SPECIAL REPORT
The economy

Black gold, white gold

The rentier system is in trouble, in the big oil-producing states and beyond

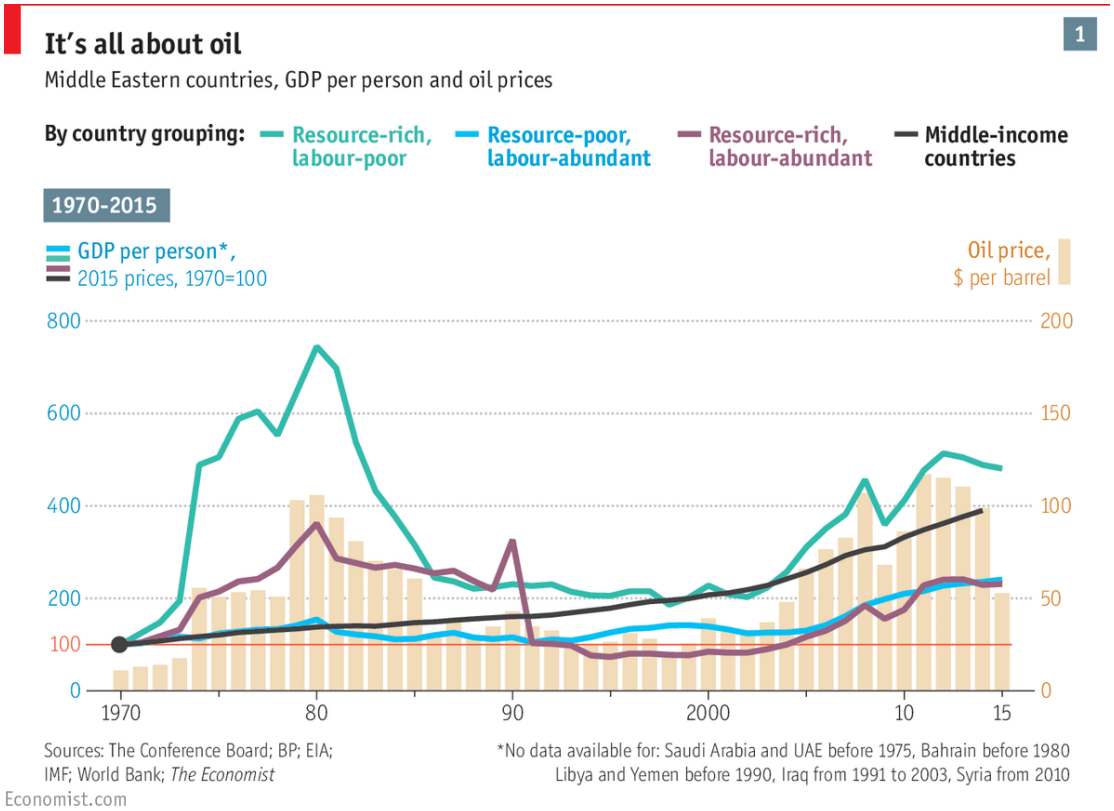
May 14th 2016

FROM THE AIR, the red sand dunes of the Empty Quarter stretch out beyond the bend of the earth, like countless piles of powdered brick. Between the mounds the winds have exposed patches of grey: salt flats that encrust the rock, and great riches of oil. The Empty Quarter was once the passage for camel caravans carrying precious frankincense across the southern Arabian peninsula. These days Saudi Aramco, the giant state-owned oil company, has laid roads and pipelines in the wilderness to carry the much-prized Arabian extra light crude and gas to the refineries and export terminals hundreds of kilometres further north.

Shaybah, a small town of 1,500 people, emerges from the sand. Those who work there say the winds never move the dunes, yet they quickly cover anything that has cut through them, such as the airstrip, which must be cleared regularly. Everything, including sand for construction (the local stuff being too fine), had to be brought by long convoys of lorries. Drilling through the dunes is impossible, so oil wells start from the patches of salt flats and then push out horizontally to get at the oil. Aramco is one part of

the Saudi state that works impressively well. In fact, it is more of a state within a state, with its own schools and air services.

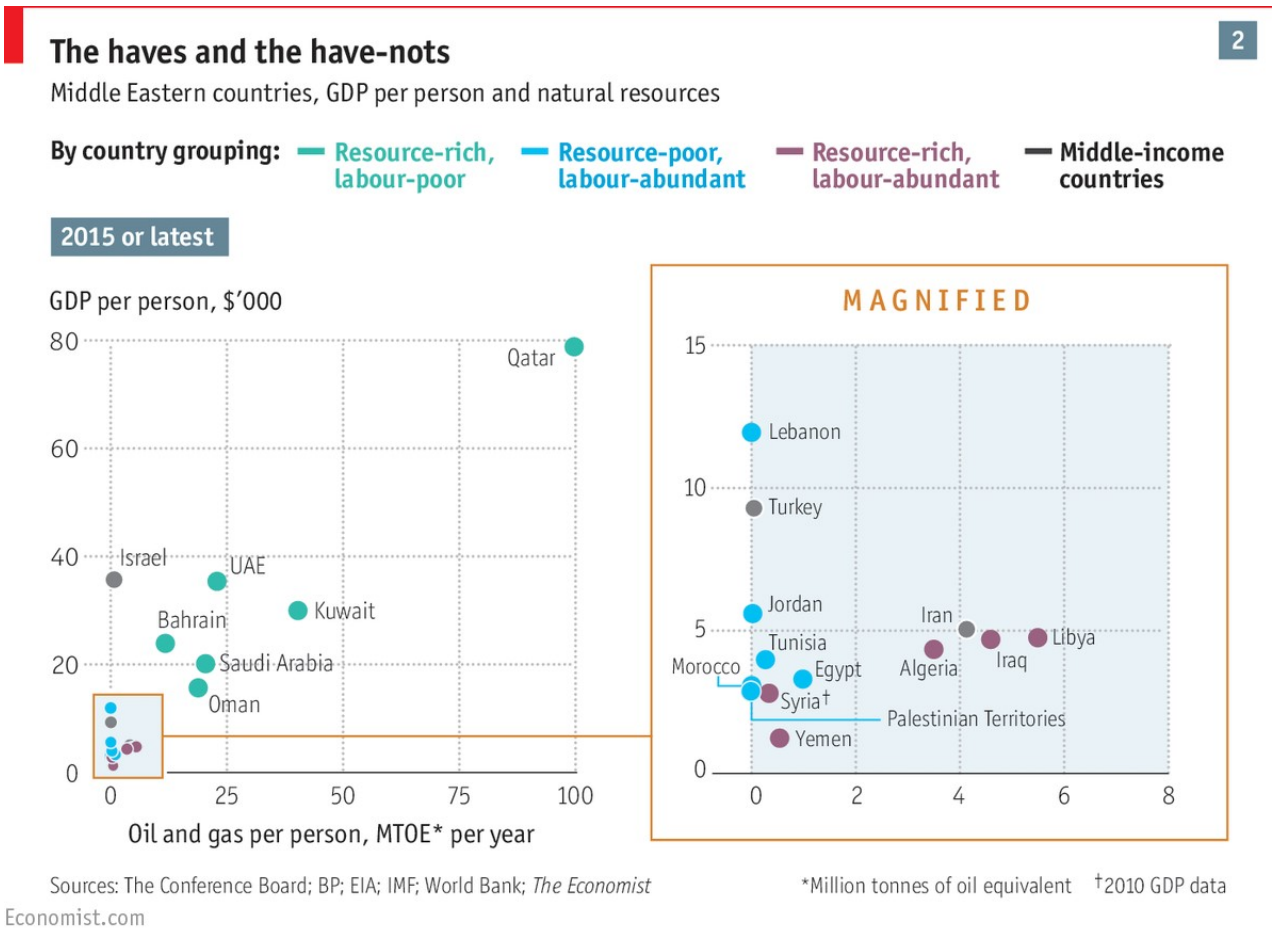
Aramco's executives dismiss the idea that the slump in oil prices, from a peak of about $115 a barrel in 2014 to little more than $45, spells doom for Saudi Arabia's oil economy. Shaybah was developed when oil was at $15 a barrel, and its fields would still be profitable at $10 a barrel, Aramco claims. The company continues to drill exploration wells to keep up its proven reserves and is investing both upstream and downstream. Producers of more expensive oil, including some from shale in America, will be driven out of business long before before Aramco is in trouble, its managers say; as global production falls and demand recovers, the price is bound to rise again.



Abundant and easily accessible, oil has been the basis of the Gulf's rentier model of the state: the ruling family collects the rent from oil and distributes the proceeds generously, in the form of public goods, welfare and subsidies, in return for compliance from the population.

This model applies across much of the Arab world. Its economies can be divided into three broad categories: resource-rich, labour-poor Gulf sheikhdoms with lots of oil and gas but few people; resource-rich, labour-abundant states, such as Algeria and Iraq, that have natural resources and

larger populations; and resource-poor, labour-abundant countries, notably Egypt, that have little or no oil and gas but lots of mouths to feed (see charts).



It was once thought that the middle group, with the resources and manpower to industrialise, would do best; in fact it has done as badly as the oil-poor grouping. And those middling states tend to be more nakedly authoritarian: they may not have enough oil to buy the quiescence of their people, but plenty to pay for the machinery of repression.

To a degree the whole Arab world is an oil-driven economy: all three groups tend to rise and fall with the price of oil. Millions of Arabs from resource-poor countries are guest workers in oil-producing states. Conversely, high-spending Gulfies like to holiday in places like Cairo and Beirut. Grants and loans from Gulf states help sustain poorer Arab countries.

Some countries, such as Egypt and Jordan, also enjoy "strategic rents": subsidies provided by Gulf states and the West because their stability is deemed essential to regional order. Egypt, for instance, has been heavily

supported by Saudi Arabia and the United Arab Emirates since the coup in 2013.

Saudis may not be the richest people in the Gulf, but their country remains the world's largest exporter of oil. And for all of Aramco's bullish talk about the prospects for oil, there is anxiety about the future. The regional contest with Iran is keeping output high and oil prices low. Saudi Arabia says it will curtail production only if Iran does; Iran insists it has every right to return to pre-sanctions levels of output. The inconclusive war in Yemen, and support for governments and Sunni groups elsewhere, do not come cheap.

The Saudi budget deficit is forecast to reach 13.5% of GDP this year even after a raft of money-saving measures, including cuts to energy subsidies. The government is drawing down its large pile of reserves and is borrowing on international capital markets. But as Simon Williams, an analyst at HSBC, a bank, points out, "Saudi reserves of wealth do not offer a solution. They only buy time."

What goes for Saudi Arabia applies, to a greater or lesser extent, to all members of the Gulf Co-operation Council. Qatar, the wealthiest of them, is likely to be least affected; Bahrain and Oman, with less oil, will be in deeper trouble. Plans to start taxing Gulf citizens are in the pipeline, starting with a 5% value-added tax in 2018.

Beyond oil

Saudi Arabia and other Gulf states will have to do what they have long promised but for the most part failed to achieve: diversify away from oil. Not every country can become a tourism and services centre like Dubai. Prince Muhammad bin Salman, the Saudi ruler's 30-year-old son and the power behind the throne, has spoken most ambitiously about the change he wants to bring about through his "Vision 2030", a plan to wean his country off oil by that date, if not sooner.

To listen to Saudi ministers, their answer to the ineffectiveness of the Arab state is to sidestep it as much as possible. Prince Muhammad intends to make wholesale use of the private sector, even to provide basic services such as education and health care, and wants to sell stakes in state assets including Aramco, the crown jewel and probably the biggest company in the world. The government talks of selling valuable land to developers, mining other sorts of minerals, creating a defence industry and greatly expanding tourism—but for pious Muslims, not the Western sort.

All this is likely to bring wrenching social change for which Saudi society may not be prepared. A generation of men that expected to be paid for do-nothing government jobs will have to learn to work. The talents of women, who already make up the majority of new university graduates, will have to be harnessed better. But for now even the limited reforms to give women more opportunities have gone into reverse. To achieve its goals, Saudi Arabia will have to promote transparency and international norms, which will mean overcoming resistance from the powerful religious establishment and the sprawling royal family.

But perhaps the biggest problem looming for Saudi Arabia is the need to find jobs for a rapidly rising population. Real output per person in the Gulf is lower today than it was in the 1970s (partly because of migration). Well over half of Saudis are 30 or younger. Public-sector jobs are a form of unemployment benefit that was unsustainable even when oil prices were high. This is a common problem across the Arab world. An abundance of young workers should prove a boon, but in many Arab countries the peak of the youth bulge in the 1990s coincided with a long period of stagnant output, high debt and painful economic adjustment.

Import-substitution models under which countries sought to promote domestic production behind protectionist barriers survived longer in the Arab world than elsewhere because oil and other rents masked the inefficiencies of its economies. Where Arab countries belatedly started to promote non-oil exports, they found that more competitive Asian countries had got there first. Still, the macroeconomic numbers gave few hints of the looming political explosion in 2011. In the preceding years growth had picked up, unemployment was stable (though high) and inequality seemed manageable.

The crisis seems to have been precipitated by two factors. First, the economic adjustment brought cutbacks in public-sector jobs and services; and second, part-liberalisation appeared to favour only the well-connected. This fed resentment of corruption. Of the three slogans of Egypt's revolution—"bread, freedom, social justice"—two had an economic component. "Middle-class families were not able to maintain their living standards," notes Amr Adly of the Carnegie Middle East Centre, a think-tank in Beirut. "People did not have the same opportunities as their parents, even though they were better educated."

The turmoil of the five years since the Arab uprisings has dealt a blow to all the non-oil Arab economies, even if lower oil prices have provided some slight compensation. HSBC estimates that collectively they have lost about 15% of potential GDP. Egypt's budget deficit has widened to more than 10% of GDP. Manufacturing has stagnated and tourism has suffered (see chart). Part of the crisis stems from the country's self-inflicted shortage of dollars, induced by the government's reluctance to allow the currency to fall to its market value. In a bid to keep down domestic prices for staples—Egypt imports much of its food—the central bank is, in effect, rationing the supply of dollars. This is at the expense of manufacturing industry, which cannot import the components it needs and finds its exports priced out by the high exchange rate.

Rather than unfetter the economy, Egypt persists in announcing grandiose projects: the expansion of the Suez Canal, a gleaming new city in the desert and even a bridge over the Red Sea to link Egypt with Saudi Arabia. If all this is to become reality, it will have to be financed by the Gulf. An audiotape of an unflattering conversation leaked last year allegedly captured Mr Sisi exclaiming: "Man, they have money like rice."

For all of Egypt's considerable advantages—comparatively early industrialisation in the 19th century, extensive irrigated agriculture thanks

to the waters of the Nile, good transport provided by the Suez Canal, a large internal market and proximity to European ones—the country has been unable to seize the opportunity of globalisation. “We are still trapped in the time of Gamal Abdel Nasser, with state-led development and state-dependent workers,” says Mr Adly.

An instructive example is Egypt’s troubled cotton industry, once the country’s “white gold”. Premium-quality long-staple Egyptian cotton was brought to European markets in the early 19th century by a Frenchman, Louis Alexis Jumel, who gave his name to luxury cotton. Production of Egyptian cotton for British and French mills increased rapidly, boosted by the interruption of cotton trade with America during the civil war of 1861-65.

Under Nasser the industry was nationalised. Egypt tried to boost industrialisation by building a vast state-owned mill at Mahalla, in the Nile delta. The production of cotton was favoured over domestic food crops, and farmers had to sell below international market prices.

The premium varieties were exported for foreign currency, and the lower-quality medium- and short-staple cotton was used to make cheap clothes for local consumption. But as international textiles markets opened up, the inefficient Egyptian mills began to lose money. Growing labour unrest at the mills, culminating in a deadly riot in 2008, was an important precursor to the Tahrir Square demonstrations in 2011.

A rising star in the west

In Morocco, by contrast, the mood is hopeful. A smaller country than Egypt, and far from the upheavals to the east, it has been more successful than most other Arab states at holding on to its all-important tourist industry. It is building up its manufacturing sector by seeking to link into the European supply chain, doing for French industry, in particular, what eastern Europe has done for German companies. Renault-Nissan and PSA Peugeot Citroën have built new car-assembly plants in Morocco, and plans are in hand to develop a wider network of local suppliers.

Even more ambitiously, Morocco is working to build an aircraft industry, based outside Casablanca’s international airport. Emerging from the embryo of Royal Air Maroc’s engine-maintenance business, an early step was the manufacture of high-specification electrical wiring for aircraft. On the

factory floor of Matis Aerospace, red-veiled women are hunched over the cables—Boeing on one side of the main aisle, Airbus on the other.

Nearby a subsidiary of Safran, a French technology group, is making carbon-fibre casings for jet engines. Bombardier, a Canadian aircraft-maker, is setting up shop to make parts for its airframes. The government is part-funding a vocational training school for the aeronautical industry.

Hamid Benbrahim el-Andaloussi, the president of GIMAS, the aerospace industry's trade body, says Moroccan factories can make components 30% more cheaply than European or American ones without any loss of quality. At present the industry consists of about 100 companies with 11,500 employees and $1 billion-worth of exports; by 2020, he predicts, it will more than double in size.

Morocco still has far to go. Much of its agriculture, which employs about 40% of the workforce, is rain-fed, and a drought this season has knocked back growth from 4.5% in 2015 to a forecast 2% or less this year. Foreign investors must contend with entrenched incumbents, including the royal family's large holdings through firms that go by such names as Ergis and Siger (anagrams of "Regis", Latin for "of the king"). Even so, Morocco shows a dynamism that is sorely needed across the Arab region.

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