EMEA

SAUDI ARABIA: THE KINGDOM TO COME

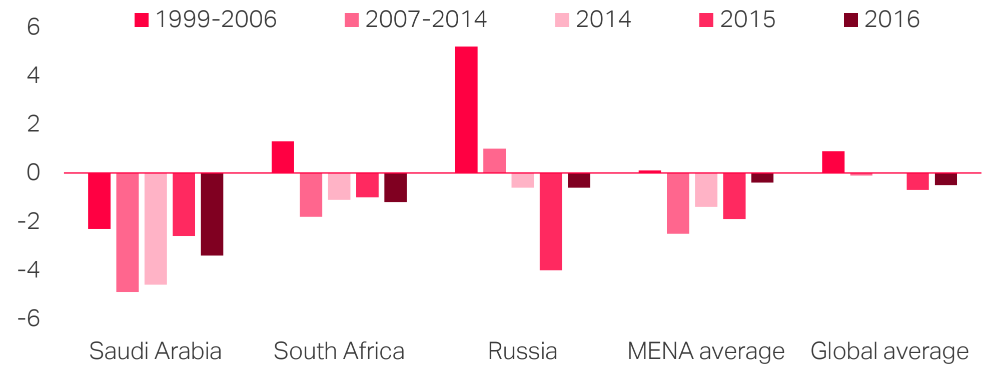
Marcus Chenevix

Over the last 12 months we have closely followed Muhammad bin Salman's relaunch of his Kingdom. In this note we join up the findings of the past year of research to answer the question: what will the new Saudi Arabia look like?

- The new Saudi Arabia will be more repressive and more visibly unstable – but also more dynamic and able to enact radical reform.
- The economic "reform" agenda of MBS amounts to an expansion of the already enormous Saudi state: expenditures are becoming smarter, not smaller; and the Kingdom's breakeven oil price is rising, not falling.
- On a conventional checklist of reforms, much is missing: the exchange rate will remain fixed, labour policy will remain unchanged and productivity-raising education reform is decades away.
- But other reforms are happening: fiscal policy is becoming more effective and, most important, social reform is creating seismic shifts in Saudi society – shifts that will materially boost consumption.
- There will be an investment opportunity here, but not just yet. Trapped local savings mean that Saudi equities trade at an unjustified valuation premium while deteriorating credit fundamentals weaken the fixed income case.

Saudi Arabian productitvity is deteriorating

Total factor productivity growth (% YoY)



Source: Total Economy Database.

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Reforming the political system

Saudi Arabia becomes an absolute monarchy

From 1975 to 2017 the Kingdom was ruled by consensus: nothing was done that did not reflect the general opinion of the royal family. To understand the system that MBS is tearing down, we have to look back to 1975, when King Faisal was shot dead by a disgruntled young prince. Faisal had been the obvious successor to Saudi Arabia's founder, King Abdulaziz, since the establishment of Saudi Arabia in the 1930s. He was so powerful in comparison to his relatives that when he died, there was no one of similar stature to take his place. The princes therefore opted to divide power among themselves, with the king becoming first among equals and more a figurehead for the consensus decisions of the royal family than a ruler in his own right. This was rule by princely consensus – a system of royal oligarchy.

That system persisted through the reigns of Khaled, Fahd and Abdullah. It defined Saudi Arabia for 40 years. The post-Faisal compromise maintained stability and royal privilege by distributing power among the senior members of the royal family and the religious establishment. The princes and clerics turned ministries, governorates and even divisions of the army into personal fiefdoms. In fact this system shaped many of the traits that define Saudi Arabia to the outside world:

- **Religious conservatism:** In the wake of the 1979 mosque siege, the government came to an accommodation with the clerics in order to put an end to religious unrest: in return for their political support, the clerics were given control over public space, whether that space was the street, the schools or the media.
- **Cruel and unusual punishments:** Saudi Judges can decide cases according to their own individual interpretation of Islamic law, with little reference to precedent or statute. This out-dated system has survived precisely because it does not represent the rule of law. From the perspective of the princes, rule of law would have undermined their power – power that rested on informal privilege and a weak central government.
- **Lavish spending:** The fact that individual princes were concerned mainly with expanding their own empires and that powerful princes were of almost equal esteem to that of the king meant that the central government had little capacity to control or regulate spending. An acute example is provided by defence imports.

The old system did have its merits: under rule by consensus, the Kingdom kept out of regional conflicts, avoided making international enemies and spent money lavishly in the more remote parts of the country, which may otherwise have been neglected. Moreover, the system was stable and good at handling transitions of power – the passing of any one individual did not compromise the whole system.

However, the system was dying a natural death from the moment King Salman took the throne. A new generation needed to take power. Furthermore, the oil price slump meant that the system had to be tightened and made more adaptive if it was going to survive. That said, Salman certainly accelerated the process. Just four months after being crowned, he fired his brother as crown prince and then went on to dismiss his nephew, until his own son was set up as sole successor in 2017.

Starting in 2015, King Salman began cutting the princely class out of policymaking. In parallel with his changes to the succession, Salman started to change the way in which the Kingdom made policy: the process became more formal and more power was put into the hands of the Royal Diwan (the office of the king) as opposed to the royal family. In 2015 Salman dissolved the Kingdom's Supreme Economic Council and its equivalent for security policy, both of which were sprawling committees stocked with royal family members and senior technocrats. Little debate of any value took place on these large committees, whose primary function was to rubberstamp decisions and bolster collective authority. Salman replaced them with two smaller and leaner committees that played much more direct roles in policymaking – committees on which substantive discussion that leads to new policy could take place. Furthermore, unlike the old councils, the new ones are devoid of princes and filled instead with technocrats alone. From the start, the only prince on the new committees was MBS himself, who was chairman of both.

As he was cutting the princes out of policymaking, King Salman seems to have already been considering the problem of compliance. Sometime in 2015 (as far as we know), Salman began to create a new security force known as “al-Ajrab” (the name of the sword of Saudi Arabia’s founder). This secretive military unit, which exists outside the normal command structure and is staffed with loyal, non-royal officers, appears to have been created specifically to deal with princely opposition. In fact, it was this force that MBS used in November 2017 to carry out his mass purge of the Kingdom’s elite – the purge that effectively brought the old political system to an end once and for all.

Centralization of power since the accession of King Salman in January 2015

Date enacted	Reform
Jan-15	New, stripped-down, committees formed on economy and security
~ Sep-15	Formation of al-Ajrab for dealing with princely opposition
Apr-15	Salman replaces his brother with his nephew as Crown Prince
Apr-16	Religious police stripped of powers of arrest
Apr-16	"Vision 2030" unified economic strategy announced
Summer 16 –	**MBS begins to assume de facto power**
Jun-17	MBS replaces his cousin with himself as Crown Prince
Jul-17	MBS takes personal control of intelligence apparatus
Oct-17	Mass arrest of clerics and intellectuals
Nov-17	Mass arrest of princes and oligarchs

Sources: Brookings, al-Monitor, TS Lombard.

The old Saudi Arabia tolerated some level of dissent – especially from elite classes. One of the features of the old system was an assumption that dissent needed to be mediated out of existence rather than overtly crushed. The central goal was the avoidance of discord rather than the imposition of any particular agenda – after all, without a single leader, the kingdom did not have a single agenda to impose.

There were, of course, numerous classes of society that the government routinely crushed: Shia, migrants and, not least, women. However, property owning Sunni men were treated much more accommodatingly than in other Middle Eastern states and were assumed to have certain rights before the ruler. For example, ordinary male Saudis, if imprisoned for political reasons, could expect substantial financial compensation from the government. Opposition to government policy, if based on grounds of religion, was tolerated and sometimes even succeeded in changing policy. Religious dissidents, including convicted terrorists, could expect a programme of attempted “rehabilitation” rather than punishment. Among elites, there was considerable latitude to express dissent, figures like Jamal Khashoggi were able to publish their ideas and express their views relatively freely for decades. The state ensured deference, but at the same time Sunni Saudi men were encouraged to feel (even if the impression was false) that they and the royal family were all part of the same elite and that being a member of this elite entailed certain rights.

The new Saudi Arabia will be even more authoritarian. Under MBS, this model of the state is changing. First, the princely class and the clergy no longer have the right to dissent. The state is strong enough to coerce compliance: conscientious objectors will no longer be tolerated. Second, with the arrival of taxation, and the accompanying need for enforcement, the notion that the people and the state are all part of the same elite can no longer be sustained: the people must obey the state and pay their taxes, and what is more, they will not be consulted about these taxes. Third, rather than the avoidance of dissent, MBS seeks actual buy-in to his political project – that is, overt support rather than passive acquiescence. Members of elite and ordinary people are now expected to actively demonstrate their loyalty, whether on social media, in the traditional media or in any other form of public space.

This is state capture in reverse – the imposition of the state's agenda on corporations. Media companies like MBC and contractors like the Bin Laden group used to deal with the state as a partner and in fact were able to exert influence on policy. The power relationship has now changed, these corporations will now have to implement the policy of the state, whether or not that suits their bottom line. Under MBS, Saudi is becoming an authoritarian state, one in which the state sets the direction of society, defines public conversation and suppresses all forms of dissent. Despite Saudi Arabia's autocratic history, this is new.

Is this new system a bad thing?

For investors at least, the answer is "No" – this change is mostly a good thing. For the first time in a very long while, the Kingdom now has the ability to draw up and then implement radical economic reform. This is a direct consequence of the scrapping of consensus-based rule.

However, it is also true that the Kingdom will now suffer from more visible instability. The old oligarchy and the clerics, will resist their loss of power, and their attempts at resistance are far from over. We will continue to see arrests and purges over the coming years. That said, the Saudi state almost certainly possesses the means to successfully crush elite dissent. Although it is likely that al-Ajrab will be busy in the coming years, if anything its operations are likely to become more slick and more accomplished than the half-bungled Ritz operation that brought this political change to the attention of global media.

Having one man making policy carries its own risks: we cannot know yet how MBS' personal rule is going to work. With just one man steering government, any individual shift in his thinking may become policy. Therefore, critical to this kind of one-rule is the circle that surrounds the ruler – the people who moderate and influence his executive decisions. So far MBS' choice of advisors has ranged from excellent (Adel al-Jubeir as foreign minister) to inexplicable (Khaled bin Salman as ambassador to the US). Judging by Yemen and Qatar, this policymaking process is at the moment fairly arbitrary and erratic, but we do not yet know how things will develop; certainly this will be an important area to watch in the new Saudi Arabia.

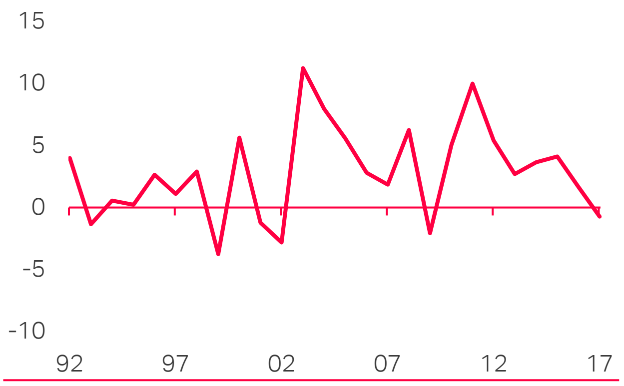
Reforming the economy

Smarter and more efficient, albeit just as state-dominated

While remaking the political system was a huge task, reforming the Saudi economy is the most difficult part of Muhammad bin Salman's task. If MBS does not fix the economy, his political project will be at risk, not from the elites but from the people themselves. There are immediate issues: a fiscal system burning through FX reserves and the longest economic slowdown since the 1990s. But there are also long-term problems: an economy in which less than 40% of the population are economically active, the unemployed outnumbering private sector workers and the steady decline in productivity since the 1990s (see chart on the front page). It has taken a chain of bad decisions, all of which seemed reasonable at the time, to get the Saudi economy to this point, principally:

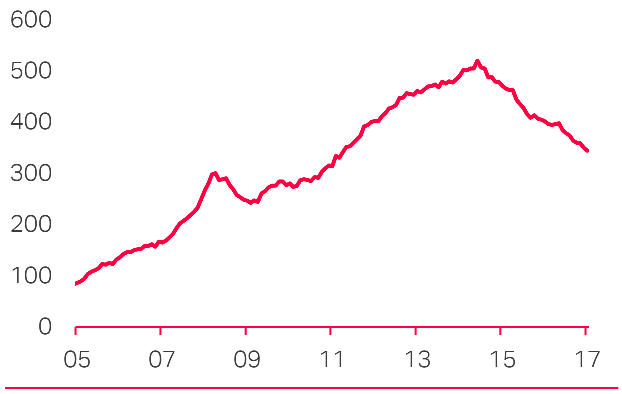
- The handover of public education to the religious establishment in 1979
- The decision to keep the currency peg post-2008
- The bungled introduction of unemployment benefits in 2011
- The failure to this day to reform labour laws

Saudi dipped into recession in 2017
GDP growth (constant USD) YoY (%)



Source: Bloomberg

And SAMA reserves still falling fast
Saudi Arabia total reserves ex. gold (USD bln)



Source: FRED

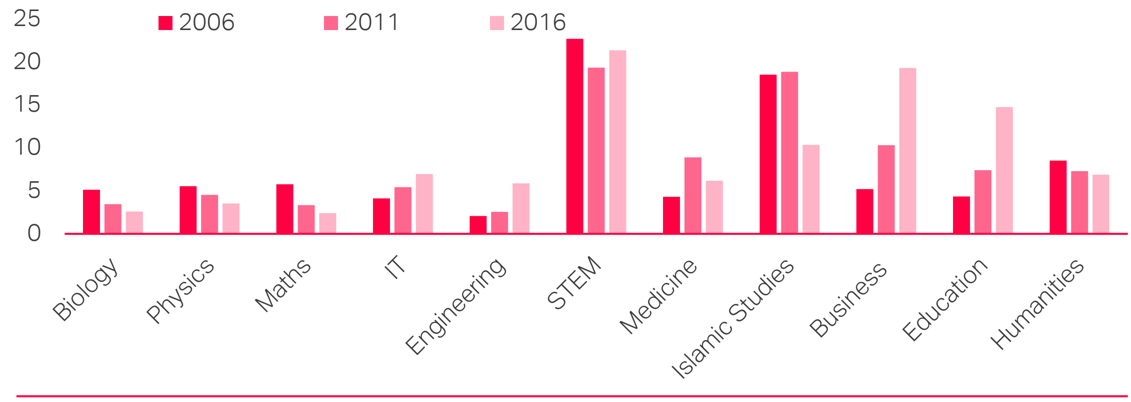
The reform of the Saudi economy cannot be avoided. Trump's tweet last month was accidentally eloquent: there really are "record amounts of oil all over the place" and the global supply dynamic has changed irrevocably. Prices above US$70/bbl can no longer be sustained in the long term. When we speak to officials and business leaders in other Gulf States, they are under no illusion: the current recovery in oil prices will not last. In order to reform, MBS needs to use his mastery over the political system and the popularity he currently has a young leader in a honeymoon period, in order to get painful structural reforms done – and the sooner the better. Below is our report card on progress so far in five key areas where painful reform is necessary.

1. Education reform: Insufficient so far

The Saudi education system is failing to produce employable graduates. For decades Saudi Arabia's rulers have focussed on education as a source of economic malaise, indeed it is the problem that the kingdom is most willing to accept exists. And yet, the system still falls woefully short of meeting the needs of a modern economy.

The Saudi education system is good at participation – but not results. Every year, some 400,000 Saudis graduate from high school; of these, 25% go on to obtain a professional diploma of some kind while the rest go to university. On the face of it, this is a considerable success – at 77%, it is a higher rate of university admission than in most developed countries. However, nearly 40% of those who go to university never graduate. Of those who do graduate, just 20% have studied a STEM subject (one related to science, technology, IT and/or engineering) of the kind generally seen as essential to a modern economy. The most shocking element of the education data we have collected is that despite years of talking about reform, the proportion – and even the number – of students studying STEM subjects has fallen over the last decade (see chart below). Clearly, education reform is not yet working.

Progress on education reform has been patchy at best
Percentage of Saudi Students graduating (BA level) from key subject areas



Source: Ministry of Education.

The government is spending time and money on the issue of education, but that may not be enough. Under MBS, the government has poured billions of dollars into the university system, but the problems in Saudi education go much deeper than the universities, which have to work with the product that the high schools send them. Improving that product will require imposing higher standards on Saudi Arabia's 500,000-strong teaching staff – a body of workers that accounts for a full 8% of all employed Saudis. The reform of the curriculum and the reduction of religious influence are helping, but successful reform of Saudi schooling is still years, perhaps even decades, away. The government is working hard at this problem, but the damage done in 1979 was extensive and it will take more than just money to fix it.

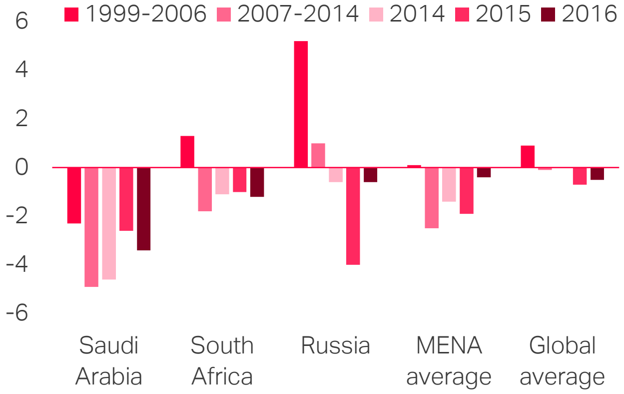
2. Labour market reform: Non-existent

If the government accepts that it has a problem with education, the same cannot be said of the labour market question. MBS likes talking about education, and he can justifiably point to some real successes. But he never mentions labour market reform. The Saudi labour market is split into two: Saudi workers (43% of the labour force) and foreigners (57%). The Saudi workers are paid three times more than the foreign workers and have access to a pool of jobs unavailable to foreigners. The foreign workers, meanwhile, are prevented from changing employer and taxed if they bring family members with them. They work under what is known as the "Kafala" system, under which their residency in Saudi is at the pleasure of their employer, who is their "kafeel" or "sponsor".

As we set out in an in-depth investigation of the Kafala system last year, this system has become economic madness. Kafala was originally seen as a way to reduce the political threat posed by foreign workers and to ensure that Saudi businesses had a ready supply of cheap labour. However, the two-tier labour market means that Saudis, who are already (thanks to the problems in education) under-skilled, are also undercut. Through the salary difference, the system in effect incentivizes businesses to hire foreigners rather than Saudis.

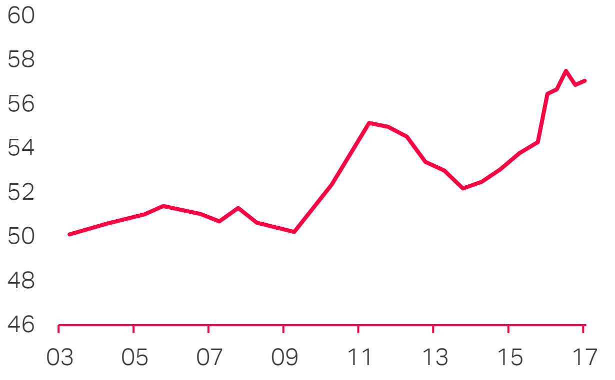
The system creates more problems than just unemployment. Perpetual suppression of wage growth undermines, in turn, any motivation for employers to invest in raising productivity, while the migrant workers' low wages and lack of dependents denies the Kingdom the normal multiplier effect that it should have received from its enormous project spending. In the Kafala economy, infrastructure spending ends up being used mainly on the wages of enormous quantities of cheap labour, and since those workers have no dependents in the country, they simply send the money home. The construction projects are completed, but all secondary beneficial effects to the local economy are negated.

Saudi Arabian productitvity is deteriorating
Total factor productivity growth (% YoY)



Source: Total Economy Database

As the foreign worker problem only grows
Foreigners as percentage of total labour force



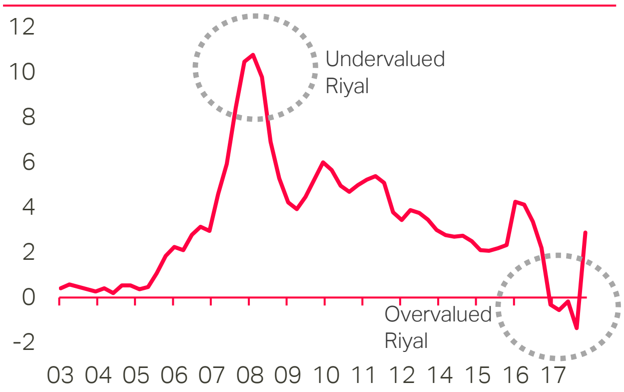
Source: Labour Ministry

The government is dimly aware of the problem but is tackling it in the wrong way. As a result of the Kafala system, youth unemployment rates in some Saudi regions exceed 50%. Saudi jobseekers outnumber Saudi private-sector employees and, as mentioned above, productivity has consistently fallen since the 1990s. The government is trying to help the situation by designating some professions as "Saudi only" and by subsidizing employers who hire Saudis – in effect expanding the protected public sector to encompass large parts of private business. But, as can be seen from the chart above, the proportion of foreign workers has continued to rise. As long as the government fails to allow migrant wages to rise, all its attempts to "Saudize" the private sector workforce will go against the current – a current created by the government's own policy. For now, MBS has failed to show that he understands or intends to deal with this problem.

3. Monetary reform: Non-existent

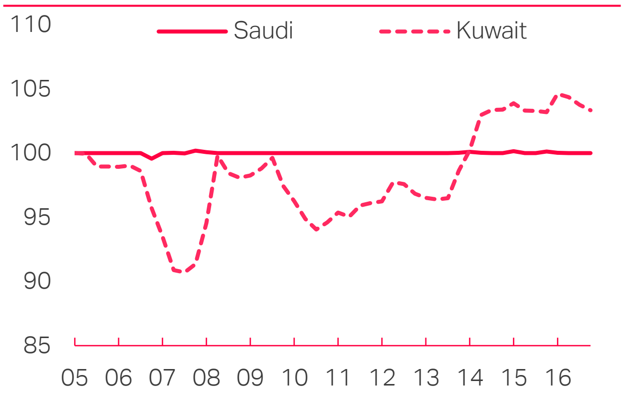
Like the Kafala system, the currency peg is another sacred cow of Saudi politics. Saudi Arabia has had a currency peg for the last 40 years. This peg was initially a good idea: it anchored inflation expectations through the 1980s and 1990s and protected the economy from what would otherwise have been crippling FX volatility as a result of fluctuating oil prices.

Peg-based distortions clear in CPI data
Saudi CPI (% YoY)



Source: Bloomberg

Kuwaiti Dinar shows how SAR should move
SAR and KWD to USD, relative change



Source: Bloomberg

The Saudi monetary authorities have long argued that the special circumstances of the kingdom's economy justify a perpetual peg. SAMA, Saudi Arabia's central bank, has long argued that in Saudi Arabia's case, the clear advantages of the peg (stability and clarity) are not outweighed by the disadvantages of a fixed exchange rate especially for a price-taking commodity exporter. Back in May 2017, we produced a detailed analysis of the riyal peg and its effect on the Saudi economy, for which we read SAMA's own policy documents justifying the peg. That justification can be summarised as follows:

SAMA counter-arguments to objections against the fixed exchange rate

Standard arguments for FX flexibility	Reasons why these disadvantages do not apply to Saudi Arabia
A fixed exchange rate does not provide stability because the credibility of the peg is always questioned	The credibility of a Saudi peg would not be questioned as SAMA's foreign reserves are so enormous that any speculative attack would inevitably fail
A fixed exchange rate robs the monetary authorities of the ability to appropriately set interest rates	Saudi Arabia does not have to rely on interest rates as an instrument of economic policy; the state is powerful enough to regulate the economy using fiscal policy
A fixed exchange rate prevents external balances adjusting to terms-of-trade shocks	Saudi Arabia's only significant export is oil, which is dollar denominated; keeping the cost of imports low is far more important

Sources: SAMA, TS Lombard.

MBS seems to completely accept these arguments which limits the scope to which he can reform the economy. SAMA's arguments in favour of the peg assume that the Saudi economy will remain broadly controlled by fiscal flows, mainly dependent on oil and untroubled by the desire to be competitive. The fact the MBS is not considering any kind of monetary policy reform means that his "new economy" is going to look a lot like the old economy: fiscal flows will continue to dominate the economy, non-oil exports will never amount to much and the state will continue to sit on a huge pile of foreign currency reserves in order to maintain the credibility of the peg.

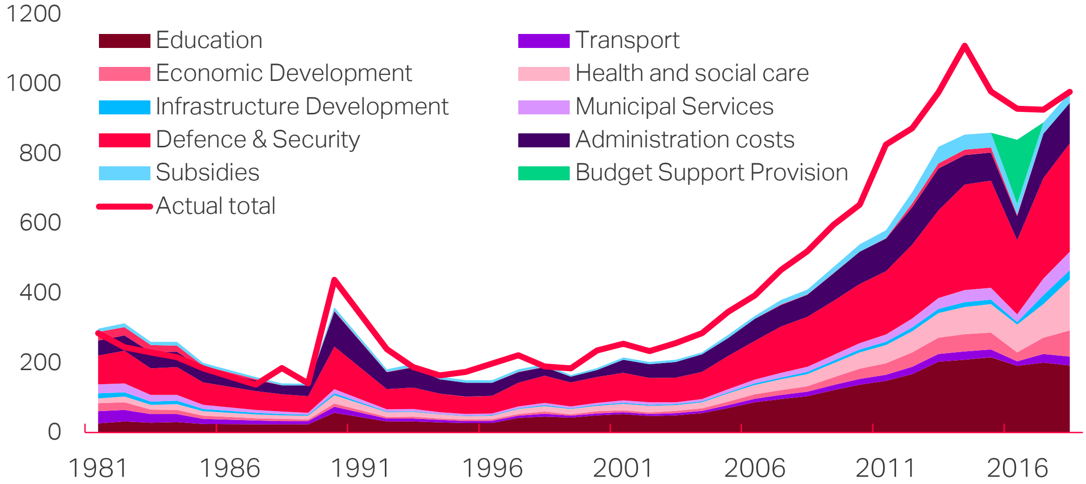
4. Fiscal reform: Some progress, but no austerity

As shown by the decision to keep the peg, MBS does not intend to reduce the size of the Saudi state. Saudi spending has come down since 2014, but this is a far cry from fiscal adjustment as generally understood. Despite much sound and fury about austerity, budgeted spending has, in fact, gone up. What has come down is the enormous overspend that used to be generated by the old political system's inability to centralize spending decisions (this is why the actual and budgeted spending figures converge in the chart below).

MBS is not reducing spending – his is not that kind of government. Any idea that MBS would be interested in austerity is simply not borne out by reality. The only austerity measures taken by Saudi Arabia came before MBS assumed power; since his accession to *de facto* rule, spending has steadily risen. In the past year, non-oil income (led by VAT) has risen by SAR45 billion, but expenditure is projected to rise by SAR52 billion. The deficit is shrinking but owing solely to rising oil revenues. Make no mistake, in the event of a second oil slump, Saudi Arabia will be hit just as hard and will burn through its FX reserves to the same extent as last time. MBS's project clearly does not include austerity; on the contrary, he wants to grow the state and make it more powerful. So, it is no surprise that this week the IMF raised its estimate for the Kingdom's breakeven oil price from US$83bbl to US$88bbl.

A far cry from austerity

Budgeted and actual Saudi general government spending (SAR billions)



Source: SAMA

State support for the economy is getting smarter though. In the past Saudi Arabia stimulated the economy through wages and subsidies. This is now changing. In the 2018 budget, wage-heavy spending areas such as education and security have been reduced, as have subsidies. Capital investment meanwhile has increased greatly – and that will boost potential growth. However, such massive and increasing state activity suggests that Saudi growth is not going to be very investible – the economy will remain a state directed machine.

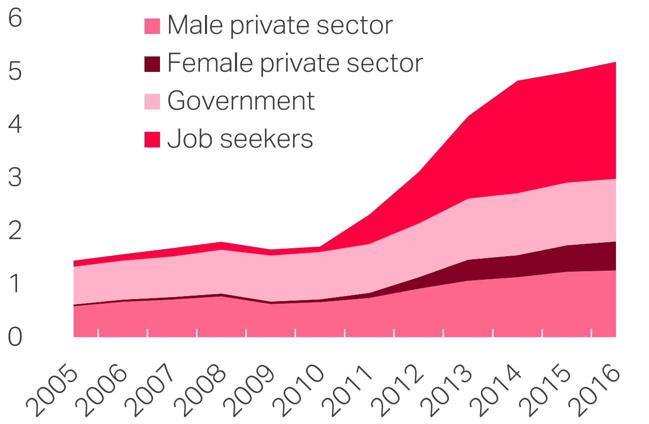
5. Social reform: Huge progress

Amid a lot of avoidance of pain, one area stands head and shoulders above the rest: social reform. If we wanted to give MBS the benefit of the doubt, we could make the following argument: of course he is avoiding painful economic reform, but the social reforms he is driving through are using all his available political capital. In the last two years, MBS has ended the ban on women driving, allowed a rebirth of public entertainment and stripped the religious police of most of their power. These measures are transforming Saudi society.

As we wrote in December 2017, this social change is long overdue and will be welcomed by most Saudis. Over the past 30 years, the structure of Saudi society has altered enormously. In the last five years alone, Saudi fertility rates have dropped by 25%; and since 1994 they have fallen by a staggering 70%. The close communities in which the religious police were intended to operate are already a thing of the past in a society that has largely atomized into small, property-owning households. From what we can tell of social attitudes, this is a society ready to welcome this change.

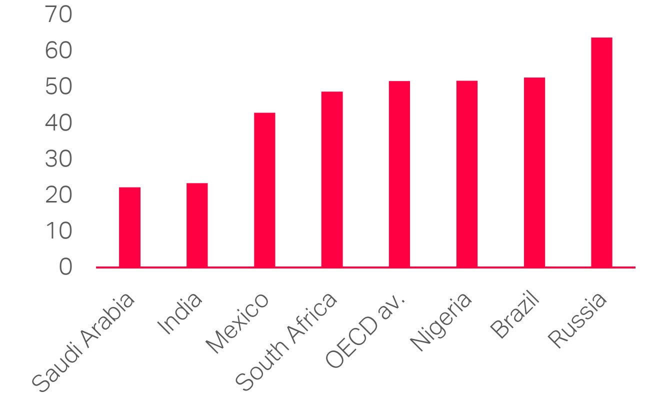
The emancipation of women will help to alleviate all the structural problems listed above. The problem of female emancipation (or lack thereof) feeds into all the structural problems examined here, be it high unemployment, reliance on migrant labour, high university dropout rates or even uncompetitive wages. In short: Saudi women struggle to find work because they are not free to do so; they struggle to finish their education because the investment can seem futile. In turn, Saudi men have a high level of dependents to support, meaning that they tend to require high wages and are less willing to take professional risks or work in lower paid jobs. A change as simple as allowing women to drive is a big step forward: more women will now be able to work independently, opening up the pool of available Saudi labour to employers, providing cheaper Saudi workers and motivating women to obtain further professional skills. In the long run, the additional competition will also improve the skills of male Saudi workers.

Women likely large portion of job-seekers
Labour force by working category (mln people)



Source: SAMA

While female participation rates are very low
Female particiaption rate (%)



Source: World Bank

The improvement in conditions for Saudi women will have a profound beneficial effect on the economy. Even though more conventional structural reforms are not happening, this social change cannot be ignored. By giving Saudi women a more independent life, MBS is brining millions of new workers and consumers into the market. The sort of companies that stand to benefit most are banks and consumer goods firms. However, with a change this big, it may be that the companies that will benefit most do not exist yet, at least not as listed stocks.

Investment conclusion

Saudi Arabia's reform is for real but not as marketed. MBS has a vision for the Kingdom and has created a political system that will allow him to implement it; but that vision is one in which the state is not minimal but immense. Saudi Arabia under MBS will become neither a humming centre of entrepreneurship nor a major exporter. In fact, Saudi Arabia's investible economy as a whole is not going to be at the centre of the Kingdom's recovery – much as was the case in the UAE in the wake of 2008. This will be a big spending, interventionist government prepared to enact radical change but not to relinquish control.

The clear statist bent of reform sheds light on future progress of Saudi privatisations, including that of Saudi Aramco. Our understanding of MBS's direction of travel pushes us to two conclusions on the likely progress of planned privatisations:

1) They will happen – he is going to need the money.

2) The state will maintain complete control over all companies sold.

Given that Saudi Arabia's breakeven oil price is rising, MBS is going to have to carry out privatisations of at least parts of Aramco, the Tadawul, Saudia, SABIC and dozens of other state owned businesses. But he will not want to give shareholders any actual control, to do so would rob the crown prince of important tools for imposing his agenda.

Within this statist model, the opening up of society is going to drive rapid growth in the real economy: the emancipation of women, the easing of restrictions on public entertainment, and the opening of the kingdom to foreign visitors are painful reforms which will structurally benefit the economy. Saudi Arabia will return to growth this year, and in the coming two or three years we will see rapid growth in the non-oil economy (of 3 -5%) even if oil prices once more fall back towards US$40/bbl.

There are opportunities here but not yet. The Saudi assets currently on offer are vulnerable to de-rating. Equities and real estate assets are overvalued as a result of the protective effect of the closed economy. Trapped local savings (of which there is a huge quantity) seek local growth assets and so tend to pour into domestic equities. The entry of Saudi Arabia into the MSCI EM index will therefore not have the normal effect of greatly increasing available capital and therefore valuations in the long-term. Saudi assets are already, if anything, over-bought off local investment alone. The fixed income side is less distorted in this sense, but the Kingdom does not offer prospects for long-term improvement in credit fundamentals.

Overpricing will fade in the coming years. As Saudi markets become more open to international investors and local money more diversified this effect should fade, but in the short-term it is likely to worsen. When the opening process is more complete (maybe 12 – 18 months from now) both banks and consumer goods look set to become more interesting areas that could benefit from continued, state-led, growth. On the fixed income side, we stick to our negative fundamental view since we initiated coverage in November 2016. Everything that we understand about MBS's plans lead us to believe that this is a government that will always spend more than it earns, and will always prioritise growth over fiscal prudence.

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