions which will serve to promote mineral investment
and coordinate inter ministerial linkages, provide reliable geological and technical information. For the mining sector as a whole the vision is an open one with a level playing field with easy access to exploration rights thus minimizing state mining reserves and eliminating discretion in granting license. So mining sector has been ahead in the race for diversification which implies placing a much heavier weight on the mining sector in achieving development objectives.

Saudi Arabia’s strategies for diversification and economic reforms does not mean that its petroleum sector will lose its importance, in near future. No matter, how successful economic, demographic and social reforms become, Saudi Arabia’s strategic position, economy and ability to meet the expectations of its people will still remain dependent on the revenues provided by its petroleum sector. While Saudi energy export can not by themselves support the Saudi Arabia of the twenty first century. They will remain the most important source of the kingdom’s income. Saudi Arabia will remain a petroleum sector driven economy, even if it is successful in both diversifying and expanding its private sector. In fact much of its diversification, and much growth of economy will consist of ventures that add value and labour intensity to the Saudi economy through the production of petroleum related products.