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Saudi Arabia as an Emerging Market: Commercial Opportunities and Challenges for South Africa

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ABSTRACT

Saudi Arabia is a country on the rise with its sights set on full integration into the global economy. Since the late 1990s, Saudi policymakers have made a concerted effort to reform the country's economy, and to position it as an investment destination and an important player in the global economy.

Economic reforms have created many opportunities for outsiders seeking new trade and investment avenues. The country offers boundless economic possibilities, and its economic potential has yet to be fully tapped. Saudi Arabia is a pivotal country in the Gulf region and exhibits characteristics of an emerging power.

South Africa should take Saudi Arabia seriously as a commercial partner. South Africa's evolving South-South strategy, centred on Brazil, Russia, India and China, should also include countries in the Gulf and the broader Middle East. In particular, South Africa should deepen trade and investment ties with Saudi Arabia.

South Africa should take advantage of Saudi Arabia's desire to foster closer economic ties with Africa. Apart from seeking economic opportunities within the growing and modernising Saudi economy, South Africa should actively promote itself as a natural and attractive destination for investment by Saudi Arabia and other Gulf countries. South Africa's external strategies – both through government's diplomatic efforts and commercial strategies – ought to give strong priority to Saudi Arabia as a growing market in the Gulf region, and as an important global actor.

South African policymakers should revive the country's relationship with Saudi Arabia and work towards elevating two-way relations. Existing co-operation mechanisms, through which the two countries can pursue structured and purposeful economic dialogue, should be strengthened.

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ABBREVIATIONS AND ACRONYMS

BRIC	Brazil, Russia, India and China
CMA	Capital Markets Authority
G20	Group of 20
GCC	Gulf Cooperation Council
GDP	gross domestic product
IMF	International Monetary Fund
IT	information technology
JBC	Joint Business Council
JEC	Joint Economic Commission
KAEC	King Abdullah Economic City
OECD	Organisation for Economic Co-operation and Development
SABIC	Saudi Basic Industries Corporation
SAGIA	Saudi Arabian General Investment Authority
SAMA	Saudi Arabian Monetary Agency
UAE	United Arab Emirates
US	United States
WTO	World Trade Organisation

INTRODUCTION

Saudi Arabia is a country on the rise, with its sights set on full integration into the global economy. Its leaders have been hard at work, striving to transform the oil-dependent country into a thriving modern state that is able to compete in the world economy. Since the late 1990s, Saudi policymakers, under the leadership of King Abdullah, have made a concerted effort to reform the country's economy, and to position it as an investment destination and an important player in the global economy. The stereotypical image of a backward desert economy and a breeding ground for Islamic extremism is one that the Saudi authorities are determined to erase. Economic reforms have created a profusion of opportunities for outsiders seeking new trade and investment avenues.

Many countries, both developed and developing, have been rushing to conclude trade and investment treaties with the Saudi Kingdom. The Kingdom is a pivotal country in the Gulf region and exhibits characteristics of an emerging power. Emerging powers are countries whose influence in the global system is growing. They possess a combination of traits that include: stable macroeconomic policies; domestic economic reforms; large populations and growing middle classes; a significant resource base; growing defence spending; regional clout; integration into the global economy; active participation in global governance processes, such as membership of the Group of 20 (G20), the World Trade Organisation (WTO), and some form of relationship with the Organisation for Economic Co-operation and Development (OECD); and foreign policies that are underpinned by a strong commercial focus and, in some cases, a strong thrust into Africa.

This paper makes a case for South Africa to take Saudi Arabia seriously as a commercial partner in the Gulf region. South Africa's evolving South–South strategy, centred on Brazil, Russia, India and China (the BRIC countries), should also include countries in the Gulf and the broader Middle East. In particular, South Africa should deepen trade and investment ties with Saudi Arabia, and, for South African businesses seeking new trade and investment opportunities in the Gulf region, the Kingdom merits serious consideration.

The paper consists of five parts. The first contextualises Saudi Arabia's evolution since becoming a modern state in the early 1930s. The second examines the economic reforms that the Saudi governing elite has implemented in recent years to open up the country's economy and improve the investment climate. The third discusses the economic outlook for Saudi Arabia, while the fourth analyses commercial activities and opportunities in the Kingdom. The concluding section presents the case for deepening diplomatic and economic links between South Africa and Saudi Arabia.

SAUDI ARABIA IN CONTEXT

Saudi Arabia is a very different country today from the state formed in 1932. Over the decades, the country's economic profile has vastly improved, although, politically, an absolutist lineage is in charge. The Saudi modern state emerged only in the early 1950s, coinciding with the development of oil resources in the country.

Oil dominates the country's economic activity and is pivotal to the Kingdom's diplomatic relations with the West. Currently, oil makes up 50% of Saudi Arabia's nominal

gross domestic product (GDP) and 90% of export revenues.¹ The country holds about 25% of the world's oil reserves and is by far the largest exporter of oil. In 2009 the country achieved the remarkable feat of generating 12.5 million barrels of oil per day, the result of a technically complex infrastructure development that cost \$100 billion over a five-year period.²

Although the country's oil reserves could last for over 70 years, the depletion of oil supplies elsewhere could increase pressure on Saudi's oil resources.³ Therefore, the Saudi government has developed a strategy to reduce dependence on oil, diversify the economy, and build industrial infrastructure for the future. The government has been working on a plan to grow its petrochemical sector, with a strong emphasis on ploughing investment into alternative energy projects.⁴

A major focus has been on infrastructure development, social services, education and housing. Rising oil prices in 2008 gave Saudi Arabia leeway to reduce its debt from about 100% of the GDP to less than 20%.⁵ As a result, government spending has been the main driver of economic activity, and the government has pledged to spend \$400 billion on infrastructure and hydrocarbons investment over the next five years.

If oil resources dwindle and the social security net weakens, Saudi Arabia's massive welfare state could be engulfed in a cauldron of social discontent. Saudi Arabia has a significant number of young people, most of them unemployed and uneducated, making up over 60% of the total population. The growing middle and professional classes are largely liberal-minded and fervent champions of economic reform, but they remain small in relation to the wider population. Widespread poverty and economic inequalities have bred social tensions in Saudi society. The government is mindful of the social cleavages and their implications for the future stability of the Kingdom. Thus, placing social development at the centre of economic modernisation is crucial to the country's development strategies.

One of the important pillars of the Kingdom's development plans is to increase skills and broaden the absorptive capacity of the labour market. As part of its modernisation drive, the government has spearheaded a process of 'Saudisation', which is intended to get young Saudis to work, and to increase their education and skill levels. It is hoped that this will ultimately reduce reliance on skilled and unskilled expatriate labour.⁶ The reforms have also given women access to education, which was previously unheard of in Saudi Arabia.

An important sign of the commitment to education is the \$12 billion pledged to create a university near the Red Sea port of Jeddah, Saudi Arabia's second largest city and busiest port.⁷ According to *The Economist*: 'In the past five years alone, new government programmes have sent close to 200 000 Saudi students overseas, more than were sent in the previous 20 years.'⁸ All of this suggests that government is serious about transforming the Saudi society and economy and building human capital that will sustain modernisation.

However, notwithstanding attempts to transform the Saudi economy, some challenges remain. Apart from the most pressing issues – those of diversifying the economy and addressing deep-seated social challenges, especially high youth unemployment and a fast-growing population – political and ideological tensions represent another challenge. These include issues related to political succession and contestation between different religious sects in society. In the past, succession issues have somehow resolved themselves, with the royal family managing to reach a consensus on who will occupy the Kingdom's highest

political office. Even so, uncertainty abounds over how such questions will be handled in the future.

ECONOMIC REFORMS AND INVESTMENT CLIMATE

Saudi Arabia's accession to the WTO has served to lock in a broadly liberal reform agenda, which emphasises strengthening the private sector's role in the domestic economy and promoting openness in trade and investment policies. In 1997, with a Cabinet decree (No. 60 of 1.4.141H, 5 August 1997), the Kingdom unveiled a comprehensive plan that sets out 20 economic activities slated for privatisation.

These economic activities straddle social and economic services: water and sewage; desalination; telecommunications; aviation services; railways; roads (their management, operation, maintenance and construction); airport services; postal services; seaport services; government-owned hotels; sports clubs; social services; agricultural services; and health services. A subsequent Cabinet decision (No. 25 of 11/11/1421 AH, 5 December 2001) designated the Supreme Economic Council as the supervisory authority to oversee the privatisation process. These two pieces of legislation reaffirmed the Saudi government's intent to strengthen the role of the private sector in economic development. They also indicate clearly the country's economic policy direction to prospective investors.

The Saudi government defines its core economic development objectives thus: 'Diversification of the economy, particularly through laying more emphasis on industry and agriculture and developing mineral resources; improving of living standards and quality of life; achievement of balanced growth throughout all regions of the Kingdom; strengthening the role of the private sector through encouraging its participation in various socio-economic development projects; achievement of social and economic integration among the Gulf Cooperation Council (GCC) countries; and supporting economic co-operation with other countries.'⁹

Recent state-supported investments point to a future scenario where a growing component of the economy will be the non-oil sector – mainly agriculture, industry and the mining sector. No doubt, the oil sector will remain significant for many years to come, but Saudi rulers are uncomfortable depending on one major export sector. The country is thus keen to change its economic profile, integrate its economy into the global economy and secure the economic welfare of its people.

The Saudi government sees the private sector's role as one of improving the capacity of the economy and stimulating regional and international competitiveness. Furthermore, the privatisation of state-owned entities provides a way for the government to raise revenues and improve efficiencies by, in particular, reducing government spending and increasing employment opportunities. Government's role, on the other hand, is that of a facilitator, fostering conditions for the development of a competitive state that enjoys respect both in the Gulf region and in the global economy.

Saudi Arabia's General Investment Authority (SAGIA) actively promotes investment in the country, and aims to position Saudi Arabia among the top 10 most competitive and investor-friendly nations. The body is responsible for strategic investment promotion and country marketing. To lend weight to its goal of attracting foreign investment, SAGIA provides a range of incentives to prospective foreign investors: 100% foreign ownership of

projects; no restrictions on repatriation of capital; personal income tax exemption; and a 20% corporate tax for foreign companies (down from 45% before 2000).¹⁰ Further, SAGIA has a mandatory turn-around period of 30 days to process investment applications, failing which it is required to issue a licence. SAGIA has in the pipeline more than \$600 billion worth of investment projects over the next 20 years.¹¹

According to new investment regulations, companies can be 100% foreign-owned with the exception of designated sectors (the so-called 'negative list'); foreigners can have access to low-cost loans from the Saudi Industrial Development Fund on similar terms to Saudi companies; and foreign companies are now allowed to own land for licensed activities and for housing employees.¹² Another important investment regulation is the 'System of Real Estate Ownership and Investment of non-Saudis', according to which non-Saudis can own real estate for their private residence.¹³ These measures have helped to foster a business-friendly climate and provide certainty about the investment environment.

Achieving goals, such as expanding the ownership of productive assets by Saudi citizens, is seen as possible through a managed process of privatisation. There are, of course, sectoral exceptions such as hydrocarbons, and limitations on the acquisition of stakes in state-owned entities. In 2007 the government restated its commitment to accelerate privatisation by announcing that it would divest \$800 billion worth of state-owned corporations in the following 10 years. The privatisation of Saudi telecommunications in 2003 – through the sale of a 30% government stake – underscores the Kingdom's seriousness about economic reform. More recently, a private company was appointed to run all the eight seaports in Saudi Arabia and a feasibility study is (at the time of writing) currently underway on the construction of a new seaport in Al-Lith. In March 2010 a decision was made to privatise the Saudi national airline. These are important reform measures calculated to create investor confidence and to position Saudi Arabia as an attractive investment location.

However, regulations that limit access to previously state-owned companies remain. Participation in state-owned entities earmarked for privatisation is possible only through the purchase of an equity stake in a Saudi limited liability company, enabling a foreign entity to be a 'strategic partner'. In addition to a liberal investment framework, Saudi Arabia possesses other attractions, which in some measure compensate for a political system that remains closed and opaque. According to the 2010 World Bank Doing Business Report, Saudi Arabia ranks number 13 out of 183 countries for ease of doing business, 61 for ease of getting credit, four for starting a business (it takes five days to start a business, compared with the OECD average of 13). Securing a construction permit involves 17 procedures, compared with the OECD average of 15. Registering a property involves two procedures, compared with the OECD average of four.¹⁴

Furthermore, Saudi Arabia is a repository of a large base of investable funds and is the only Gulf country to have weathered the global financial crisis with relative ease, thanks to its previously conservative investment strategy. Its sovereign wealth fund, the Saudi Arabia Monetary Agency (SAMA), is one of the world's largest, with \$500 billion assets under management. The McKinsey Global Institute suggests that petrodollar investors are likely to plough more investments into real estate and land, commodities and emerging markets.¹⁵

While not exhibiting the expansive characteristics that are the hallmark of the United Arab Emirates (UAE) Fund, SAMA has been central in spearheading Saudi investment

in countries such as Jordan, Egypt and Morocco. Saudi Arabia's investment in Egypt, particularly in tourism infrastructure (a significant share of tourists in Egypt come from the GCC countries) has certainly been an important source of economic growth for Egypt in recent times.

Saudi Arabia has a growing stock market, Al Tadawul, which was established in 2004 and is regulated by the Capital Markets Authority (CMA). In August 2008 the CMA allowed foreign investors to buy Saudi shares indirectly via licensed brokers.¹⁶ Insider trading, market manipulation and poor disclosure are reined in by the CMA. The stock market is still classified as a 'frontier market' by index providers. Nonetheless, the Al Tadawul's gradual opening to foreign investors via a derivative instrument, 'total return swaps', is illustrative of Saudi's readiness to join the league of respectable emerging markets. As a London-based hedge fund manager points out, 'once (Tadawul) opens up fully to foreign asset managers it's only a matter of time before it makes it into the emerging market indices, and it could become as important as India or South Africa to institutional investors.'¹⁷

Nevertheless, it is worth noting that the Saudi business environment, while generally open, is still dominated by a mixture of state-owned and family-run enterprises, many of which are linked to the royal family. About 90% of Saudi's businesses are family-owned. Unsurprisingly, a major Saudi company, Saudi Basic Industries Corporation (SABIC), which has featured in the Global Fortune 500, is state-owned. However, all of this could be a part of a past that is gradually receding, as focus shifts towards creating room for private sector-led development.

ECONOMIC OUTLOOK

Saudi Arabia's economic outlook is positive, at least in the short to medium term. In its 2009 Article IV Report on Saudi Arabia, the International Monetary Fund (IMF) affirmed Saudi's reform direction, pointing out that: 'In recent years, the authorities consolidated their macroeconomic position, strengthened the financial sector, and implemented structural reforms to boost private sector-led growth.' In a similar exercise in 2010, the IMF highlighted a number of positive developments in Saudi Arabia in the wake of the global financial crisis.¹⁸

The IMF gave Saudi Arabia a thumbs-up for successfully weathering the global financial crisis. It noted that this was the result of prudent fiscal policies that allowed policymakers to respond effectively to the crisis. Further, the IMF highlighted: a good supervisory and regulatory framework; signs of future growth of the non-oil sector, with a projected growth of 4.5% in 2010, underpinned by expansionary fiscal policies and improvement in credit; and the likely decline of inflation against the backdrop of a projected rise in global interest rates.

COMMERCIAL ACTIVITIES AND OPPORTUNITIES

Saudi Arabia is a country with enormous opportunities and vast potential. In order to expand economic activities, attract foreign investment, attract managerial expertise and

technology, address a high demand for housing and increase the absorptive capacity of the labour market, Saudi Arabia has proposed the development of six mega-cities as the lynchpins of its development strategy. Construction has already begun on four of these economic cities: King Abdullah Economic City (KAEC), Prince Abdul Aziz bin Mousaed Economic City, Jazan Economic City and Knowledge Economic City. Costing in excess of \$60 billion, this ambitious development project is expected to promote economic diversification, create over a million jobs, build homes for five million residents, and contribute \$150 billion to Saudi's GDP.¹⁹

KAEC is the cornerstone of this economic cities' development.²⁰ Being built by the Dubai-based Emaar Economic City, KAEC is the size of Washington DC and is located 100 kilometres north of Jeddah. Worth over \$27 billion of investment, KAEC is divided into an industrial zone, a seaport, residential areas, a waterfront resort area, an educational zone and a central business district. Industries and services such as steel, aluminium, petrochemicals, pharmaceuticals, tourism and finance are being established in this area. The first phase of this project will target light and medium industries, as well as logistics companies involved in warehousing and distribution of goods, with subsequent phases involving petrochemicals and metals manufacturing. KAEC has attracted the interest of a number of Western companies, and some of them are already involved in this development through joint ventures with Saudi companies.

Apart from Emaar Economic City – the main developer – a number of other companies are active in this impressive commercial project. Those that have already signed contracts with Emaar include Orange Business Services (overseeing the design of telecoms services); Ericsson (broadband network development); CISCO Systems (developing Plastics Valley structure networks); American-based StrateSphere Enterprises and PolymerOhio Inc (developing Plastics Valley); CEMCO (infrastructure for the industrial zone); Bin Laden Group (responsible for constructing residential towers); and Siemens (electrical transmission and distribution).

An \$8 billion development, the Prince Abdul Aziz bin Mousaed Economic City, is expected to be a new location for transport and logistics-related service industries. Covering an area in excess of 156 million square metres, it will include 'an inland port with warehousing and distribution services, agricultural processing industries as well as mining and related industries designed to exploit the region's natural resources.'²¹

The Knowledge Economic City, being built at a cost of \$7 billion, is designed to transform Saudi Arabia into a global knowledge hub and a mecca of culture, tourism and services. The Jazan Economic City (costing \$27 billion) will host a state-of-the-art industrial zone that will also serve as an export platform for global markets, especially Europe, Asia and Africa.²²

Companies that have been most active in the state-sponsored economic development programmes being rolled out in various economic mega-cities include 'national champions' such as Saudi Aramaco (the world's largest oil company, which supplies more than 10% of global oil demand and manages over 98% of the Kingdom's oil reserves),²³ SABIC (largely petrochemicals), Olayan Group (trading and industrial infrastructure), Dallah Albaraka Group (media, banking and construction), and the Bin Laden Group (construction and equity management).²⁴

OPPORTUNITIES AND CHALLENGES FOR SOUTH AFRICA

Saudi Arabia has been riding the crest of a wave. Under the leadership of King Abdullah, economic reforms have not only charted a new economic destiny for the Kingdom, but also spawned numerous opportunities for foreigners seeking new trade and investment outlets. With its economic potential not yet fully tapped, the country offers boundless economic possibilities. South African businesses scouring for commercial opportunities in the Gulf region should seriously consider Saudi Arabia.

It is in South Africa's interest to forge closer economic co-operation with the Kingdom. Yet, surprisingly, bilateral relations between South Africa and Saudi Arabia are not as strong as they should be. This is not for a lack of trying on Pretoria's part. In 2007, before he was ousted from office, former President Thabo Mbeki undertook a state visit to Saudi Arabia, which was aimed at strengthening economic ties. During the visit, an important instrument for bilateral engagement – a Joint Economic Commission (JEC) – was created to facilitate ongoing dialogue between the two countries. However, despite its enormous potential to identify mutual areas of economic co-operation between the two countries, the JEC has been dormant: it last met on 23 February 2009 and is unlikely to meet in 2010. Similarly, the Joint Business Council (JBC) between South Africa and Saudi Arabia remains inactive, and South Africa's private sector activity in Saudi Arabia is minimal. This is a challenge that South Africa must overcome.

South African policymakers should revive the country's relationship with Saudi Arabia and work towards elevating two-way relations to a higher level. That South Africa has not positioned itself strategically to be able to exploit the abundant growth opportunities in Saudi Arabia and the broader Gulf region points to a weakness in South Africa's economic diplomacy. Already, South African firms lag behind western companies, mainly from Great Britain and the United States (US), who already have a presence in the Kingdom.

Significantly, they also trail behind companies from other emerging economies, such as India and China, which have established footprints in the country. These emerging powers have been pushing hard to strengthen trade and investment relations with Saudi Arabia, and Indian and Chinese companies have undertaken infrastructure projects through joint ventures with some of the major Saudi companies.²⁵ China's commercial relations are reflected in the country's growing importance as a leading consumer of Saudi's oil, having overtaken the US as the main importer in November 2009. Moreover, there are 70 Chinese construction firms (employing about 20 000 people) operating in Saudi Arabia. The endless stream of Chinese business delegations to the Kingdom almost every week underline the growing commercial relations between Saudi Arabia and China.

India's involvement is evident in the Knowledge Economic City, where India's world-class information technology (IT) firms have a strong presence. Over 190 Indian companies have applied for and/or received licences to invest in Saudi Arabia, including Air India, New India Assurance, Wipro Ltd, Tata Consultancy, Tata Motors, Progressive Construction Ltd and HDFC Bank.²⁶ Both India and China are exploring the possibility of concluding free trade agreements with Saudi Arabia, a clear illustration of the economic importance they attach to the Kingdom.

Strengthening diplomatic and economic links with Saudi Arabia is a clear imperative for South Africa. South Africa should view Saudi Arabia (and the other GCC countries) as one component of a clearly defined South–South strategy, and as a priority country

alongside economically influential and commercially attractive countries such as China, India, Brazil, Russia, Indonesia and Turkey. South Africa's external strategies – through both government's diplomatic efforts and commercial strategies – ought to prioritise Saudi Arabia, as a growing market in the Gulf region and an important global actor.

By joining the WTO, Saudi Arabia committed itself to opening up its economy through the reform of its trade and investment policies, and its regulatory structure – with the private sector as a key driver of economic development. Saudi Arabia is also the only Gulf state that is a member of the G20, an important entity that shapes global governance processes. Moreover, the country has a desire to extend its political and economic friendships beyond traditional ties with the West. In particular, the Kingdom has set its sights on sub-Saharan Africa where it seeks to strengthen strategic and diplomatic relations while also engaging in commercial exchanges with the continent.

In recent years, the Gulf states, including Saudi Arabia, have become important sources of inward investment. Across Africa, the Gulf states have been 'looking for investors and partners in key areas such as petrochemicals, transport and related infrastructure, health care, power, IT and manufacturing.'²⁷ They have also been actively involved in countries such as the Sudan, Ethiopia and Tanzania.²⁸ For example, countries from the UAE have invested about \$380 million in Sudan across a range of sectors, including telecommunications, banking, hotels, infrastructure development and manufacturing businesses.²⁹ A Saudi group owns boutique lodges in Mozambique and hotels in Namibia. In South Africa, Dubai-based companies have bought the V&A Waterfront and the Pearl Valley Signature Golf Estate, while Saudi investors also funded cellular provider, Cell C.³⁰ The Abu Dhabi Investment Authority, through its subsidiary Mubadala Development Company, has invested \$400 million in Nigeria's telecommunications sector. It has also invested in power stations and oil and gas projects in Algeria, as well as in Guinea's aluminium industry.³¹ Furthermore, Saudi Arabia has shown a keen interest in agriculture and has earmarked several African countries for the purchase of agricultural land: this is aimed at tackling the Kingdom's growing food-security concerns by controlling supply at source.

South Africa should harness the benefits of Saudi Arabia's desire (and other Gulf countries) to foster closer economic ties with Africa. Apart from seeking economic opportunities within the growing and modernising Saudi economy, South Africa should actively promote itself as a natural and attractive destination for Saudi investment. Realising this objective will require the strategic promotion of South Africa as a key investment partner of Saudi Arabia by both the South African government and the business sector. This, in turn, will require a strengthening of existing co-operation mechanisms – notably the South Africa–Saudi JEC and JBC – through which South Africa can pursue structured and purposeful economic dialogue with the Kingdom.

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