DISCORDANT EGYPTIAN AND SAUDI VISIONS 2030
AND THE FORGOTTEN QUEST FOR MENA ECONOMIC INTEGRATION

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Abstract

The Arab Spring brought about, simultaneously, an oil-price geopolitical premium for Saudi Arabia and other Gulf Cooperation Council countries and economic hardships for Egypt and other countries of the Spring. Over the past five years, GCC countries offered financial support to soften the economic blow to the Egyptian economy. However, an envisioned major injection of investments to ensure long-term economic success did not materialize due to a combination of lower oil prices—which forced Saudi Arabia, in particular, to worry about its own long-term economic success—and the inability of successive Egyptian regimes to implement sufficient reforms to reassure prospective investors. Minimal financial support to Egypt has continued, mainly from Saudi Arabia and the United Arab Emirates. Recent funding from those countries is now linked to an expected IMF loan that would signal the Egyptian government's commitment to economic reform. Unfortunately, long-term Visions 2030 economic plans for Egypt and Saudi Arabia were developed by each country in isolation of its neighborhood, despite economic and political conditions that are similar to the 1990s, when many viewed regional integration as the way forward for the region’s economies. This paper discusses the shortcomings of these narrow national visions and argues for a comprehensive framework for regional economic integration, wherein each country’s vision is harmonized with those of its neighbors.
Introduction

In its 2010 Article IV consultation, the International Monetary Fund expressed its satisfaction that the financial crisis, which reached its pinnacle in September 2008, had had minimal effects on the Egyptian economy. The crisis led to significantly lower oil prices, as shown in Figure 1, which, for the net oil importer, had helped to counterbalance the negative economic effects of the Great Recession. Nonetheless, the economic pressures of slowing growth and the return to higher oil prices eventually made the country’s authoritarian bargain untenable. By mid-February 2011, Egypt was under the direct rule of the Supreme Council of the Armed Forces, and then underwent two regime changes. Through this five-year period, Egypt has received tens of billions of dollars in financial support from Gulf monarchies.

The Arab Spring and Petrodollar Recycling

In some sense, this financial aid may be seen as the partial recycling of additional petrodollars those Gulf monarchies were earning due to the significant geopolitical premium added to oil prices. The latter may be seen clearly in Figure 1, both in terms of a return to triple-digit oil prices despite the continuing oil-market glut, as evidenced by the secular rise in inventories, and in the marked premium of the Brent price above the WTI price for the period between the removal of Egyptian President Hosni Mubarak and the assumption of office by President Abdel Fattah El-Sisi in June 2014. In the week of El-Sisi’s inauguration, the now late King Abdullah of Saudi Arabia called for a major donor conference “to help Egypt overcome its economic difficulties,” warning fellow Gulf monarchies that those who did not contribute would “have no future place among us.” Many thought of this effort as a Marshall plan that would help Egypt rebuild and overcome the loss of revenues from tourism, workers’ remittances, and Suez Canal receipts, which constitute its main sources of foreign currency.

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2 Represented here by U.S. crude inventories outside the strategic petroleum reserve; for lack of a better measure of global crude inventories. This is the standard proxy used in the literature. See, for example, L. Kilian and D. Murphy, “The Role of Inventories And Speculative Trading in The Global Market for Crude Oil,” *Journal of Applied Econometrics* 29(2014): 454–78.
The donors’ conference was to take place in the Egyptian resort city of Sharm El-Sheikh, and in anticipation of very large contributions, the Egyptian government postponed the conference to March 2015, in part to prepare a list of 15 megaprojects that promised, at the time (September 2014), to attract at least $100 billion in investments. Toward that end, the government of Egypt published “Sustainable Development Strategy: Egypt’s Vision 2030," along with a “Five Year Macroeconomic Framework and Strategy,” for the Economic Development Conference held March 13–15, 2015. The latter report, which showcased positive economic reform steps already taken in 2014 such as a partial reduction of fuel subsidies, was shown to prospective donors and other conference attendees, which

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included IMF’s managing director, the U.S. secretary of state, and numerous heads of state and senior officials from many countries and multinational organizations.

**Scaled Down Donor’s Conference**

Saudi King Abdullah died in January 2015, a few months prior to the event, and his successor, King Salman, seemed less eager to support a massive infusion of capital into the Egyptian economy, especially in light of lower oil prices, which put significant pressures on Saudi Arabia’s own finances. The Gulf monarchies’ financial support at the conference amounted to only $12.5 billion—$4 billion each from Saudi Arabia, Kuwait, and the UAE, and $0.5 billion from Oman—approximately one-quarter of which were deposits to the Central Bank of Egypt, while the rest were to take the form of investments in various projects. In addition, several billion dollars’ worth of memoranda of understanding on potential investments in various sectors were signed, with the lion’s share focused on the energy and power sectors.5 Despite the great fanfare preceding and following the March 2015 conference, the Egyptian reform program has stalled—for example, failing to follow through with a second step of fuel subsidy removals in summer 2015. Support from Gulf monarchies has slowed down significantly, and by late summer 2016 has been linked to an IMF loan predicated on continued Gulf support and Egyptian implementation of a reform program to stem the hemorrhaging of resources through the twin fiscal and current account deficits.

Returning to Figure 1, we can see that oil prices resumed their decline after a period of political stabilization in Egypt under the rule of President El-Sisi, despite the unprecedented mounting of inventories signifying a major glut in oil markets. Although oil prices need to fall further to clear the market, suggesting that prices continue to reflect geopolitical risk, the Gulf monarchies seem increasingly unwilling to recycle significant portions of their petrodollar wealth to Egypt, in large part because their own economies are suffering from substantial fiscal deficits at current oil prices. Moreover, with sluggish economic growth worldwide, and the continuing improvement in shale technology that has made the U.S. a major producer in oil markets, Saudis, in particular, have recognized that they need to plan ahead for the world beyond oil riches. The emerging vision was clearly based on the report published by McKinsey Global Institute (MGI) in December 2015 titled “Moving Saudi Arabia’s Economy beyond Oil.”6 In April 2016, Deputy Crown Prince Mohammed bin Salman announced Saudi Arabia’s Vision 2030, which attracted global attention, especially because of the planned partial public offering of Saudi Aramco to help fund the massive investment program advocated by MGI.7

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5 The total could have amounted to $92 billion, according to initial reports. See http://www.atlanticcouncil.org/blogs/menasource/what-was-pledged-at-egypt-s-investment-conference.


New Terms for Saudi Investment in Egypt

Almost concurrently with the publication of Saudi Arabia’s Vision 2030, Saudi King Salman visited Egypt to sign 36 agreements for investments of up to $25 billion. This followed in the footsteps of an agreement with Saudi Aramco to fulfill Egypt’s petrol needs for five years, valued at approximately $23 billion. Details of all the planned investments were not revealed to the public, but they suggest two patterns. The first is that Saudi Arabia’s Vision 2030, which stipulates making the kingdom an investment powerhouse, does include Egypt in its investment destinations. The second is that the degree of coupling in Egypt’s and Saudi Arabia’s 2030 visions is rather limited in scope. Neither vision takes into consideration the developmental synergies between the two countries, and, indeed, regional effects beyond the two nations.

Earlier Calls for Regional Economic Integration

Before oil prices began to recover in 1998, then soar after the invasion of Iraq in 2003, the Arab countries’ lack of economic growth combined with abnormally high population growth rates was viewed as a ticking time bomb. The main challenge was how to generate economic growth in a region that had been very dependent on oil prices during the 1970s and 1980s. The answer sought during the early to mid-1990s focused on peace dividends that could have enhanced regional integration and promoted inter-industry trade. As analysis of the potential for regional integration progressed, El-Erian and Fischer asked the question, “Is MENA a Region?” Their conclusion was that, despite many geographical and cultural factors that may favor regional integration, “on the economic front, MENA is remarkably unintegrated.” The authors made a strong case that intra-regional trade can grow considerably, and that differences in factor endowments promise significant yields to growth.

They also suggested that with peace, resources that had been directed toward military spending instead may be redeployed toward more productive and growth-inducing investment. Unfortunately, Figure 2 shows that while Egypt’s military spending as a percentage of GDP has, indeed, declined precipitously (except during the early 2000s), Saudi military spending has remained disproportionately very high. As the threat of another Arab-Israeli war has diminished, the threat of war with Iran and its allies has increased.

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9 Deputy Crown Prince Mohammed bin Salman, who is most strongly associated with Vision 2030, has expressed this in a number of interviews, including, for example, one with The Economist, available here: http://www.economist.com/saudi_interview.
As a result, Saudi Arabia, which views itself as the primary target of Iranian geopolitical threats, has viewed almost all regional cooperation efforts through the lens of its conflict with Iran. In recent years, the conflict has fueled direct military activities in Bahrain and Yemen as well as proxy battles in Syria. Although the Egyptian military was of limited assistance in Yemen, reluctance to commit ground troops to Saudi Arabia’s war on the Yemeni Houthis, which started shortly after the death of King Abdullah, appears to have dampened the initial enthusiasm for a massive investment effort in Egypt, which in turn confirms that Saudi Arabia has thought of regional investments—especially in Egypt—in geopolitical terms, rather than pursuing an agenda of regional economic integration.

The theme of regional economic integration was not abandoned in the 1990s. Citing some positive evidence on diversification in the export bases in Egypt, Morocco, and Tunisia, economic researchers continued to suggest that wide differences in regional income levels and resource endowments should provide ample “incentives to engage in intra-industry trade driven by product differentiation.” In particular, multiple authors have agreed that capital rich GCC countries, like Saudi Arabia, which were seeking to industrialize, may

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pursue a more efficient strategy of foreign direct investment in labor rich countries like Egypt. However, while the labor rich countries in the region have been actively seeking inbound foreign direct investment, especially from Saudi Arabia, the latter has not seen the benefits of exploiting such synergies as sufficiently attractive. This is reflected in Saudi Arabia’s Vision 2030, issued a year after its Egyptian counterpart, which continues the tradition of focusing on domestic rather than regional economic diversification, which would require a different approach to institutional reform to enhance labor and capital mobility as well as intra-regional trade in manufactured goods.

In the remainder of this paper, we shall examine the Egyptian and Saudi 2030 visions in some detail, albeit limited by the level of detail in the available documents, with attention paid to two main issues. The first aspect we will discuss is the viability of the industrial and trade policies implicit in the publicly available documents for the two visions, which are conditional on current economic conditions and potential comparative advantages of the two countries in the regional and world markets. The second aspect we will consider is the harmonization of the two national visions, at the very least to avoid counterproductive beggar-thy-neighbor competitive investment policies, and, ideally, capitalize on synergies and growth potential that may be unleashed through greater regional integration.

**Egyptian Vision 2030, Economic Reform, IMF Loan Agreement**

The main target of Egypt’s Vision 2030 was significant economic growth driven by higher investment and exports. The envisioned target GDP growth rate of 7% was only achieved in recent decades during 2007–08, before falling to the 5% range in 2009–10, languishing near 2% for the 2011–14 period, and recovering to 4% in 2015.14 This growth, which was envisioned to increase the services sector from roughly 50% of GDP in 2014–15 to 70%, was to be accomplished by increasing investment to 30% of GDP, which is more than double its 2015 rate (as gross capital formation to GDP) and 33% higher than the highest rate of 22.4% investment to GDP, which occurred before the financial crisis peaked in late 2008. Exports of goods and services were growing around 25% per annum between 2004 and 2008, but has shrunk substantially since then. Thus, Egypt’s Vision 2030 targets were essentially to replicate the best performance of the Egyptian economy circa 2005-2008, and sustain it for more than a decade. This growth was envisioned to reduce the unemployment rate from 13% in 2014–15 to 5%, and to satisfy a wish list of socioeconomic improvements across the board in education, gender and geographic equality, health care, entrepreneurship and innovation, and institutional efficiency.

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Megaprojects and the Suez Canal

The primary public-private partnership investment priorities were “megaprojects,” mainly for (i) developing the Suez Canal area into a major industrial zone and logistics hub, following the example of Dubai; (ii) energy sector investments to address fuel and power shortages that had debilitated the economy in earlier years; and, to a lesser extent, (iii) land reclamation to expand the agriculture sector. In the event, the Suez Canal megaproject was the one to take center stage during El-Sisi’s first year in office. The envisioned plan for an initial public offering was abandoned in favor of a massive $8.2 billion bond issuance through retail banks, which the Egyptian public bought within a week. The newly dug Suez Canal lane now allows ships to move in both directions at a faster pace, reducing wait time by more than a factor of three.

The massive project, marketed in Egypt as a “New Suez Canal,” was accelerated to completion within one year, even though it could have been completed at a significantly lower cost in three years. The announced economic rationale was that faster passage would increase the flow of ships, and hence revenues from the Canal. In reality, the deceleration of global trade concomitant with the current regime of slow global economic growth has resulted in lower receipts from the Suez Canal, even as the obligation to begin repayment of principal and interest draws near.

Despite its obvious economic drawbacks, especially the unnecessarily higher costs incurred due to hasty acceleration, and the depletion of dollar liquidity within the country, which has exacerbated the country’s longer term foreign exchange crisis, one must admit that the Canal megaproject did have significant short-term benefits. First and foremost, the new regime needed to cement its political legitimacy through tangible accomplishments, and the quick completion of this high-visibility project proved, as El-Sisi wished, that Egypt “can get things done.”

On the financial front, the opportunity to earn an interest rate of 12%, which was 100 basis points higher than bank CD interest rates at the time but significantly lower than Egyptian treasury bill rates, was advantageous both to the government and investors. As a result, the offering incentivized some to de-dollarize their savings in order to earn the higher interest rate, thus preventing the Egyptian pound from depreciating very significantly during that period, as shown in the bottom panel of Figure 3, despite the continued hemorrhaging of foreign reserves and overall foreign currency liquidity, as shown in the top panel of Figure 3. Needless to say, this financial benefit was only temporary, but it reinforced the positive political value of the megaproject. Unfortunately, the country’s finances have continued to deteriorate since then, despite multiple injections of financial assistance from GCC countries—depicted as jumps in 2013 and 2015 in the top panel of Figure 3—due to Egypt’s continued structural twin deficits (fiscal and trade), which require painful economic reform measures.

Figure 3. Egypt’s Official Reserve Assets and Foreign Currency Assets in USD Tens of Billions (Top); Egypt’s Official Exchange Rate in Egyptian Pounds per 1 United States Dollar (Bottom)
Egypt’s Economic Reform Agenda

The “Five-Year Macroeconomic Framework and Strategy” that accompanied Egypt’s Vision 2030 promised a battery of economic reforms to address the structural macroeconomic imbalances and put the country on the path to sustainable diversified growth. The document included a table of fiscal and structural reforms that had been implemented or envisioned at the time of the donors’ conference.\(^\text{15}\) In this regard, subsidy reform is the most important—and most difficult—component of any reform program, including the one proposed in early 2015, variations on which were approved by the

Egyptian parliament and facilitated the preliminary approval of a $12 billion Extended Fund Facility loan from the IMF in August 2016. As shown in Figure 4, 2015-16 and 2016-17 budgets were forecast to generate fiscal deficits of less than 10% of GDP. This is impossible to accomplish without dramatic subsidy reduction, along the lines of these budgets. Hesitation to follow through with these reforms has prompted GCC donors to link any further financial support to an IMF program that would ensure long-term macroeconomic sustainability.

**Figure 4. Egyptian Subsidies Burden as Per 2016-17 Budget (in EGP billions)**

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<tbody>
<tr>
<td>GDP</td>
<td>1,575.5</td>
<td>1,843.8</td>
<td>2,101.9</td>
<td>2,429.8</td>
<td>2,833.4</td>
<td>3,246.5</td>
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<tr>
<td>Food subsidies</td>
<td></td>
<td></td>
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<tr>
<td>Actual</td>
<td>30.3</td>
<td>32.6</td>
<td>35.5</td>
<td>39.4</td>
<td>37.8</td>
<td>41.1</td>
</tr>
<tr>
<td>Percentage</td>
<td>(1.9%)</td>
<td>(1.8%)</td>
<td>(1.7%)</td>
<td>(1.6%)</td>
<td>(1.3%)</td>
<td>(1.3%)</td>
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<tr>
<td>Petro subsidies</td>
<td></td>
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<tr>
<td>Actual</td>
<td>95.5</td>
<td>120.0</td>
<td>126.2</td>
<td>73.9</td>
<td>61.7</td>
<td>35.0</td>
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<tr>
<td>Percentage</td>
<td>(6.1%)</td>
<td>(6.8%)</td>
<td>(6.0%)</td>
<td>(3.0%)</td>
<td>(2.2%)</td>
<td>(1.1%)</td>
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<tr>
<td>Elect. subsidies</td>
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<tr>
<td>Actual</td>
<td>8.6</td>
<td>13.3</td>
<td>23.6</td>
<td>31.1</td>
<td>29.0</td>
<td></td>
</tr>
<tr>
<td>Percentage</td>
<td>(0.5%)</td>
<td>(0.6%)</td>
<td>(1.0%)</td>
<td>(1.1%)</td>
<td>(0.9%)</td>
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<tr>
<td>Fiscal deficit</td>
<td>167.3</td>
<td>239.7</td>
<td>255.4</td>
<td>279.4</td>
<td>251.1</td>
<td>319.5</td>
</tr>
<tr>
<td>Percentage</td>
<td>(10.6%)</td>
<td>(13.0%)</td>
<td>(12.2%)</td>
<td>(11.5%)</td>
<td>(8.9%)</td>
<td>(9.8%)</td>
</tr>
</tbody>
</table>

Source: [http://www.mof.gov.eg/MOFGallerySource/Arabic/PDF/analytical_statement16-17.pdf](http://www.mof.gov.eg/MOFGallerySource/Arabic/PDF/analytical_statement16-17.pdf), and earlier budget analytical statements; accessed August 2016.

The dramatic reduction in fuel subsidies during El-Sisi’s first year in office (which coincides with the 2014-15 fiscal year) was facilitated by a combination of (i) increased domestic prices of refined fuels shortly after El-Sisi took office (by 78% for Gasoline 80, 40% for Gasoline 92, and 63% for diesel), and (ii) the precipitous fall in crude prices, as seen in Figure 1. Simultaneously in summer 2014, electricity prices were increased by 20% on average. This was advertised in anticipation of the March 2015 economic development conference as proof that the new regime had the political will and capital to execute such difficult subsidy reductions. The five-year strategy was consistent with the 2015–16 and 2016–17 budgets and promised more waves of fuel and electricity subsidy removals. However, in summer 2015, the government did not follow through with its promised second wave of fuel price increases, even as it did implement a second wave of a 20% increase in electricity prices. The head of the Egyptian General Petroleum Corporation, the state oil company, announced that the actual petroleum subsidy cost in 2015-16 was EGP 55 billion, which was better than budgeted. However, this may be a gross underestimate if it was calculated using the official exchange rate, which was significantly below the black market rate for much of the fiscal year.
Financing Gap Crisis in Egypt, IMF Loan, and Difficult Reforms

The Egyptian government and the IMF have estimated that after implementing tough reforms—which would include significant depreciation of the Egyptian pound, deep reductions of subsidies, and privatization of some state-owned enterprises—the country’s funding gap will be approximately $21 billion over three years. The sharp drop in worker’s remittances, tourist receipts, and Suez Canal revenues, caused by a combination of global economic lethargy and security concerns, have made it necessary to implement those reforms at a dramatic pace. The tentative agreement between Egypt and the IMF, which has been strongly supported by Saudi Arabia and the UAE to stop the financial hemorrhaging, includes an IMF loan of $12 billion over three years, to be supplemented by another $9 billion from GCC countries, the World Bank, and the African Development Bank.16

Interestingly, the Egyptian government has not followed the usual tactic of blaming the IMF for mandating those reforms that will be painful to the largest segment of the population. The standard playbook for countries that need IMF programs is to use the fund as a precommitment device and a target for diverting the public’s anger. The GCC donors have clearly opted for using the IMF as a precommitment device for the Egyptian government, but the latter seeks to portray the IMF loan less as a final measure to avoid economic collapse and more as a “certificate of good economic health” from the international finance institution, ostensibly to attract foreign direct investment to boost long-term growth. However, the big surge of foreign investment from Gulf monarchies, envisioned by the late Saudi King Abdullah during his last days, is highly unlikely to materialize, given the direction of Saudi Vision 2030, to which we shall turn shortly. Foreign investment from other sources is less likely still. Instead, with urging from the United States and international financial institutions, the Gulf monarchies are likely to provide the minimal financial support needed to prevent the Egyptian economy and regime from failing, both out of genuine concern and fear of political contagion.

The likely outcome of this trajectory is not promising. The Egyptian government and population will begin to resent the Gulf monarchies for limiting their financial support as the population’s economic suffering intensifies, especially for the middle class, which benefits the most from the current subsidy system. Conversely, the Gulf monarchies will resent the Egyptian government for continuing to request financial support to cover its fiscal and trade deficits and continuing to consume beyond its means, with no end in sight. A sample of this mutual resentment has been in evidence since plans to transfer two contested islands at the mouth of the Gulf of Aqaba from Egypt to Saudi Arabia were announced during King Salman’s visit to Egypt. As of the time of writing of this paper, four months after the announcement, the issue remains politically sensitive for both countries—Egyptian pride was injured by the perception that it was selling land in exchange for

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financial support, and the exchange of insults on social networking sites and in the press has not abated.

**Saudi Arabia’s Vision 2030**

As mentioned above, King Abdullah’s vision of a massive investment to ensure the long-term success of the Egyptian economy and regime has been replaced by instrumental support to keep the system afloat and ensure its continued support in regional conflicts. In the meantime, Saudi Arabia announced its own Vision 2030 in April 2016, around the time of King Salman’s trip to Egypt. The motivations for diversifying the Saudi economy away from oil was also well expressed in an IMF paper prepared for the Annual Meeting of Arab Ministers of Finance in Manama, Bahrain, that same month. This paper highlighted the vulnerability of economies that are highly dependent on oil because of its contribution to macroeconomic instability and the capital-intensive nature of the industry and related sister industries. The latter is particularly troublesome for Saudi Arabia because of its high rate of population growth over the past four decades, which has resulted in very high rates of unemployment, especially among youth—a problem shared with Egypt, as shown in Figure 5.

The “Economic Diversification” IMF paper focused on the macroeconomic stability need for diversification and the macroeconomic conditions necessary for private-sector growth in non-oil sectors, including fiscal consolidation, improving labor regulations, improving access to finance, and attracting foreign direct investment. Another IMF paper, descriptively entitled “Learning to Live with Cheaper Oil,” predicted that low oil prices will result in slower growth and higher unemployment in the medium term. A few months earlier, in December 2015, McKinsey Global Institute published a paper promising that despite all the challenges posed by low oil prices, a massive $4 trillion investment program could propel the Saudi economy to double its GDP between 2015 and 2030, just as it had nearly doubled between 2003 and 2013. This paper became the backbone of Saudi Arabia’s Vision 2030, announced by Deputy Crown Prince Mohammed bin Salman in April 2016.

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The IMF and MGI agreed on the macroeconomic preconditions for the diversification of the Saudi economy, but the MGI report went much further. Underestimating the institutional and social frictions that may impede the necessary reforms, MGI proposed a “full potential” scenario that would include a significant increase in female labor market participation, convergence between public and private sector wages for Saudis, and higher labor productivity. The main vehicle for avoiding a “reactive” trajectory that would take the country from 120% liquid financial assets to GDP and leave it with 140% of GDP debt in 2030—and instead achieve a full potential of doubled GDP and a debt-to-GDP ratio of 30% in 2030—is to draw down on the country’s reserves even faster, or otherwise raise funds through borrowing and selling some assets, to invest in the Saudi non-oil sector. Labeling the approach a “micro-to-macro” methodology, MGI listed eight sectors as potential growth engines, in descending order of potential magnitude: travel, trade, mining, advanced manufacturing, banking and finance, construction, petrochemicals, and health care.
MGI’s Strangely Linear Projections

MGI’s approach to identifying investment opportunities and magnitudes is driven by a strangely linear model. Thus, in Box 4 on pp. 47-48 of the report, MGI explains that it reached the number $4 trillion by applying what it calls the “rule of 2.5,” that “it takes additional investment of 2.5 percentage points of GDP to bring about each additional 1% of GDP growth.” The authors claim that previous MGI work “has established a strong empirical relationship between a country’s investment rate and its growth rate” that justifies their modeling assumption. The paper cited for MGI’s empirical work states that “the rule of 2.5 assumes a constant marginal productivity of capital,” which was inexplicably inferred from a plot of capital output ratios for various countries against their GDP per capita.20

The incoherence of MGI’s approach is not limited to its incorrect inference from visual inspection of the wrong graph. Indeed, the authors of the 2010 paper note that “empirically, we see a small increase in the capital output ratio of most countries over time,” which should have alerted them to nonlinearities that make extrapolation far beyond historical data of any given country, with a simplistic “rule of 2.5,” unwise. More importantly, the approach followed by MGI ignores the problems of the absorptive capacity of an economy, the possibility of public investment crowding out private investment, comparative advantage in the sectors wherein investments are increased, and the international market conditions that will determine whether a particular investment is more or less conducive to economic growth, to mention only a few of the many factors that have been studied extensively in the economics literature over the past century. Indeed, to illustrate the absurdity of a “rule of 2.5,” imagine if Saudi Arabia were to invest an additional 25% of GDP in the oil sector. It is obvious that this would flood the market and not cause a 10% increase in GDP.

The issue of public investment crowding out private investment, which is currently seen in abundance in Egypt, is particularly important for recognizing the incoherence of MGI’s daring recommendations and irresponsible projections. Exhibit 30 on p. 101 of the company’s December 2015 “Saudi Arabia Beyond Oil” report explains their rationale for the “full potential scenario” that will ostensibly result in doubling GDP by 2030. The title of the graphic tells it all: “front-loaded government investment could help stimulate the economy and drive a transformation,” which, ostensibly, would boost private investment-driven growth. In some sense, this is very similar to the Egyptian government’s recent megaproject mindset, as well as Saudi Arabia’s own experience. Indeed, the kingdom has

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20 McKinsey Global Institute, “Farewell to Cheap Capital? The Implications of Long-Term Shifts in Global Investment and Saving,” December 2010, available at: http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/farewell-cheap-capital. Exhibit 4, p. 12, shows a great deal of dispersion in capital output ratios, between about 125 to about 400 for different levels of per capita output. At best, the plot suggests no strong relationship between per capita income (Y/Pop) and this capital-output ratio (K/Y), although no statistical test of the slope being zero is offered. But a flat line, even if correct, says next to nothing about the claimed effect of increasing investment to output (dK/Y) on output growth (dY/Y) without specifying the assumed population growth.
been no stranger to megaprojects over the years, all of which have promised to diversify the economy away from oil and deliver macroeconomic stability. In this regard, and especially under new conditions of budget deficits, the underdevelopment of the Saudi financial sector would almost guarantee that massive public investments would crowd out private investment. MGI’s vision of a surge from the recent nearly equal public-private split in investment, to 81% of the foreseen $900 billion investment coming from the government during 2016–20, and then an investment boom that reaches $2 trillion in 2026–30, 74% of which would be private, is at best a mirage.

Linearity in Sectoral Prospect Analysis

Turning to MGI’s “sector-level deep dives,” we see similar linear projections. For example, “we assume labor productivity will remain constant in upstream mining, and that in downstream manufacturing it will converge to the average of major EU economies today (the United Kingdom, Germany, and France). This would amount to doubling of labor productivity by 2030” (p. 131). Bridging the deficit in technical and vocational education and training, discussed in Box 7 on pp. 91-2, and “opening up the kingdom to enable the productivity-driven economy envisioned in the full potential scenario,” as discussed on p. 96, are major challenges that cannot be overcome without transforming Saudi society within a few years. This would require a complete rewriting of the rentier, welfare state-based social contract of the country, which was only minimally altered by the Saudization program (replacing foreign workers with Saudis). Other platitudes—like calls for greater openness, competition, and efficiency—are likewise unlikely to materialize within the next decade, at least not to the extent that would double labor productivity while at the same time create jobs for the armies of today’s unemployed Saudis.

Likewise, Exhibit 13 on p. 51 extrapolates that Saudi Arabia can “increase its rate of material extraction by two to three times” by comparing the rates of production of phosphate, gold, and copper as percentages of their respective reserves in Saudi Arabia and the rest of the world. An actionable sectoral analysis would require not only careful analysis of the relative production costs in Saudi Arabia relative to other countries—that is, comparative advantages that would be determined in part by geology and in part by factor endowments of willing and appropriately skilled labor, etc.—but also analysis of the global market conditions for these minerals, which may not be conducive to making major fixed capital investments to boost production in this decade or the next. Indeed, the only potential comparative advantages mentioned in the report, without actual comparison to competitors in these particular markets, pertain to cheap energy and new major ports for transport. Hence, while the report does highlight some industries wherein there may be potential for growth, the feasible magnitude of that growth under current and potential economic conditions is

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far from clear, and the projected returns on the proposed massive investments are far from convincing.

Therefore, we have seen that the Egyptian Vision 2030, predicated on massive investments from GCC countries, is inconsistent with the Saudi Vision 2030, which is focused on investing the country’s dwindling financial resources in pursuit of domestic growth that cannot be attained. In turn, comparison to the similar Bahraini Vision 2030, envisioned a decade earlier, or to the very different UAE transport hub models that are not applicable, do not promise success of the Saudi Vision 2030. In this regard, the financial problems that Saudi Arabia is likely to face in the forecast extended period of low oil prices, with slower credit growth and higher nonperforming loan ratios, as a recent IMF paper has projected, suggest that a massive public investment surge could stifle private investment to an extent that further diminishes long-term growth—as we have observed in Egypt and elsewhere.

Impediments to Regional Integration

Before offering regional integration as an alternative panacea, it behooves us, as Ahmed Galal and Bernard Hoekman put it, “to acknowledge the glaring fact that the project [of Arab economic integration], 50 years later, remains more of a hope than reality,” because of a variety of institutional impediments, as well as competitive “concerns over the distribution of gains from integration across and within countries, [and] issues of national sovereignty.” Those distributional issues have become particularly problematic when geopolitically driven financial support in recent years has amounted, essentially, to extending the GCC rentier welfare state to incorporate the very large Egyptian population. These fissures were on full display toward the end of 2015, as the UAE and Saudi Arabia made no secret of their frustration with Egypt’s continuing economic problems, slow pace of reform, and repeated demands for further financial support from the GCC.

Indeed, there is ample legitimate concern over Egypt repeatedly burning through financial assistance to temporarily bridge its fiscal and trade gaps, without taking the necessary steps to stem the financial hemorrhaging through subsidy and employment practice reforms. In the meantime, real investment efforts are stifled by bureaucratic red tape and its concomitant problem of corruption in land deals and to obtain various operation permits.

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Although Transparency International’s Corruptions Perceptions Index for Egypt has shown modest improvement, reaching 36 (rank 88) in 2015 compared with 32 (rank 118) in 2012, it remains qualitatively insufficient to change investors’ preferences substantially. In the meantime, the World Bank’s Ease of Doing Business ranking for the country has declined from 110 in 2012 to 131 in 2016. Therefore, the obstacles of bureaucracy and corruption have continued or worsened after 2011, exacerbating the problem of capital flight for Mubarak-era investors and disincentivizing new real investment in the country. Indeed, even when some investors overcame bureaucracy and corruption obstacles during the Mubarak years, they found themselves embroiled in legal battles regarding their earlier investments, and the proper legal reforms to prevent this pattern from repeating have not been forthcoming.

One proposed solution, motivated by similar models in China and the UAE, has been to establish industrial zones. The idea of creating industrial zones within which legal processes and rights can be made more transparent was pursued in the late days of the Mubarak regime, with help from China, focused mostly on the Suez Canal region. However, these attempts were not always politically palatable. For example, early concerns that Chinese investments in the Canal city of Ismailia would not create sufficient jobs for Egyptians had to be addressed in numerous public announcements that explained the gains in bilateral trade and employment creation. Many of the same ideas have resurfaced more recently, now focusing on development projects in the Sinai, despite the security challenges in that region, mainly from ISIL.

However, it must be noted that such industrial zones solve only part of the problem. In this regard, the relative success of the textiles-focused qualified industrial zones collaboration with Israel has been contingent on enhanced access to U.S. markets. In this regard, the primary reason for Saudi interest in the Salman Causeway connecting Saudi Arabia to the Sinai seems to be the prospect of enhancing exports of Saudi goods to Europe and Africa, rather than increased economic integration and meaningful increase in intra-regional trade in goods and services.

27 See http://www.doingbusiness.org/rankings.
Another Chance, A Quarter-Century After Madrid

The Madrid Peace Conference of 1991 promised more than simply an end to wars between Israel and her Arab neighbors; it also promised peace dividends that would enable regional economic integration and long-term prosperity. Those dreams of regional peace and prosperity have been revived in recent months. Thus, in May, Egyptian President El-Sisi called for renewed negotiations between Israelis and Palestinians, and promised that if this peace is achieved, “the region will see wonders.” Shortly thereafter, Egyptian Foreign Minister Sameh Shoukry met with Palestinian leadership in early July, followed by a visit to Jerusalem during which he met twice with Prime Minister Benjamin Netanyahu, and the two watched a football game together. Not long thereafter, a distinguished former Saudi general visited with members of the Knesset as well Israeli Foreign Ministry Director-General Dore Gold. Although the Saudi government was quick to explain that this visit was not a sign of normalizing relations, it was consistent with a new pattern of overt interactions with high-level Israeli officials.

Certainly, the envisioned investments to develop industrial zones in the Sinai and the Salman Causeway that traverses the Gulf of Aqaba require coordination with Israel, at the very least. Increased regional trade and cooperation beyond security issues—including, perhaps, offering job opportunities and more reliable trade routes for the residents of Gaza—may not be far behind. This is consistent with many recent proposals aiming to alleviate hardships for residents of Gaza and make long-term peace a possibility. Unfortunately, those recent proposals also have been driven mainly by political and humanitarian considerations and, therefore, fall short of re-envisioning the regional economic integration model contemplated after the Madrid conference.

In June, world leaders met in Paris in an effort to put together “economic and security incentives” to reach a final peace agreement between Israel and the Palestinians, which was rebuffed by the Israeli Foreign Ministry as a missed opportunity. In the meantime, improving relations with other Arab countries have led to a potential paradigm shift, which Israeli Prime Minister Netanyahu has explained on multiple occasions in recent months. For example, he said in a recent speech shortly after the Egyptian foreign minister’s visit that “[w]e have always said that the moment we solve or make progress or have a breakthrough in peaceful relations with the Palestinians, we’ll be able to achieve peaceful

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36 There have been numerous proposals along these lines throughout the past two decades. See, for example, Geoffrey Aronson, “Building Sovereignty in Palestine – A New Paradigm for the Gaza-Egypt Frontier,” paper for Canada’s IDRC, April 19, 2007, available at: http://fmepp.org/wp/wp-content/uploads/2015/01/rafahfinaldraft_ap07.pdf, and references therein.
relations with the entire Arab world. There’s no doubt this is always true—but more and more, I think this process could also run in the opposite direction: The normalization of advancing relations with the Arab world could help to advance peace—a more sober, stable, and better-backed peace—between us and the Palestinians.”38

In fact, this is not a new vision, but one that was advocated by Shimon Peres and others a quarter century ago as “The New Middle East,” in which, as Peres put it, “ultimately, the Middle East will unite in a common market—after we achieve peace. And the very existence of this common market will foster vital interests in maintaining the peace over the long term.”39 At the Paris conference in June, U.S. Secretary of State John Kerry said he planned to work toward organizing an international peace conference by the end of the year, which would coincide with the last few weeks of the Obama administration. A more productive approach would be to begin planning for a major Madrid-style international conference in 2017, when the new administration would have ample time to follow through. Ideally, this conference should not be focused on the narrow Israeli-Palestinian problem, but would bring together corporate and political leaders to forge a regional Vision 2030 that leverages the potential regional economic peace dividends to incentivize parties to reach peace.

Nationalist fervor and myopic and narrow short-term interests in various countries are quite likely to present significant resistance to this effort. Indeed, as we have seen in this paper, these same narrow worldviews have driven Egypt and Saudi Arabia to fashion their own discordantly narrow national 2030 visions, despite their multiple historical ties and obvious complementary production factors. Not only did these visions fail to transcend narrow national interests to consider regional synergies that can make the whole more than the sum of its parts, but they also have failed to present viable paths for their respective countries that are consistent with its neighbors’ visions. An alternative approach to regional industrial planning would include all regional countries’ economic plans in calculating each country’s potential comparative advantage and path to long-term economic success.

The United States can play a pivotal role in reviving the lost drive for regional economic integration—leveraging our incomparable advantage as home to the largest and most sought after market, as well as to corporations that can introduce technical and managerial knowledge to transform the Middle East’s capital and idle resources, including labor, into globally competitive production chains. In parallel with Netanyahu’s recognition of the political paradigm shift—that peace with the Palestinians goes through other Arab capitals—we may come to recognize another economic paradigm shift: that common interests in economic peace dividends can be drivers of political peace, and, despite all the obstacles, economic and political conditions may be better for pursuing this vision today than they were in 1991.