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**WTO and the dangers of Privatization: An analysis of the Saudi Case**

Economic structures in the Arab-Persian Gulf have evolved as a response to societal needs, not market needs. Attempts to modify, or liberalize, these structures by merely changing the rules of the market, such as is being tried through the World Trade Organization [WTO] negotiations, will fail unless the causes that created these economic patterns are understood and addressed.

The economic structure of the Kingdom of Saudi Arabia is somewhat different than those of any other place. This essay will present in some details a view of the structural form of the Saudi system as of late 1998, analyze how it has evolved the way it has, and review the changes to this structure presently taking place.

The evolution of the Saudi economic structure over the past 25 years seem to have reflected the need of the leadership, especially that of King Fahad, to solve societal problems through economic structures. In order to maintain stability in the kingdom, while maintaining the absolute control of the state by and for the royal family, Saudi Arabia developed an economic model that fostered a total separation of the royal family from the commoners.

This separation which has been fully in place until late 1998 and which, by and large, is still the norm, provided for the complete control of

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industry, finance and oil by the commoners, while leaving all matters of internal security, military matters and land to the royal family. The realm of the royal family was not designed merely as a control mechanism of the means of repression. In fact it is just the opposite. The king's incentive to the royal family to control the military et security apparati allow the princes to focus on the very large military expenses and subsequent commissions and prestige, thereby removing the financial need to be involved in business, finance and energy related activities. In turn, this allows the commoners to access the large sums of money spent on the rest of the economy, including oil, and as such keeps the number of disgruntled citizens very low, minimizing the need for heavy repression while maintaining control.

The separation royals-commoners did not happen overnight, it evolved over the past 25 years. The ultimate cause of the policy of separation can be boiled down to: 1- the fact that the royal family is above the law, and 2- that the King cannot change impose obedience to the law to the royal family as he depends on the family for his legitimacy. The King, early on in his career, as adviser to two previous monarchs may have realized that the royal family could over the assets of the commoners at minimal compensation. Therefore, unless he found a good economic place for the family away from the commoners, there would be tensions in society. Since commoners outnumber the royal family 1000 to 1, long term tensions would break the royal family's hold on the state. Therefore a tight but generous separation of economic

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structures was needed to keep “peace in the valley” and the ultimate control of the state by the Al-Sauds.

Efforts to change the economic structure of the Kingdom are likely to fail if they focus solely on changing the apparent rules of trade, business and investment. In this context the negotiations to join WTO and the efforts exerted on the Saudis to “open up” their economy to foreign competition are not likely to have the expected effects. In fact no amount of economic liberalization will get implemented properly until the basic societal problem of the status of the royal family relative to the law is resolved.

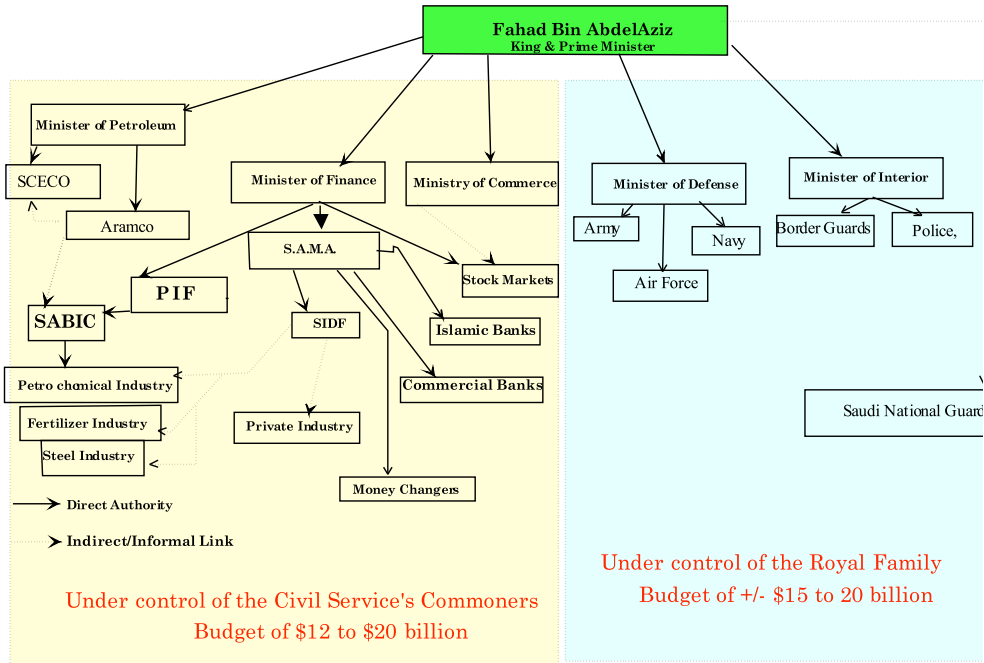
Similar analysis could probably be made about other Gulf countries. Certainly the accession of Bahrain or Qatar or Kuwait to WTO will have enormous impact on the local societies and may bring some substantial disruption in the relationship between the rulers and the ruled and the social order in general. It is much more likely, however, that the local states have only limited intent to abide by the liberalized economy implied in the WTO regulations.

A comparison of the impact of the liberalized economies of the Gulf countries may show that all their economic structures also evolved along societal needs, not market needs. Any changes to the economic structure will be effective only if the societal needs allow it.

Trying to change the local rules of the game without considering their causal background will lead only to these rules being violated or simply

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ignored. This will also lead to potential conflicts with the more developed countries who will expect “fair play” on signed agreements. For example if foreign “widget: manufacturers do not wish to go through local agents and pay them the standard 15 per cent commission, there may be very strong push within a given state to stop imports of Western “widgets”. This would bring suits at the WTO. The suits would be lost by the Gulf states, but the judgments would still be ignored, eventually leading to the withdrawal ,de jure or de facto, of the state from the organization. No foreign pressure will succeed in forcing society to adapt. It has to come from within.





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### **Saudi Arabia's economic structure between 1973 and 1998.**

Institutions which control large flows of money in the kingdom are either managed by the royal family or by the civil service composed of commoners, never by a mix of these two groups. For example, until January 2000, the oil sector was completely managed by the civil service. The Minister of Oil and Minerals is always a commoner, so is the president of the Saudi oil company, Aramco, and all the staff of both institutions. The Saudi approach to state owned economic management has been to place the oil sector in the hands of the most professional people. This professional-ization of the oil sector has spilled over to the main electricity companies where the top staff is usually ex-Aramco. Aramco still has a large number of foreign employees, but at the management level most positions are held by Saudi civil servants, all of them commoners.

The Ministry of Finance [MOF] is also controlled by commoners. The Minister of Finance has always been a commoner. Perhaps the most influential Saudi minister in modern times has been Mr. Mohammed AbalKhail who stayed in the position from 1971 to 1995. Under his guidance and his strong influence over the Saudi Monetary Agency [SAMA, the central bank of Saudi Arabia] the MOF became very influential on all the economy. SAMA which regulates the banks, issues the currency and invest the country's reserves. SAMA does not carry independent fiscal or monetary policy. In turn SAMA has a strong role at the board level and the staff of the

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Saudi Industrial Development Bank [SIDF]. SIDF's funds most of the private industrial ventures. SIDF's funding include loans of up to 15 years interest free and with long and generous grace periods [up to five years]. Without SIDF funding private industrialists would find it very difficult to get started as there are no medium term loans available from banks, no venture capital firms and a very limited stock market.

The MOF has a strong hand in the management of the Public Investment Fund [PIF]. PIF was created in 1971 to provide capital to major state owned companies. The original plan was that PIF would invest in various large concerns and once established and profitable PIF could then resell its shares to the public at large. In fact, none of the PIF shares have ended up in the public. PIF today owns the airline company, the bus company and mainly 70 per cent of the Saudi Basic Industries Corporation [SABIC].

In line with the rest of the institutions controlled by the MOF, none of the firms owned by PIF have any involvement of the royal family, except to a certain extent Saudia, the airline company. One cannot underline enough the fact that SABIC is as important to the kingdom as Aramco. Indeed, SABIC is seen as the future of the country. The overall sales of SABIC in 2000 were \$7.1 billion and its net profits after tax \$967 million. More importantly, it employed 25 000 persons, 76 per cent of which were Saudis. SABIC buys petroleum products and natural gas from Aramco and through

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16 industrial ventures manufactures over 21 million tons of petrochemicals, metals, fertilizers, etc. In 2000, SABIC's capacity was 28 million tons, an increase of 10 million tons over 1999 and is scheduled to increase production to 48 million tons by 2010<sup>1</sup>.

The two pillars of Saudi wealth and future growth are Aramco and SABIC and both are entirely controlled by the commoners of the civil service and through the Ministry of Oil and Minerals [MOOM] and the Ministry of Finance [MOF]. Both are managed by senior civil service commoners, whose sole allegiance are to the King directly.

The MOF also had complete control of the financial sector. The banking sector is 100 per cent privately owned. However, the influence of the Monetary Agency is pervasive. The three largest 100 per cent Saudi owned banks are under very tight scrutiny from SAMA. The largest, National Commercial Bank fought for a long time to keep its full independence, but weighed by large bad loans and a very nasty brush with the US authorities on their involvement with BCCI had to take the PIF as a 50 per cent shareholder, thereby giving the MOF and SAMA control of management and policy. The Riyadh Bank, for many years the second largest bank in the kingdom has been under SAMA close supervision since it almost when bankrupt in the 1970s. The third purely Saudi Bank and the third largest

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<sup>1</sup> All figures on SABIC were found on the 2000 audited Annual Report of SABIC at [www.sabic.com](http://www.sabic.com)

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today is AlRajhi Banking and Investment Corporation, the only Islamic bank officially licensed in the kingdom. AlRajhi only won its license after four years of negotiations on how it could operate as a bank in Saudi Arabia under full supervision from the Monetary Agency. The other banks were originally foreign owned and now only have minority foreign shareholdings. Their boards are Saudi controlled and when they were Saudi-ized in the 1980s, SAMA had the responsibility of vetting the board members, the founding shareholders and the chairman of each bank. Thus the influence of SAMA has been very powerful within the banks. Further many of the Saudi officers in the banks have been at one point or another employees of SAMA, SIDF or the MOF.

The stock market also seem to be entirely under the control of the MOF. Officially the stock market is regulated by the Ministry of Commerce. In 1987, a stock exchange floor was actually opened to trading in Riyadh. However, the floor was closed within 30 days by order of the Minister of Finance. Today all purchase and sale of shares can only be done through the banks, supervised by SAMA. Total market capitalization of over is \$67 billion with 76 companies allowed to be traded. The ability to float shares on the stock market is highly regulated by SAMA. Any company willing to issue floatable capital is vetted for a few years by SAMA. It must show a history of profits, reputable board members, and be within the guidelines of the five year plan. Most of the companies traded on the stock exchange, one way or

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the other are fully dependent on the goodwill the Ministry of Finance or the Ministry of Oil for their core business.

For example, much of the daily stock trading is in bank shares. However, the banks income comes from principally from lending to state owned or controlled firms and the large amount lent directly to state in the form of development bonds and treasury notes. The banks also receive large fees from confirming letters of credits for Aramco, performance bonds for most of the ministries and the cash deposits related to these transactions.

Other companies whose shares are traded in the stock markets are Saptco, the transportation company, fully dependent on state subsidies and guaranteed dividends, SABIC which is 70 per cent owned by PIF, cement companies which rely in cheap access to energy, etc. Therefore, it is safe to say that the stock market is under full control of the MOF. Naturally, this is a major impediment to the development of entrepreneurship in the kingdom, which in turn is a major brake to the economic development of the country by the private sector.

### **Evolution over the years**

This very tight control of these major sectors of the economy by the civil service, in particular by the MOOM and the MOF, did not happen suddenly. The banking sector for example saw its first major change when the foreign banks were told to “Saudi-ized” or shut down. In the late 1970’s the demand for banking products was huge with over \$100 billion being spent

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by the state to modernize the country. The foreign banks were operating in the kingdom through wholly owned branches and could easily have developed their infrastructure to meet the demand. However, they were major competitors to the two Saudi banks, NCB and Riyadh Bank. When told to create a capital base and allow a 60 per cent Saudi shareholding to continue operations, the banks mainly cooperated. The profits to be earned from the increase business in the kingdom would outweigh the loss of control. Further SAMA had very large deposits in the home banks of the old branches and could influence priorities in the home countries. Only Citibank, which had a strong policy of no joint venture anywhere, was reticent to accept the change, but, seeing the profit potential in the Saudi market and the very large deposits of SAMA at the bank, relented and created the Saudi American Bank. The Saudization of the banks was very controlled by SAMA, which, as mentioned earlier, managed to have a strong say on how the board was chosen and the banks managed.

National Commercial Bank, the largest bank (it controls 28 per cent of all Saudi banking assets) was privately owned mainly by the bin Mahfouz family and was not eager to place itself under the review power of SAMA. NCB was able to fend off the efforts of the MOF to dilute the bin Mahfouz by making it issue shares to the public, to properly demand audited statements and open its doors to SAMA inspectors. It managed to stay quite independent by providing large loans to the royal family. However, this

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proved to become the bin Mahfouz's undoing. During the notorious BCCI scandal, Mr. Khaled bin Mahfouz was seen to be a major shareholder and favored creditor to BCCI. Thus, when BCCI went bankrupt and its management placed under criminal investigation, the Attorney General of the State of New York shut down the National Commercial Bank branch in New York, and indicted NCB's major owner, Mr. Khaled bin Mahfouz. This was a difficult blow for the bank, since it cannot operate its foreign exchange desk, its letters of credit and performance bond operations or effect dollars transfers properly without US dollar accounts in New York. Only by obtaining the support of SAMA who stated that it would support NCB's activities overseas, the bank could obtain the normal correspondent banking support of the US banks and of the Federal Reserve in New York. NCB lost its branch in Manhattan and Mr. bin Mahfouz paid a \$150 million fine, but the bank survived.

Not by coincidence, however, NCB "asked" for a full audit by SAMA. This audit took one and half years to be completed. The shareholders were required to write off \$1 billion of bad loan and recapitalize the bank accordingly. This amount of money was sizable even for the bin Mahfouz who eventually had to settle for the sale of 50 per cent interest, and relinquish control of management to the Public Investment Fund, placing NCB squarely under the umbrella of the Ministry of Finance.

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The Money Changers, a traditionally very independent group of financiers in the Gulf, had always managed to stave away SAMA and the MOF. In Saudi Arabia, especially, they were very cash rich. They handled most of the remittances from the millions of foreign workers to the home countries. This gave the changers a very large float in the hundreds of millions of dollars. Investing this float became the main activity of the money changers. They used to speculate in commodities. The money changers which had traditionally been the buyers and sellers of gold, became buyers and sellers of wheat, sugar, etc. They set up, as early as 1978, very modern links to the main trading floors of Chicago, New York and London, buying and selling futures and options as well as the commodities, buying of the margin, etc. They also ran regular banking counters, providing checks, loans and venture capital to local entrepreneurs.

Such activities were unsupervised and eventually one of the most aggressive money changers started taking very large positions in gold. Unfortunately the price of gold, which had risen to \$850 an ounce over ten years, collapsed to below \$300. This money changer based in Damman (Abdallah Al-Rajhi, the oldest son of Saleh Al Rajhi-the largest money changer in the kingdom, but entirely separate from his father) could not meet his obligations to his bankers, brokers, and mainly to the foreign workers whose remittances he failed to transfer. SAMA accepted to intervene, but only after the council of ministers agreed to force all money changers to

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report regularly to SAMA, and cease all banking activities or seek regular banking licences from SAMA. Only Saleh AlRajhi in Riyadh accepted to seek a banking license. SAMA made him wait four years for the license. AlRajhi now operates as the only Islamic bank in the kingdom but under supervision from SAMA.

Other major sectors of the economy followed a similar pattern. Until 1975, the electricity companies had been owned separately in each city and developed helter skelter throughout the kingdom. Faced with a huge increase in demand in the mid 1970s and calls for common electrical standards throughout the country (Jeddah had European standards, Damman American ones, Riyadh a mix of both, etc.). The state established three major interconnected electricity companies. These companies bought out the local owners and established large new plants financed by SIDF. The management came mainly from Aramco. In this instance, the important electricity sector came fully under the control of the civil service.

The oil sector also came to be totally controlled by the civil service. In the late 1970s some princes tried to muscle in on the trading of oil [the most famous, but probably not the only one, was Mohamed bin Fahad's attempt to obtain commissions from British Petroleum which became front page news in the Financial Times in London]. Very quickly the trading was limited solely to Aramco and Petromin, both civil service controlled. Eventually, Petromin

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was absorbed by Aramco. Today all petroleum sales and production are handled solely by Aramco.

The major economic development of Saudi Arabia in the 1980s and 1990s came from a hugely successful entry into petrochemicals. This was achieved by the establishment of the Saudi Arabian Basic Industries Corporation [SABIC]. SABIC was established as a holding company taking a controlling or complete interest in all the petrochemical joint ventures in the kingdom. Each of the 16 subsidiaries borrows separately. Seven of these subsidiaries have 50 per cent foreign ownership, but all are controlled out of the Riyadh headquarters. Again SABIC is fully controlled by the civil service, with no royal family members involved in management neither at the holding nor the subsidiary level. It is important to note that SABIC's sales will be above \$10 billion in 2001, may reach \$20 billion within three years, and that the company is quite profitable. The present rate of investments in petrochemical by the private and public sector leads one to speculate that by 2020, Saudi Arabia will sell more petrochemicals than oil. Therefore the importance of SABIC in the kingdom is enormous. It is not yet as important as Aramco to the final income of the state, but since it adds value and create jobs in its subsidiaries and all the numerous attached services, SABIC and petrochemicals in general are more important to the kingdom than Aramco and the production of crude oil.

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### **Defense, military and internal security**

The military forces of Saudi Arabia are among the best equipped in the world. The Kingdom has spent over \$372 billion in the past 16 years<sup>2</sup> to obtain the best airplanes, tanks, missiles, ships and detection systems that money can buy. A good portion of this money was spent using a large number of foreign technicians to train the Saudi forces. Nevertheless, as a fighting force the Saudi military services were not able to deter the large forces of Iraq, or for that matter were not able to have any major role in the fighting against Iraq in Desert Storm.

The weakness of the Saudi forces is due in part to its dual structure. The Ministry of Defense ("MOD") controls the Army, the Air Force and the Navy all totaling 105 000 men. The Saudi National Guards ("SNGs"), which total 57 000, are under a totally separate command. They have their own budget and plans. The military structure and the subsequent huge cash flows spent to support them are a way for the King to preserve the unity of the royal family. By allowing the enormous expenditures on both the Army side and the National Guard side, the King is able: 1- to insure that a coup will not take place, as both sides would exhaust each other, 2- to give to the main contenders to the throne an appearance of power and plenty of money to maintain themselves and their retinue and 3- to give the impression to his people that the oil money is spent for the glory and honor of Saudi arms and goals.

Theoretically the Armed forces are responsible to the King. In practice, however, the National Guards know only one ultimate commander and that is Prince Abdullah bin AbdelAziz, the Crown Prince. The Army, Air

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<sup>2</sup>Cordesman, Anthony. *The Conventional Military Balance in the Gulf in 2000*. Center for Strategic and International Studies, Washington DC, 2000.

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Force and Navy are under the command of the Minister of Defense Prince Sultan bin AbdelAziz. Prince Naif bin AbdelAziz, the Minister of Interior, for his part controls over 120 000 employees<sup>3</sup> including the secret police, the coast guards and the border patrol. The other major intelligence group is the General Intelligence which was run until August 2001 by Prince Turki Al-Faysal and reported directly to the King<sup>4</sup>.

The amount of control that the King actually exercises over the various services (army, navy, SNGs, etc.) is somewhat limited by the fact that the King cannot easily dismiss the junior princes or order around the more senior ones. There is no Joint Chief of Staff that would centralize and coordinate operations between the various military branches.

The independence of each of the services is checked by a sprinkling of family members throughout. At SNGs, Prince Abdullah's deputy, is Prince Badr bin AbdelAziz, a half brother to the King and to prince Abdullah, and two of Abdullah's sons are commanders. The MOD has at least 12 major princes from various clans and a large but unknown number of lesser princes.

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<sup>33</sup>Cordesman, Anthony: *The Gulf and the Search for Strategic Stability*, Westview Press, Boulder, Co. 1984. At the time this figure was larger than the Army and National Guards put together.

<sup>4</sup> Prince Turki Al Faysal was replaced by Prince Nawwaf bin AbdelAziz, a first generation prince. Prince Nawwaf is widely seen as close to Prince Abdallah, the crown prince. This change can be interpreted as the crown prince securing his control over the intelligence services while the king is very ill.

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Some of the most expensive weapon systems bought by the Kingdom cannot be used effectively against their major foes. For instance the various F-15s and the AWACS purchased from the US lack the sophisticated equipment that makes the plane useful against Israel. They lack IFF recognition capability<sup>5</sup>. They lack advanced ELINT (Electronic Interdiction) systems which preclude them from seeing US type (i.e. Israeli) aircrafts and detailed ground activities. These omissions were made in order to get the sale to pass through the US Congress, but ensures that the Saudi forces are dependent on US support to fight foreign aggression.

The senior princes like Prince Bandar bin Sultan, Prince Sultan and the King himself certainly know the weaknesses of the systems. The Saudis would have preferred to obtain the weapons with the right equipment. However, Iraq's invasion of Kuwait and its subsequent defeat by external forces has underlined the Saudi's inability to defend itself from external threats. One can ask why the Saudis have spent \$372 billion on a military force organized to be inefficient and equipped with systems that do not defend the country against at least one of its major foes.

All suppliers to the military are Saudi merchants or foreign firms working through Saudi intermediaries. Unlike civilian government contracts, which must be competed for in closed bids, Saudi military contracts

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<sup>5</sup> IFF allows recognition of a plane as friend or foe. [Cordesman, 1994, 590-600]

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are negotiated. Most of the Saudi firms and intermediaries involved in the negotiated contracts are directly or indirectly controlled by members of the royal family<sup>6</sup>.

Therefore, the Saudi military structure may appear very weak and poorly organized, but not so by accident. The military organization is merely a solution to an internal political problem. The king must maintain the cohesiveness of the Al-Sauds in spite of the competition for power within the family. His only tools are persuasion and money. It is important for him to allow the senior princes to feel important and powerful but to limit their power in a subtle but efficient manner.

### **Summary of the socio-economic structure**

The chart above summarizes the fact that there is very surprising dichotomy in the kingdom's socio-economic structure. The commercial, industrial and financial sectors are tightly controlled by the commoners of the civil service. In country where the royal family has absolute political control, this cannot be by accident. Naturally, the family has received its share of the oil spoils through the military and security expenditures, but it is unlikely that without the close hold of the civil service on the rest of the socio economic structures that the princes would have been satisfied with their proto-apartheid situation.

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<sup>6</sup>Personal notes from conversations in Riyadh between 1978 and 1983.

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Ultimately the civil service is responsible to the king. Without the king's support, the present structure could not have evolved. In fact, one can infer that this socio-economic structure was designed by the king. The purpose of the structure being to ultimately make sure the tensions between royals and commoners do not become unbearable to both parties. Since both commoners and royals can manage a very large sum of money and maintain professional control of their own bailiwick, peace is kept in the valley.

Unfortunately this is done at a substantial financial cost. On the one hand, the military is kept inefficient but rich. On the other hand, the very tight control of the economy by the civil service to maintain the structure creates bureaucracy and limits entrepreneurship. Since only entrepreneurs can create enough jobs for the fast growing population, the state is caught on a dilemma. If the financial markets are relaxed, firms allowed to raise capital easily, privatization of state assets undertaken and thus the economy kicked forward, then the royal family can easily use its large overseas deposits and its above-the-law statute to take major controlling shares in the energy, petrochemical and financial sectors. Such take over would crowd out the commoners, and ultimately bring unprofessional management to the jewels of Saudi economy, such as Aramco and SABIC. This would create tensions, loss of market share and ultimately prominent questioning of the royal family's birthright to leadership.

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### **Evolution since late 1998**

#### **Finance**

Until 1998, the financial sector was controlled solely by commoners. The owners of banks and the board of directors consisted only of commoners and the supervision by SAMA and the MOF was also entirely made by the civil service, itself controlled solely by commoners. The first major change to this pattern came when a small bank opened its capital to Al Waleed bin Talal bin AbdezlAziz. The Saudi United Commercial Bank [since then renamed United Saudi Bank], was founded in 1980s. It remained quite a mediocre player in the banking market until 1998 when Prince Al Waleed bin Talal became a 30 per cent owner and chairman. In 1998 the bank was allowed to take over the bankrupt Saudi Cairo Bank. In the mid 1990s, Prince al Waleed built a five per cent stake in Citicorp [the holding company of Citibank, New York], becoming its largest shareholder. This burnished his reputation as a savvy investor and banker. It also gave him a strong links to the Saudi American Bank [SAMBA], partly owned and managed by Citibank. In 1999 Al Waleed bin Talal was able to leverage his knowledge of banks and became the largest shareholder in SAMBA. Since then, SAMBA started growing more aggressively and became the second largest bank in the kingdom, with 23 per cent of all the banking assets. SAMBA is technologically the most advanced of the all the banks in Saudi Arabia, the

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most profitable, and is very likely to become the lead bank in the kingdom, and the only one with a royal connection.

#### **Oil**

Another major change in the economic structure of the kingdom has been the establishment of the Supreme Petroleum Council in January 2000. This council is now in charge of establishing policy for oil production. The council is chaired by the king and co-chaired by the crown prince and Prince Sultan bin AbdelAziz [the Minister of Defense]. The council has nine other members, eight are commoners, including the ministers of oil and of finance, and one a senior Prince, Saud Al Faysal bin AbdelAziz, the Minister of Foreign Affairs who is delegated to run the council affairs<sup>7</sup>.

The council provides a major change in the policy procedures of the kingdom. Until then all major decisions on production levels, investments and OPEC policy were made by the Minister of Oil and the King, bypassing input from the major princes. The implementation of these decisions was undertaken by the MOOM and Aramco, all totally staffed by commoners.

The new council was established shortly after efforts were made by certain members of the royal family to allow for foreign investments in the production segment of the oil sector [often called the “upstream sector”]. The kingdom, which already has a 10.5 million b/d of capacity, is the only

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<sup>7</sup> For the exact text of the decree of formation of the Supreme Petroleum Council see Middle East Economic Survey January 10, 2000, 43-2.

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producer in OPEC who can rapidly fulfill any potential shortfall in supply.

Many forecasts predict that the increase in demand in the West and especially in the Far East will create a ten to 15 million b/d shortfall. Saudi Arabia should be poised to take this big increase in market share and the resulting income from it.

The major oil companies, arguably, are needed in the Gulf to help develop the capacity for the estimated shortfall because such an increase would require about \$50 billion in investments which the kingdom does not have at this time<sup>8</sup>. To test the interest of the foreign companies, Crown Prince Abdallah attended a meeting in Washington with the main US oil firms in September 1998 organized by the ambassador to the US Prince Bandar bin Sultan bin AbdelAziz. Prince Abdallah asked the companies for “suggestions” on how they could return to the upstream sector in the kingdom<sup>9</sup>

However, shortly after the meeting the Minister of Oil announced publicly that upstream investments by foreign oil companies were not needed because Saudi Arabia already had unused capacity of about 1.5mm b/d and that the increase needs of the world were far from being proven, especially

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<sup>8</sup> This amount is merely an estimate, a rule of thumb, developed from a study from the IEA and papers by Prof. Stauffer whereby the cost of establishing production in the Gulf region varies between \$4 and \$8 billion dollars per million barrel per day of production. Saudi Arabia having the most efficient locations and geography should be able to increase production of \$1mm b/d for about \$5 billion.

<sup>9</sup> At present all upstream investments and production are handled solely by Aramco. Aramco will often subcontract engineering and drilling activities to foreign often American firms like Halliburton, Fluor, or the French Schlumberger,

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since at the time the Far East economies were barely recovering from the 1997/1998 downturn. Behind this meeting and statements lie the fact that Aramco is able to develop the oil production itself. It has done so in the past with great success<sup>10</sup>. The geology of Saudi Arabia does not require the extensive technological miracles of the North Sea and even if it did, it could easily purchase the support of the large US, French or Norwegian engineering firms. The capital needed, of course, is very large, but if handled gingerly such amounts over time could be easily provided to Aramco by the the world financial markets.

The actual request for “suggestions” from the oil majors on reentering the upstream sector was not generated by Aramco or the MOOM, but seemingly from the royal family. In 1998 the price of oil was in the low teens due to the crisis in the Far East. The societal split discussed above requires large sums to be disbursed to the royal family side of the equation. With oil income falling \$30 billion per year, the amount allocated to defense and thus available to the royal family was shrinking. It seems that many senior members of the family could see that oil should come back to their control. Inviting the foreign oil companies back in meant that:

1. The royal family could take control of oil policy away from the civil service

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<sup>10</sup> Aramco develop the newest Saudi field of high grade oil in the Rub Al Khali, a difficult place to drill, and brought 500,000 b/d to the market in less than two years

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2. The royal family could decide what volume should be produced and retake control of the sale structure, ie reintroduce a royal family role in the flow of money from the Aramco sales to the Ministry of Finance
3. It left open the possibility that major princes could be the sponsors of the foreign oil firms, thereby replacing commissions on arm purchases by commissions on oil production

The announcement of the Minister of Oil dampened all these possibilities, but a compromise was found. The gas upstream sector was opened to foreign companies and the oil policy making was transferred to the new council.

The compromise, however, was a victory for the civil service. The gas upstream sector is relatively small compared to the oil sector. Furthermore, gas production in the kingdom is not very profitable compared to oil. The gas has to be sold locally, putting the investors solely in the hands of the Saudi civil service which controls the users mainly SABIC for petrochemicals and SCECO for the electricity production. The large contracts signed by ExxonMobil and BP in June 2001 are interesting to these oil companies, not so much because of the potential profits, but because it will put them in a favored position should the Saudis open their oil reserves which had been closed since the mid 1970s to foreign investors.

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The other leg of the compromise, the creation of the Supreme Petroleum Council does transfer policy making to major princes. However, it is significant that the man in charge of running the council, Saud Al Faysal is reputed to be of high integrity, not close to the Americans, and not close to the senior princes of the Sudairi line, such as Prince Sultan or Prince Naif. This means that the council cannot be counted on to become a rubber stamp for US requests to increase production, nor a body pushing production for the sake of immediate income for financing of military and security expenses.

Hence, even though there are changes to the “social contract”, the basic structure is still in place. The major sectors of the economy are still controlled by the civil service and the military and security by the royal family, with the sclerosis of the economy that it created.

## **Liberalization, Privatization, WTO negotiations, etc.**

### **The Saudi Advantage**

The kingdom is faced with the major challenge and opportunity of a huge population growth. A 3.5 per cent to 4 per cent annual growth require that at least 250,000 jobs be created each year.<sup>11</sup> The jobs will be created either through a take back the jobs of the 6 odd million foreigners and or from new industries and services.

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<sup>11</sup> Assuming a total Saudi born population of 14 million a 3.5 per cent growth implies 490,000 new citizens per year, which requires at least ½ as many jobs.

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Many of the foreigners jobs could be handled by Saudis, but many tend to be low pay, low skill. Saudi employers prefer to hire foreign labor which under the present laws are kept in semi-slavery with no rights and low wages. The incentives to hire Saudi to perform menial duties are not there today. The more highly paid and prestigious jobs presently held by foreigners, such as: accounting, engineering, middle management are better targets but still subject to the same lack of incentives to replace foreigner with medium to good pay but no rights or job security by Saudis who will require good pay and rights and security. The main state owned Saudi firms, such as SABIC are mostly Saudi staffed, but not the private firms.

One of the solutions to the employment issue is to develop industry rapidly which will create jobs to be filled by Saudis. To do so, the kingdom needs to develop industry where it has a natural advantage ie in energy related, value adding products. In essence, it means the future of the kingdom is in petrochemicals and energy based productions such as aluminum or direct reduction steel.

SABIC now controls about five per cent of the world chemicals and will probably have a market share of nine per cent within three to five years<sup>12</sup>. This increase will create jobs, but not enough. The country needs to rely on industrial job creation by the private sector. The private sector already

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<sup>12</sup> The market figures are computed by comparing SABIC's production with the production of the 97 most common petrochemicals in the world as computed by SRI Consulting.

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produces 1.1 million tons of petrochemicals and has projects to produce a further 3.5 million within two to five years<sup>13</sup>. A major increase by the private sector in this field could increase Saudi market share in petrochemicals to between 12 and 15 per cent in the near future. Such market share will create important conflicts with the existing producers, mainly the German, American, French, British and Japanese firms who now have the lion's share of the world market.

The kingdom has the cheapest energy production costs in the world. Saudi costs of production of one barrel of oil is between \$0.75 and \$1.50 per barrel. By contrast, the equivalent cost to BASF of Germany, the world's largest petrochemical company is \$25.0/b. Since the main cost of petrochemicals is the feedstock raw material of oil or gas, this difference could allow the Saudis to undercut the price of any petrochemical and conquer any market. The Europeans have already argued that SABIC's products need to be taxed to make up for the "unfair" advantage of Saudi costs. Today, SABIC buys its feedstock from Aramco at a discount of about 30 per cent on world prices for equivalent products. If this is considered "unfair", it will be interesting to estimate what would happen if SABIC bought its feedstock from Aramco at local production cost plus a normal profit margin for the oil company. Another way of looking at the issue would to see

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<sup>13</sup> The figures on petrochemical projects are computed at the Lafayette Group, of Annapolis MD by the author.

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what costs SABIC would occur if it took over Aramco and sold to Aramco the production it does not need as feedstock for exports. It could be argued that SABIC's feedstock costs would then be reduced not by 30 per cent but by a factor of 25.

Joining WTO would allow the Saudis to successfully argue their cost advantage and kept the markets open for their petrochemical productions. Allowing WTO judgments in favor of the Saudis will undoubtedly level the US and European petrochemical industries within twenty years. However, this is the true price of globalization, and hopefully will decrease the prices of petrochemicals enough to encourage the western and Japanese firms into developing more and better uses for these petrochemicals in fine chemistry, medicines etc, where they have a natural advantage.

If Saudi Arabia accedes to WTO this competition for market share will dominate the debate in the Gulf-Western relations and will ultimately benefit the kingdom as well as all the other producers of the Gulf such as Kuwait, the UAE and Iran. On the other hand it will not be purely a one way advantage to the Gulf.

### **The Saudi Problems**

WTO requires that trade rules be liberalized and commercial laws and their implementation be transparent. It also discourages subsidies to local industries by the states.

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Today most of the consumer and industrial products sold in the kingdom are imported (figures). All goods and services must go through a local agents or representatives who gets a commission. These agents are heavily protected and cannot be bypassed (no transfers of agencies, no direct sales, etc.). The private sector, by and large, is very dependent on these agencies. Opening trade to foreign companies would mean a substantial switch away from the agent system, cutting out a very large safe source of income from the merchant families.

Opening the trading sector to the world will not necessarily cut out all the traders. Many products require substantial after sale services, especially technologically advanced ones, such as turbines or computer systems. Foreign companies will still depend on a strong local presence to provide the services needed. However, the foreign companies will be in the driver's seat and control their own sales policy and the subsequent profits.

Foreign firms will still need local support and in the case of most smaller exporters will still rely on local distribution. However, in toto income generating will be a great deal more difficult for the average medium and small family firm in the kingdom. This may indeed create some pressure against the short term effect of WTO on society.

Another, very major impact will be the effect of privatization and of liberalization of the hold of the civil service on the economy. The first part of this paper showed that society has to keep a divide between the royals and

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the commoners and that this divide is enforced by the civil service's control of the economy. If because of WTO rules, the economy must be liberalized this divide will disappear.

If the major profit making state assets-such as SABIC- are privatized it is most likely that the capital of SABIC will be snapped up in the market by the Saudis with the biggest accounts abroad. These are basically the major princes and a few very large merchants. Since the large merchants are already involved in industry, it is likely that they will use their resources to continue developing industrial projects on their own, which would leave SABIC's shares prey to the royal family.

At thirty times earnings, the 70 per cent of SABIC, presently state owned, would fetch \$15 to \$30 billion dollars, with control obtained with \$8 to \$16 billion. Such a figure could be raised by a few major princes. If this were the case, the "social contract" would be broken. There would be two major consequences: 1-the commoners would be removed from important decisions which affect the most important long term income producing sector in the country, 2- the quality of management would drastically decline as royal family members could promote incompetent sycophants and push for investments that would provide large fee earning but non viable projects.

Another problem of unfettered liberalization in the kingdom would be the opening of the financial markets. As they stand today the market do not create any engine of growth. However, if liberalized and removed from the

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tight control of the MOF, the royal family could start muscling in on private firms. This would create great tension between the family, the merchants and the small investors.

The potential for tension is based on the assumption that the royal family will remain above the law and having bypassed the civil service can run rough shod over the commoners. Of course, WTO also requires that the local law be fair to all (including foreigners) and transparent. Hopefully a WTO accession would place the royal family under the law. Unfortunately, one cannot be sure that this portion of the WTO can be enforced as far as the relations between Saudis are concerned.

As long as the royal family has absolute control of the means of repression, communication and of the judicial appointments, it is unlikely that the average citizen will consider that he can fight “city hall”. The only champion of the commoner will remain the king and the civil service. Of course, the king’s interest is to keep the population reasonably satisfied to minimize tension and ensure the long term control of the Al-Saud family. However, he is placed in power by his own family. Thus, it takes a very strong, able, and master diplomat to juggle the support of the royal family while supporting fairness to the commoners.

King Faysal was able to provide such balance at the time when the kingdom started its transition from a desert, poor and undeveloped kingdom to the modern state it is today. He had the overwhelming respect of his

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people and of his family. The present Crown Prince, who since 1998, has been handling the affairs of the state for the ailing King Fahad, seem to also have strong support within the country. However, at 74 years of age, he needs to prepare his own succession.

Naturally, one should hope that the leadership will continue to see that the main problem of the kingdom in meeting the challenge of its own growth is to level the playing field between commoners and royal family. Negotiating with the world to accede to WTO will not achieve the results it could if this fundamental issue is not addressed internally. Otherwise, privatizing and liberalizing the economy will only create huge tensions. Most likely, WTO rules if officially accepted would be skirted or disregarded altogether. Indeed, given the choice of public strife or having a legal drawn out battle at the WTO court, the Saudis, and most of the other Gulf countries will choose the avoidance of strife.