Implications of Economic Decline in Saudi Arabia

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Brief Analysis

On April 14, 1994, Dr. Eliyahu Kanovsky, a professor of economics at Bar Illan University and a leading authority on Middle East economics, addressed a session of The Washington Institute's Policy Forum. Dr. Kanovsky discussed Saudi Arabia's severe economic crisis, and its implications for domestic politics and stability. The following is a rapporteur's summary of his remarks.

The Falling Price of Oil

Despite the embargo on Iraqi oil, drastically reduced oil prices in the former Soviet Union, and an unusually severe winter that raised energy demand, the price of oil has remained low. In fact, contrary to the predictions of sharply increasing oil prices by most analysts citing worldwide inflation, job growth, industrial development in the third world, and the drop in investment in oil exploration, the underlying trend in oil prices is downwards.

Oil prices, when adjusted for inflation, are now lower than they were before the oil shocks of 1973 and 1979. OPEC producers, while making quick gains when crises affect oil supply and sharply raise barrel prices, suffer over the long-term. In fact, oil shocks bear much of the responsibility for the decline in prices. As oil prices shoot upwards, consumers search for alternatives. Oil crises stimulate buyers to reduce demand, and to develop new technology using alternative forms of energy.

Overlooked by the majority of forecasters, a number of other factors continue to drive the price of oil downward, severely affecting the oil-based economies of the OPEC states:

•Environmental concerns: Nations are looking to other, cleaner sources of energy, especially natural gas, which continues to cut into oil's share of the world energy market.

•Russian demand: There will probably be no significant increase in Russian before the end of the decade.

•New technologies: Costs of exploration and drilling continue to drop for non-OPEC countries as new technology makes expensive operations more feasible.

•Oil reserves: World reserves are not being depleted as rapidly as was projected; in fact, they are constantly being revised upwards.

•Competing producers: Non-OPEC nations are producing more oil than ever before, reducing reliance on OPEC oil.

•Taxes: High gasoline and oil taxes are reducing worldwide demand.

OPEC states have been devastated by the loss of oil revenue. Even small producers, like Egypt and Syria, have been hurt by the lack of remittances. The prospects for instability and economic decline in many of the "oil monarchies" of the Middle East are great.

Saudi Arabia's Economic Decline

Basing its budgetary expenditures on rising revenue, Saudi Arabia heeded the advice of experts who prediced the price of oil to continue to rise about 3 percent annually. With an overflowing treasury and an even greater amount of oil, Saudi Arabia undertook massive programs of public expenditures. Lavish subsidies boosted industry, agriculture, public welfare, and set up growing bureaucracy to employ Saudi Arabia's increasing number of college graduates. The government also provided free education and health care to all its citizens but did not institute any form of income tax, regardless of wealth.

The government's generosity soon came back to haunt it. When the price of oil began to fall in 1981, the Saudis realized the cardinal rule of public administration and welfare: it is far easier to give than it is to take away. As far back as 1983, Saudi Arabia began running a budget deficit, which has continued to increase every year. King Fahd's government continued to appease the public and assuage discontent by reducing the cost of living by subsidizing public utilities.

Borrowing and Spending

At the same time as it boosted public spending, King Fahd decided to modernize Saudi Arabia's military forces, largely due to the scare from the Iraq during the Gulf War. From 1990-1993, Saudi military orders were $30 billion to the US alone. Large loans footed the bill for these expenditures, further driving the country into debt. Behind in payments to the Pentagon in 1992, the Saudis established dummy corporations to borrow more money for military purchases, amassing more debt, albeit off-budgetary. Additionally, Saudi Arabia's payments for the purchase of Boeing planes this year will come from loans from the US government.

The Implications of Economic Decline

According to an International Monetary Fund mission to Saudi Arabia in 1993, the five-year economic projection for Saudi Arabia is grim. Currently, Saudi Arabia's deficit stands at $73 billion. By the end of 1994, this figure will exceed $100 billion, and by 1997, public debt could account for 70-80% of Saudi Arabia's GDP.

Unemployment is increasing, as the already bloated bureaucracy cannot accommodate the growing numbers of Saudi college graduates needing jobs. Kickbacks and commissions to the many well-connected members of the government and the literally thousands of members of the royal family, while hard to determine, drain as much as $10 billion annually. Compounding all the other issues is a growing population increasing at 3 percent, promising to make the Saudi social spending net even wider.

The threat from this debt is clear. Eventually, social spending will decreasz, fueling public discontent. A discontented public is the breeding ground for instability and Islamic fundamentalist groups, which already have a foothold in many OPEC countries. So far, the Saudi government's reaction to discontent is to further raise public spending, thus perpetuating a vicious cycle of debt.

Economic Decline and the Threat to the Peace Process

Undoubtedly, continued economic decline could bolster the popularity and power of groups opposing the governments in OPEC countries. The popularity of Islamic fundamentalists promises to grow as the standard of living decreases.

The overthrow of the ruling regimes in Saudi Arabia and the other OPEC countries casts a shadow over the prospects for peace in the region. More radical governments in the Middle East will probably not honor any future peace agreements with Israel, and, like Iran, may seek to sever ties to the West.

To insure the stability of the country, however, King Fahd and his government must act. Saudi Arabia's present situation demands tough choices for its leaders. In order to break the cycle of debt, the kingdom must diversify its economy, cut wasteful government spending, shrink its bloated bureaucracy, and devalue its currency. The developing nations in Asia, which have few natural resources but tremendous industrial potential, could serve as a model to Saudi Arabia and other OPEC countries for modernizing and diversifying their oil-dependent economies. At present, however, Saudi rulers appear to have little interest in confronting the problems facing the country.

This special Policy Forum report was prepared by Daniel Seligson. ❖

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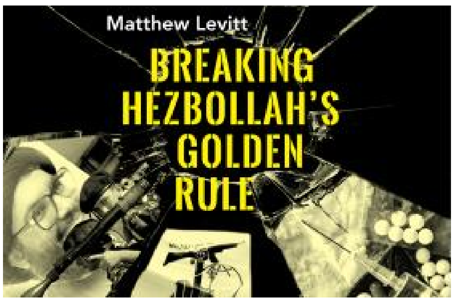

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