Journal of Economics and Sustainable Development www.iiste.org
ISSN 2222-1700 (Paper) ISSN 2222-2855 (Online)
Vol.7, No.14, 2016

Beyond Oil – The Transformation to a Market-Based Approach: Envision Saudi Arabia 2030

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Abstract
The present study sought to envision Saudi Arabia beyond 2030 by analyzing how the country will transform to a market based approach. The study rationale draws from the fact that Islamic principles that emphasize moderation are diametrically opposed to the asset pricing model in which individuals behave as price takers in a capital market that is perfectly competitive but nevertheless incomplete and frictionless. The study employed a meta-analysis of existing studies that seek to analyze Saudi Arabia's transformation from an oil based economy. In the meta-analysis of secondary data, the researcher analyzed data that was collected previously and tabulated by others. The sources of data included government institutions for instance employment statistics from the Saudi government, Saudi Ministry of Economy and Planning, Saudi Central Department of Statistics and Information, Saudi General Organization and of Social Insurance, as well as the McKinsey Global Institute Analysis. The current transformation in Saudi Arabia was attributed to the fact that, following diversification and increased acquisition of assets in external capital markets, the Saudis were slowly coming to terms with the forces of capital asset pricing model. Secondly, the transformation is also attributed to increased investor willingness to pay a premium for securities that have a high return when the market is illiquid.
Keywords: Capital Asset Pricing Model; investors; market-based approach; petrodollar; transforming economies; Saudi Arabia.

1. Introduction

Economies accrue their functional form from their environment whereby they are constantly changing to adapt to the setting in which they operate. The ever transforming nature of economies whereby they embrace new elements that are different in form from their traditional strong points is a challenge that requires constant application of theory and practice. Significant to note is the reality that, successful application of theory requires careful analysis in order to adopt the most fitting components that are in line with the corresponding scenario. In juggling with the multiplicity of scenarios, financial analysts and economists must strike a balance between projected result, risk, and available resources. This is the major dilemma facing not just Saudi Arabia, but all Gulf countries including Qatar, the United Arab Emirates, Oman, Kuwait, and Bahrain. The region has registered phenomenal growth an attribute of the vast oil reserves in the gulf. However, as Saudi Arabia and other gulf states continue to enjoy the oil boom, they are faced with the inevitable reality of depleting reserves. As such, government policy in Saudi Arabia has strived to diversify the country's economy in a bid to move away from an oil-dependent national fiscal structure. One challenge that Saudi Arabia is faced with is the fact that, its laws differ from the general laws in which other economies are operating. Moreover, owing to the dominance of Western countries particularly the United States in the world economy and a rising China with a relative economic system that is slowly embracing capitalist economic elements and easing away from a protectionist past, Saudi Arabia's goal of economic diversity requires careful analysis, strategy, and planning in order to be successful. Such is the case because Islamic Law and principles on which the country's economy is based tends to be restrictive to a certain extent limiting the ability of the national economy to fit in the general framework of the global structure. However, the rise of Shariah compliance in the West, particularly in Britain not to mention the growth of the region in general in addition to other strong Shariah compliant economic systems such as Malaysia provides strong hope for the country. The present analysis provides a comprehensive meta-analysis of research and projection in order to envision how Saudi Arabia's national drive towards a diversified economy will transcend the difficult challenges and transition the petro-dollar economic system into an all-embracing fiscal structure determined by market forces.

2. Literature review

Saudi Arabia, through its Deputy Crown Prince in 2016, unveiled its vision 2030 in which the country seeks to diversify its economy and embrace other facets that ideally exploit its rich assets including culture, its geographical location, not to mention, social and demographic position. Arab News, (2016) reports that, according to the manifesto, Saudi Arabia will primarily bank on three pillars to deliver its competitive advantage and ultimately diversify its economy. Firstly, the kingdom seeks to exploit its status in building a leading role as the heart of not only the Arab world but the Islamic world as well. Secondly, the Saudis plan to exploit their investment power in creating a stronger and diversified economy. Lastly, it will also exploit its strategic geographical location in remaking itself as an integral international trade point that connects Africa, Europe, and Asia. This vision is further clarified in three main themes including an ambitious nation, a vibrant society, and a thriving economy. As a vibrant society, the reality in Saudi Arabia is that its citizens believe and are willing to adhere to an economic system that embraces the Islamic principle of moderation while at the same time also still remaining proud of their national identity not to mention their cultural heritage. In order to achieve this, the Saudi government seeks to improve its education and healthcare system, two elements that it perceives as central to national development and growth. In order to achieve efficiency, the Saudi's also seek to privatize some of the country's sectors which will be integral as it will attract the best talent, while also leveraging on its strategic global position to connect three continents.

As noted earlier, the Saudis operate on Islamic laws, principles, and regulations that foster the Islamic religion. As such, as the country seeks to diversify its economy, it will rely on its financial institutions and market entities that are highly swayed by Islamic principles. These financial institutions as Hoepner, Rammal, and Rezec, (2010) report are rapidly growing. According to the authors, Shariah compliant assets rose by 37% and are estimated to value at \$729 billion (Hoepner, Rammal, and Rezec, 2010). By 2010, they were estimated to hit the \$1 trillion mark. Significant to note is the fact that, majority of these assets were based in Saudi Arabia, Malaysia, and Kuwait. However, western financial institutions had also grown an increasing interest in Shariah complaint Islamic assets (Cihák and Hesse 2008; McKenzie 2009). Particularly, the British government has grown a reputation as a leading Western centre of Islamic finance outside of Malaysia and the Gulf region. This follows a clearly defined policy on Islamic finance. Moreover, the UK also doubles as a leading centre for Islamic finance education not to mention the fact that more than a dozen UK banks also offer financial instruments that are Shariah compliant. A good illustration of a success story is HSBC which Hoepner, Rammal, and Rezec, (2010) report registered an annual growth of more than 50% in the fiscal year 2007/2008. The appeal of Islamic financial services also grew in the wake of the 2008 credit crunch because it remained unaffected an aspect attributed to the prohibition of high risk activities in Shariah low. Other western countries including the United States, Germany, France, and Switzerland are also warming up to Islamic financial services as they seek to attract petro-dollars from the oil rich Gulf States including Saudi Arabia.

The continuous Capital Asset Pricing Model that is the blueprint of conventional financial markets primarily assumes that there is a single good that invested firms or individuals may consume. Under this model, it is assumed that individuals behave as price takers in a capital market that is perfect competitive but nevertheless incomplete and frictionless. Moreover, these investors also trade continuously whereby they are at liberty to short-sell any assets and go on to use proceeds from such sales in full. Additionally, under this model, trading also takes place at equilibrium prices only. Another assumption of the model that was initially postulated but has been disputed in recent years was the assertion that all investors have identical probability beliefs in relation to the states of the world. In the capital markets as the capital asset pricing model has established, investors hold their wealth in the form of risky shares or in what (Breeden, 1979) refers to as instantaneously riskless asset.

Acharya & Pedersen, (2003) have also studied equilibrium asset pricing with liquidity risk. They define this risk as one that arises as a result of unpredictable changes in liquidity over time. In their study, the authors illustrated that a securities required return is dependent on the expected illiquidity as well as the co-variances of its own return and illiquidity with market return as well as market illiquidity. Resultantly, this has given rise to what the authors describe to as liquidity adjusted capital asset price model. They continue to postulate that in the event a security's liquidity is persistent, in the event such a security registers a shock in its illiquidity, there is an increased probability for a shock in its contemporaneous returns and increased predicted future returns.

Basher and Sadorsky, (2006) report that compared to 20 years ago, developed countries have diversified the energy sector to incorporate renewable forms into their energy supply and as such they are more energy efficient. The authors report that oil consumption per dollar of the GDP in developed countries is less than half of what it was in the 70s. Emerging economies however, have energy intensive economies an aspect that exposes them to the shock of high oil prices. The implication here is that changes in oil prices have a greater impact on stock market prices and profits in developing economies compared to developed economies.

Momani, (2008) lastly reports that one of the ways through which Gulf Cooperation Council (GCC) states recycle their petrodollars is through what she refers to as the absorption channel. In this channel, a GCC country such as Saudi Arabia finances domestic investment as well as consumption. As a result, this has resulted in a construction boom in Saudi Arabia as is the case in other GCC countries including the UAE and Qatar where mega projects are currently a significant part of the economy. Similarly, GCC countries including the Saudis have also invested heavily in education, capital markets, banking, tourism, and health care. Momani, (2008) adds that the Gulf is undergoing a slow but significant shift in which it endeavours to transform into a new identity, a drive that is in a large part promoted by the entrepreneurial spirit of the regions young generation mostly educated in the west. Primarily, unlike the 70s when petrodollars were recycled by investing in US government debt, the young generation in the Gulf is demanding that their government invest in them.

3. Research Methodology

The current study, for its research design employs secondary data analysis. In this study design, the researcher ideally analyses data that was collected previously and tabulated by others. The sources of data in a secondary research and analysis are numerous and may include but are not limited to government institutions for instance employment statistics from the Saudi government, Saudi Ministry of Economy and Planning, Saudi Central Department of Statistics and Information, Saudi General Organization and of Social Insurance, as well as the McKinsey Global Institute Analysis. This approach in research design contrasts to other approaches in which collection of primary data forms part of the researcher's job. It is deemed an appropriate approach to the study owing to the fact that collection of primary data is not only costly but also infeasible while secondary data is available at an analysis level suitable and effective to answer the research question. However, the approach has some limitations for instance the fact that the available data from which other researchers drew their conclusions might not have followed appropriate research models thus rendering it unsuitable. Moreover, since such data might have been collected for other purposes that are not similar to the current research question, it might not be adequate in providing insight into the current study. Lastly, as Bhattacherjee, (2012) observes, interval validity in secondary analysis tends to be problematic especially when the temporal precedence is unclear in relation to cause and effect.

4. Results and Discussion

In its bid to transform the economy, the McKinsey report notes that Saudi Arabia has continuously sought foster an economic and regulatory environment that is not only unambiguous but also transparent and increasingly conducive to business. This has moved away from the US-Saudis 70s pact in which the then U.S. treasury secretary William Simon struck a deal with the Saudis in which the latter could buy U.S government treasury bills that had not been publicly auctioned while the US could benefit by financing its burgeoning national debt. In this earlier establishment, Momani, (2008) explains that the Saudi got to recycle petrodollars by depositing their debt into commercial banks which in turn lent it to non-producing but high consuming developing countries. The agreement developed out of the U.S. government's belief that the interbank market was failing whereby there was similarly little faith in the ability of the international capital markets to recycle Saudi petrodollars. As a result, the Americans took it upon themselves to unilaterally direct the process of recycling the petrodollars by selling US government debt to the Saudis. However, in turn, the Americans agreed that the amount sold was confidential.

The reason why the arrangement worked was because petro dollar influx into US government debt kept interest rates to the minimum which in effect increased domestic consumption because the public was content. Additionally, there was increased international faith in the dollar. In turn, the Americans printed more dollars to finance their deficit as well as their military ventures with very little recourse about the dollar value. On their part, the Saudis were content with the arrangement because it cushioned them from conversion currency risks while also allowing them to secure investment in U.S. government debt. Initially, attempts by Congress to track petrodollar investments were difficult because the federal government had promised the Saudis anonymity.

This initial arrangement however, changed after 9/11 during which tensions between the Arab world and the United States were high. Another final blow to US-Saudi relations also came after the Saudis denied the Unites States permission to use their airbases in the latter's invasion of Afghanistan. The previous strong diplomatic bond would face further strain when the UAE Corporation, Dubai Ports was forced to sale its acquired ports in New York, New Orleans, New Jersey, and Miami to an American owner (Momani, 2008; Don De). In reaction, Momani, (2008) reports that there has been a shift in Saudi policy away from secretive US security investments. The capital surpluses of the Saudis in the post 9/11 era have been diverted to mostly domestic and regional markets. Secondly, the capital outflows are increasingly shifting into Asian and Middle Eastern investments. Thirdly, there has been a rapid rise in global acquisitions and away from U.S securities.

There has been an increased purchase of dollar denominated assets in the Asia and Middle East by Saudi Arabia. In the period between 2002 and 2006. Momani, (2008) reports that there has been an increase in high profile acquisitions of financial and telecommunications companies in the region. In Jordan and Egypt, Momani, (2008) adds that there are reported high profile tourist and real estate projects and a surge in capital markets activity in Casablanca, Cairo, as well as Amman. Significant to note is the fact that this rise in capital markets activity is an attribute of Saudi investment in Middle Eastern stocks. An IMF Middle Eastern chapter head also noted that there is increased investment in hedge funds in dollars as well as bank deposits. Similarly, there is an increased investment in Asia which has renewed the olden day Silk Road.

Lastly as a result of Saudi and generally GCC discontent with U.S. treasury bills, there is increased global acquisitions by GCC countries including Saudi Arabia (Momani, 2008). As a result of such a diversity investment policy, Saudi Arabia and GCC countries' asset preferences now includes half U.S. short term securities while the other half is directed into corporate acquisitions and long term securities in the United States. In 2005 alone Bloomberg reported that GCC countries including Saudi Arabia acquired $24 billion worth of company shares with a similar amount also invested in the following year (Institute of International Finance, 2006).

5. Conclusion

The question that remains relates to why such economic diversification is slowly transforming the Saudi Economy from a conservative oil based nationally controlled economy to a market based approach. There are several explanations that put the trend into perspective. Firstly, as Acharya and Pedersen, (2003) explain, this is attributed to the fact that following diversification and increased acquisition of assets in external capital markets, the Saudis are slowly coming to terms with the forces of capital asset pricing model. In this model, Acharya and Pedersen, (2003) reports that investors require a return premium for security that is illiquid when the market in its entirety is illiquid. This conclusion follows from Chordia, Roll, and Subrahmanyam, (2000) reported significant commonality in liquidity after their analysis of stocks listed on the NYSE. Similarly, there is also a systematic time-varying component reported by Huberman and Halka, (1999) of liquidity. Moreover, Hasbrouck and Seppi, (2000) reported a weak commonality in liquidity for a number of stocks listed on the Dow Jones Industrial in a 15-minute interval assessment in 1994.

Secondly, the transformation is also attributed to increased investor willingness to pay a premium for securities that have a high return when the market is illiquid. This was supported by Pastor and Stambaugh, (2001) study in their study in which they measured liquidity using the return reversals induced by the flow of orders. Lastly, under the capital asset pricing model, when the market return is low investors tend to be increasingly willing to pay a premium for a security that is liquid.

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