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DG EXTERNAL POLICIES OF THE UNION

- Directorate B -

POLICY DEPARTMENT

BRIEFING NOTE

ON

THE POLITICAL AND ECONOMIC SITUATION IN SAUDI ARABIA

AND ON EUROPEAN UNION /

GULF COOPERATION COUNCIL RELATIONS

This note has been prepared for the information of Members of the European Parliament. The opinions expressed are those of the author and do not necessarily reflect the position of the European Parliament.

Sources: *Economist Intelligence Unit*
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CONTENTS

Page

EXECUTIVE SUMMARY...3

I. POLITICAL SITUATION 4

II. ECONOMIC SITUATION 8

III. EUROPEAN UNION / GULF COOPERATION COUNCIL RELATIONS........11

ANNEX

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EXECUTIVE SUMMARY

Saudi Arabia has the world's largest reserves of petroleum and is an extremely important trading partner for the European Union.

The internal political situation is stable for the present but there are substantial pressures for change. The intensely conservative nature of society and the delicate balance between the Royal Family and the senior clerics on which political stability depends mean that such change is very difficult to implement.

The rapidly growing population has brought the national budget under strain, despite the huge revenues from oil. Currently the high oil prices have removed this problem but the excessive dependence on oil means that the kingdom is vulnerable to future changes in the oil price. Economic diversification therefore continues to be an essential element of government policy.

The war in Iraq and the fight against terrorism have produced particular problems for Saudi Arabia, whose population is suspicious of western involvement in the Middle East and strongly critical of US policy in Iraq. The country remains an important American ally but this relationship is currently strained. The government is now seeking actively to fight Islamic fundamentalism inside the country insofar as it promotes violent attacks on the regime itself and its western allies.

I. POLITICAL SITUATION

Division of power

Saudi Arabia is based on an absolute monarchy, with the ultimate authority vested in the King. The Monarch appoints a Council of Ministers that exercises legislative and executive power, the members of which are chosen from members of the Royal Family and high-ranking civil service technocrats. The King may veto any decision made by the Council within 30 days.

- **King:** Head of State.
- **Council of Ministers:** Legislative and Executive - appointed by the King.
- **Majlis al-Shura:** Appointed consultative body. Not yet a parliament.
- **Ulema:** Consultative body composed of religious leaders.
- **Regional Councils:** Devolved regional government.

King Fahd succeeded his half brother, Khaled, in 1982. During the King 's convalescence, Crown Prince Abdullah temporarily took the reigns of power; however, King Fahd appears reluctant to hand over power permanently until his medical condition renders him incapable.

The Crown Prince Abdullah has taken a much greater responsibility in the running of the state, and his succession appears to have been accepted by the other leading members of the Royal Family. Abdullah is considered more conservative, and less pro-Western than King Fahd.

Islamic Sharia Law is the primary source of legislation in Saudi Arabia although the structure of the state was codified in the Basic Law, issued in March 1992. This constitutional-style law outlines the rules for succession to the Saudi throne, giving the King's male descendants the right to approve the successor, irrespective of the wishes of the dying monarch.

Members of the Royal Family - descendants of Abdel-Aziz bin Abdel-Rahman Bin Saud, the founder of the modern Saudi State - hold the principal positions of power in Saudi Arabia. Islamic religious leaders - the Ulema - have considerable moral influence over the government and are frequently consulted over policy issues.

The 1992 reform created a tiered system of provincial government, establishing 13 regional councils headed by a regional governor. The councils comprise local and central government officials, and ten appointees of the King - frequently tribal leaders and businessmen. Saudi Arabia's tribal traditions of consensual rule offer a form of representation not dependent on elections, which allows citizens to attend forums ('majlis') held by the King, members of the Royal Family and regional leaders, at which they may petition or consult figures of authority.

Political Parties

Political parties are illegal and no form of popular representation exists, although a consultative council, the Majlis al-Shura, was established in 1992 to play an advisory role. The council was expanded from 60 to 90 members in 1997 and is composed of former government officials and intellectuals with links to tribal leaders, all appointed by the King. It holds little power and must have the King's assent to access government officials and records. However, a royal decree of October 2003 gave to the Majlis al-Shura the right to initiate legislation and elections will be held for half of the seats in municipalities during 2005. The government has expressed its intention to extend elections to regional councils and then to one half of the Majlis al-Shura itself from 2006.

Political stability

The al-Saud family dynasty dominates the political system, as it has since 1902. An estimated 5,000 princes belong to the Royal Family, forming an establishment that occupies important positions in government, the oil industry, the judiciary, business and the military.

King Fahd is now in his eighties and in poor health following a stroke in January 1996. Crown Prince Abdullah has acted as head of state during his brother's illness and has taken control of day-to-day decisions on both domestic and foreign policy.

The issue of succession should remain secure for a number of years, although the Crown Prince is in his mid-seventies. A clear line of succession exists from King Fahd to Crown Prince Abdullah, followed by Prince Sultan and his younger brothers.

Stability rests on an alliance between the al-Saud royal fanily and the 'ulema', a group of senior Moslem clerics. This body is extremely conservative and less radical than many younger clerics. There is a long tradition in Saudi Arabia of fundamentalist Sunni Islam associated with the Wahhabi sect.

Internal opposition

Opposition to the ruling establishment has hitherto been weak. The stationing of US and European troops and military advisors in Saudi Arabia throughout the 1990s and into 2000 was a cause of particular opprobrium, especially for Islamists resenting the presence of non-Muslim troops in the land of Islam's holiest sites - Mecca and Medina. Terrorist attacks aimed at US military interests began in 1995 and have resulted in the death of US military personnel and other civilians from Western countries. Saudi-born Osama Bin Laden actively opposes the Saudi monarchy and has called for its overthrow. Al-Qaeda and other terrorist organisations are now being fought with great bitterness inside the country.

The loyalty of the large Shia minority, especially in eastern Saudi Arabia has always been suspect. Religious leaders have frequently been detained without charge.

Until recently substantive democratisation has not been seen as a realistic development. A petition was presented in December 2003, which professed loyalty to the al-Saud but demanded the establishment of a constitutional monarchy. Twelve of the reformers and academics associated with this petition were arrested; most were later released after promising not to speak out further on the subject of reform, but three have recently been put on trial. Following an attempt by many of their supporters to attend the proceedings the judge has closed the trial to outsiders (October 2004).

A National Dialogue begun in 2003 has become of focus of resistance to reform. A meeting in June 2004 on the topic of the role of women in society has united Islamist opinion across a wide spectrum against social change. Women will not be allowed to vote in the 2005 municipal elections and state employees (i.e. most Saudis) have been forbidden to oppose state policies even by signing petitions calling for change.

The main source of opposition seems likely to arise in future amongst young men without job prospects. The government has sought to make foreign labour more difficult to obtain and more expensive in order to encourage employment of Saudis but many are unwilling to carry out tasks currently done by skilled and unskilled foreign labour.

The external situation

Saudi Arabia is a major regional power, due in particular to its major share of world oil reserves and its custodianship of the holy sites of Islam at Mecca and Medina.

USA

The Saudi leadership has sought less obvious reliance on the US security umbrella in view of the domestic and regional unpopularity of an open alliance. Saudi Arabia remains an important American ally although it objected to military action against Iraq and was moving towards a re-acceptance of Iraq in the international community even before the fall of Saddam Hussein. The war on terrorism and the war in Iraq have again shown the difficulty that the Saudis have in balancing their military and political partnership with the US, while also being sensitive to regional Arab feelings. The involvement of many Saudi citizens in the attacks of 9 September 2001 has of course also affected relations.

Yemen

The border dispute between Saudi Arabia and Yemen was settled in July 2000, thus putting an end to a period of very poor relations. These are now good and oilfields in the south-west are being developed.

Iran

Relations improved after the election of Mr Khatami as president of Iran in 1997 and his visit to Saudi Arabia in 1999. Closer ties permitted agreed cutbacks in OPEC oil production in 1999. Nevertheless religious differences (Iranians are Shia Muslims, not Sunnis) and the role of Saudi Arabia as an ally of the USA continue to make relations problematic.

Iraq

In common with the rest of the Arab world Saudi Arabia opposed the recent US invasion of Iraq, although it had called earlier on Iraqis to overthrow Saddam Hussein. It is gradually developing relations with the new Iraqi authorities.

Israel

Saudi Arabia maintains an embargo against Israeli goods. The impasse in negotiations and current 'intifada' have led to a hardening of the Saudi line against Israel, and closer cooperation with Egypt and Syria. Domestic resentment rises at times of wider regional tensions, as illustrated by a surge in anti-Israeli and anti-US sentiment in the wake of the crisis in the occupied territories.

A Saudi peace plan for the Middle East attracted support of the Arab League in 2002. It courageously recognised the need to normalise Arab-Israeli relations, but both it and the US 'roadmap' of 2003 have been overtaken by events.

II. ECONOMIC SITUATION

Economic performance

Government revenues, the trade balance, GDP and the current account are all currently being boosted by the surge in oil prices since 2003. Oil output is rising markedly but real growth in GDP is expected to be only 2.5% in both 2004 and 2005 (EIU, October 2004). A projected budget deficit has been turned into a surplus for 2004 of nearly $35 billion. In September the government announced new development projects totalling almost $11 billion.

As the world's leading oil exporter and producer, Saudi Arabia is also one of the most oil-dependent countries in the world. Such dependence on global markets particularly hurt Saudi Arabia during the 1990s. A growing population is placing increasing spending burdens on the government and unemployment is becoming a problem for the first time.

Oil prices are expected by the Economist Intelligence Unit to fall in 2005 and thus reduce revenues. Economic policy is based on developing a greater role for private, including foreign, investment but implementation is slow. The government is cautiously following a programme of reform to diversify the economy and reduce the dependence upon oil exports. Privatisation efforts have come hand in hand with preparing for WTO membership, with new Foreign Direct Investment laws implemented in May 2000 that ease ownership restrictions and bring foreign company taxation in line with domestic taxation.

Saudi Arabia's application for membership of the WTO has been a major stimulus for economic liberalisation. Reforms required include an end to restrictions on foreign investment in stocks and property, a dilution of exclusive agency agreements and an end to differential taxation of foreign and local companies. An opening of the foreign trade regime should benefit exports of Saudi goods, particularly non-crude oil merchandise exports - such as petrochemicals produced by the giant Saudi Basic Industries Corps (SABIC) - as well as the agricultural sector.

As with so many countries in the region, Saudi Arabia is now facing a crucial phase in its economic reform programme. The relatively easy tasks of easing FDI restrictions have been accomplished, but trade barriers, fiscal reform and economic diversification have yet to be tackled.

The privatisation of state industries is moving forward slowly, with the progressive sale of the Saudi Telecommunications Company. Further large-scale privatisations will gradually follow, possibly with the sale of the government's 70% stake in the Saudi Arabian Basic Industry Corporation (SABIC). Saudi Arabian Airlines is also to be privatised, after considerable restructuring to put it on a profitable basis.

Prospects

Despite the heavy dependence on oil, Saudi Arabia is making renewed efforts to diversify the economy, in order to provide jobs for the local population. The state is the main employer in Saudi Arabia and the cost of salaries, social services and growing unemployment is putting pressure on the budget. Unemployment in the state-dominated economy will continue to be a problem if the non-oil economy is not liberalised. New labour regulations aim to discourage employment of foreign workers and increase participation of Saudi women in the workforce. Although the current economic outlook is good there will be problems in the longer term because of the high birth rate and very high proportion of young people in the population seeking work

Future plans are expected to extend investment opportunities to local companies, joint ventures and foreign investors, in particular in the generation sector of the industry. Foreign investment in the other power sectors, those of transmission of power and of distribution, may initially be more restricted to state control.

A number of economic sectors with development potential have emerged:

<u>Tourism</u>: Much investment has been pumped into tourism projects over the past six years, aimed principally at local holidaymakers. Whether Saudi Arabia develops as a (Western) tourist destination remains uncertain, and is a long-term prospect at best.

<u>Electricity Generation</u>: Already one of the largest electricity producers in the region, Saudi Arabia's energy demand is expected to double in the next 15 years. Huge investment costs have prompted the government to initiate a break-up of the state-owned Saudi Electricity Company (SEC), ahead of gradual privatisation. There are as yet no plans to open up the sector to foreign investment, but as investment needs grow, the need to attract capital may outweigh decisions based on domestic ownership.

<u>Natural Gas</u>: Saudi Arabia announced the consortia contracted to develop the country's national gas.

<u>Mining</u>: Saudi Arabia is rich in minerals beyond the hydrocarbon sector. Saudi has rich deposits of gold, silver, copper, zinc, lead, iron ore, magnesite and phosphate. The government has given a high priority to private sector involvement in basalt, zinc and lead mining, and exploration programmes and feasibility studies continue in phosphate, gold and magnesium mining. Gold mining has been targeted for private investment.

III. EUROPEAN UNION / GULF COOPERATION COUNCIL RELATIONS

The Cooperation Council for the Arab States of the Gulf (GCC) is a regional organisation created in May 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE). A GCC Customs Union entered into force in January 2003.

The European Community does not have any contractual relations with the individual countries, but in 1988 an EC-GCC Cooperation Agreement covering trade, investment and cooperation was signed. EU and GCC Foreign ministers meet once a year at the Joint Council/Ministerial Meeting (preceded by Senior Officials' Joint Cooperation Committee) as well as during the

UNGA in September. The latest Joint Council/Ministerial Meeting took place in Qatar on 3 March 2003 under the Greek Presidency of the Council.

The meeting noted the discussions concerning establishment of a Commission Delegation in Riyadh (which opened in January 2004) and the Joint Council reiterated the view that trade, investment and cooperation were the foundations for a development of relations. But the Joint Communiqué also covers discussions on political questions of common interest such as the fight against terrorism and respect for human rights as well as regional issues.

The Delegation in Saudi Arabia provides a platform for a broader relationship that seeks to go beyond trade matters and the negotiations for a Free Trade Agreement (FTA); it will facilitate the development of the dialogue on political issues. The Commission's External Relations DG is responsible for follow-up to the Cooperation Agreement and implements a number of economic and decentralised cooperation activities.

It is intended that the EU-Gulf FTA should cover not only trade in goods but also trade in services, government procurement and intellectual property rights. The Agreement was to be signed after the GCC internal Customs Union has been constituted, subject to successful conclusion of the negotiations. The Gulf Customs Union now exists but has not yet been implemented.

Economic importance and Free Trade Negotiations

Apart from the evident strategic importance of the Gulf region in terms of energy supply, the GCC is also the EU’s sixth largest export market. [To be revised: In 2000 the EU exports into GCC reached 29 billion EURO, whereas GCC exports to the EU almost doubled in value from 12 to 22 million EURO, significantly diminishing the imbalance of trade between the two areas. However, the major part of those imports remains petroleum products. For 2001 figures for the first 9 months show an overall increase of 8% in the total volume of the trade as compared to the previous year. However, whereas the EU exports into the GCC countries increased by 16.7% our imports from the GCC countries decreased by 3%.

EU investments in the Gulf region dropped from 3 billion EURO in 1999 to 1.5 billion in 2000. At the same time the GCC investments increased by more than 15% from about 4 billion EURO in 1999 to about 4.6 billion in 2000.]

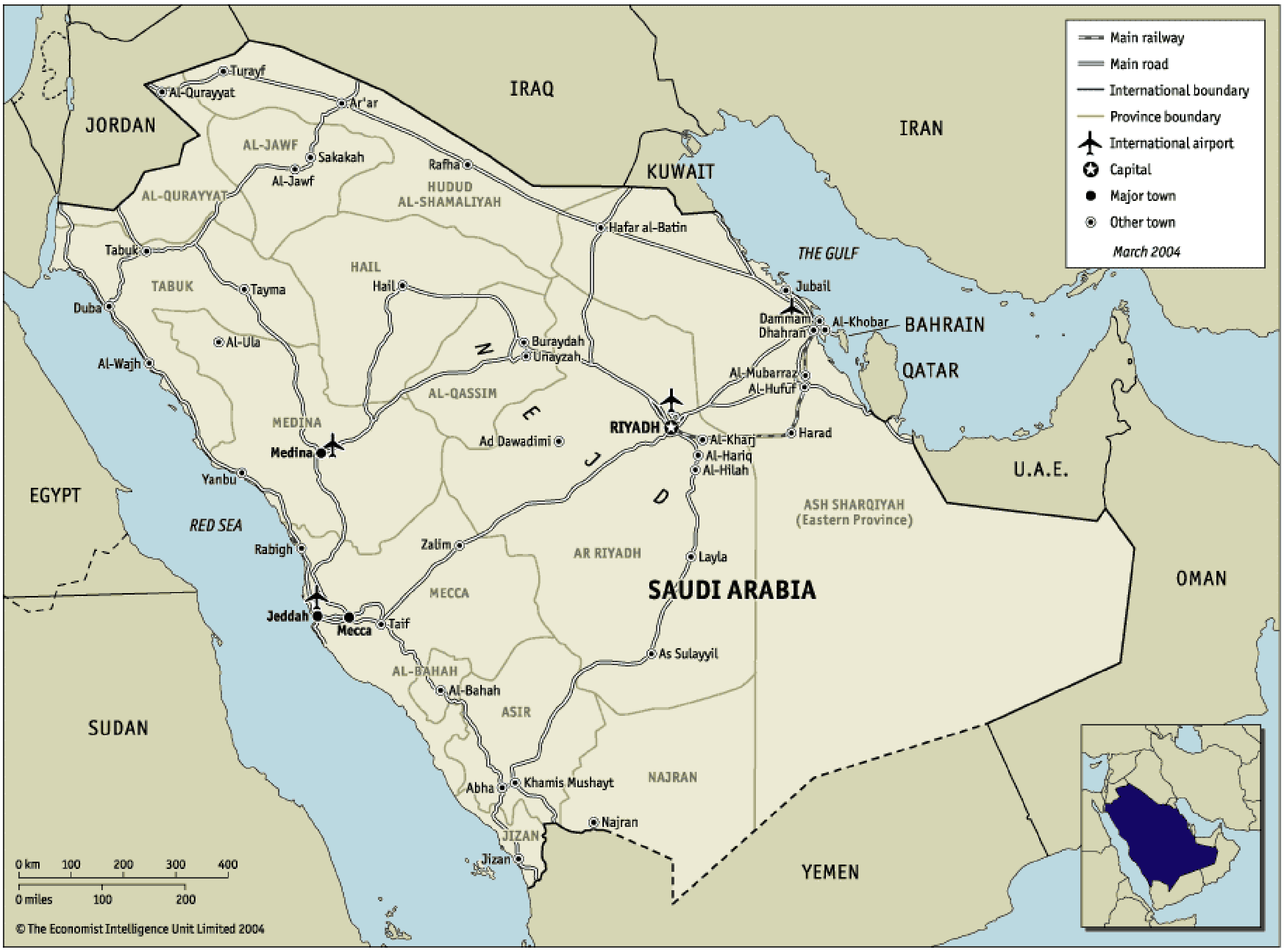
European Parliament

In its resolutions of 20 March and 13 June 2002 on the European Council meetings in Barcelona and Seville the Parliament welcomed the initiative of Crown Price Abdullah on the Middle East.

The EP already in its resolution of 14 June 2001 on development of the external service had expressed the view that it would be useful to open a Commission delegation in Saudi Arabia.

In a resolution of 13 March 2002 on women and fundamentalism, it condemned "...the fundamentalist discrimination against women persistently exercised and promoted by the Government of Saudi Arabia." It has also on occasion also criticised the human rights situation and the use of the death penalty in Saudi Arabia.

ANNEX MAP



Source: EIU Country Profile