Saudi Arabia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS 25 April 2012

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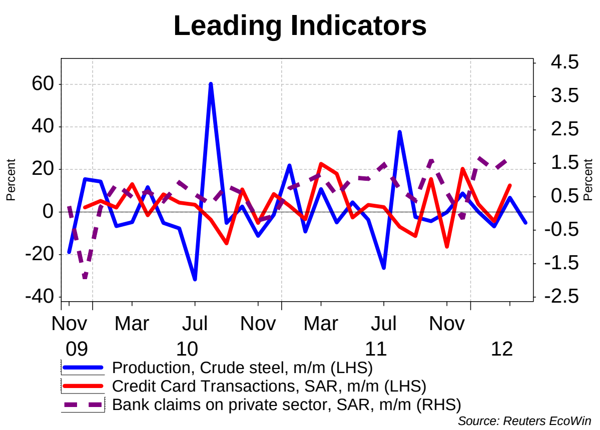
Saudi Arabia: Country Risk Factors

Strengths	Weaknesses
• Decent GDP Growth Rate • Strong Public Finance Ratios • Large Current Account Surplus • Sizeable Fiscal & International Reserves	• Low Economic Diversification • Monetary Policy Tied to the US • Low GDP per Capita • Highly Discriminatory Society • Undemocratic Political System • High Youth Unemployment

Summary: *Saudi Arabia's country risk profile is dominated by two sources of risk: 1) a prolonged fall in world oil price; and 2) simmering domestic and regional social, religious, and political tensions. Although socio-political conflict may escalate without a fall in the price of oil, it will likely remain manageable as high oil prices will provide the regime with ample resources with which to placate disaffected and unemployed youths, discontented religious activists, as well as reformist liberals. While disagreement with Iran over Syria, Lebanon, and Bahrain, as well as over Iran's nuclear programme will continue, Saudi Arabia will most likely avoid an open confrontation, due to the potentially destabilising effect it would have on the kingdom.*

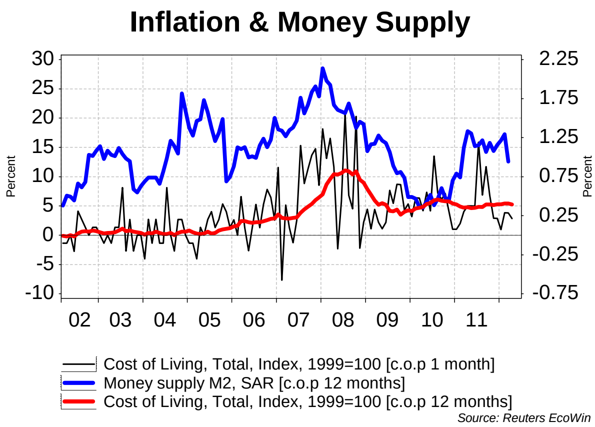
Country Risk Analysis

GDP growth is robust. Real GDP expanded by an above-potential 6.8% in 2011, up from 4.6% in 2010, driven by expanding oil output, rising oil prices, and increasing government spending. Growth will likely moderate to a still-strong 4.5% in 2012 on the back of slower growth in government spending and a smaller rise in oil revenues. The limited number of leading economic indicators that are available for Saudi Arabia also point to a softening of activity with HSBC's purchasing managers' index (PMI) weakening to 58.7 in March from 60 in January, 2012.

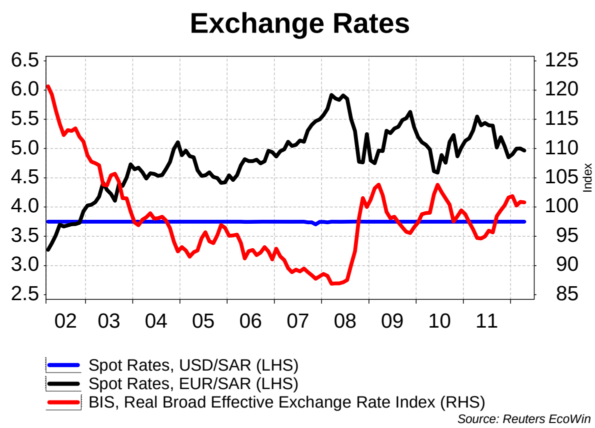


Saudi Arabia suffers from low economic diversification. Saudi Arabia holds almost 20% of the world's known reserves of crude oil, representing the largest share of any single country. Oil has allowed Saudi Arabia to build vast amounts of wealth and awarded the country with a pivotal geostrategic role. Barring a catastrophic event, Saudi Arabia's standing is unlikely to change for the foreseeable future, as reserves will last for roughly 80 years at current production levels. However, dependence on a single commodity has also come with its own set of problems. The oil sector accounts for half of GDP, but oil production and refining are capital intensive, leaving the regime in charge of creating job opportunities for the vast the majority of the population. The public sector employs an excessive 70% of the Saudi workforce. Oil also accounts for 80% of government revenue and 95% of exports. As a result, changes in the price cause volatility and unpredictability in public finances and the balance of payments.

The peg to the US *dollar* limits SAMA's monetary policy tools. Yearly inflation has trended upward since May 2011, when it bottomed at 4.6% y/y, reaching 5.4% in March 2012. The annualized month-on-month increase in March was lower at 3.5%, but is unlikely to herald significantly lower inflation in 2012. Monthly inflation tends to be cyclical with rates peaking in the middle — and towards the end — of the year. Inflation is likely to average 5% or more in 2012 fuelled by quickening money (M2) growth, reaching 17.3% in February 2012, higher oil prices, and fiscal stimulus.



Monetary policy is determined by the peg of the Saudi *riyal* to the US *dollar*, which has been in place since 1986. One benefit of the peg is that it tends to reduce volatility in the *riyal* value of oil earnings. It has also increased predictability and credibility of SAMA's monetary policy. However, it leaves the authorities with fewer tools to conduct monetary policy needed when Saudi Arabia's business cycle diverges from that of the US. The run up in inflation in 2008 to more than 10% is a case in point. While inflation has come down since then, it exceeds that of the US, thus hampering the development of non-oil (export) industries.



External finances are exceptionally strong. The current account recorded a surplus of 27% of GDP in 2011, up from 15% in 2010. The widening was driven by a near 40% rise in the average price of oil and a 6.3% rise in production. With prices staying high in 2012, the current account will likely post a surplus of more than 20% of GDP. Saudi Arabia does not publish data on its net international investment position. Nevertheless, assets (including reserves) held by the Saudi Arabian Monetary Authority (SAMA), which have increased to around 90% of GDP, provide an indication of the substantial resources at the authorities' disposal. The government owes no foreign debt. Gross external debt is low at close to 15% of GDP.

The strength of Saudi Arabia's external payments position is further underscored by the regular net inflow of foreign direct investment (FDI), averaging roughly 6% of GDP since 2007. Saudi Arabia ranks highly in 12th place in the World Bank's "Doing Business" index and have worked to attract investment in the non-oil sectors such as manufacturing (including oil refining), healthcare, and utilities.

Public finances ratios remain healthy. The rise in oil prices since the late 1990s has helped the government pay down public debt from roughly 120% of GDP to less than 10% in 2011. The budget surplus was 12.7% in 2011, despite a 25% increase in public spending. Given the large reserves held by SAMA (government deposits in SAMA reached 55% of GDP in 2011), the main short-to-medium-term threat to Saudi Arabia's public finances comes from a prolonged fall in the price of oil, a prospect that currently looks unlikely. However, over the medium to long term, population growth (currently between 2.3% and 2.5%), rising spending on social services, and expanding public sector employment may threaten the sustainability of public finances. Making matters worse is that the ratchet up of public spending — not only in Saudi Arabia, but all across the Gulf Cooperation Council (GCC) — on public sector employees, as well as housing projects and unemployment benefits risks becoming permanent and crowd out private sector development. Estimates of the fiscal breakeven price of oil vary between $70 and $90 per barrel. The breakeven price has risen sharply since social unrest broke out in North Africa, but could be levelling off if government spending growth slows and production increases.

Official unemployment is 8.5%, but the number of claimants of unemployment benefits indicates that the rate may be double. In addition, youth unemployment is close to 40%, a level that appears unlikely to come down any time soon. With almost half of the population under 21 years old, roughly 400,000 young Saudis enter the workforce every year. However, private sector employment creation is only around 200,000 per year, a fraction of which are taken by Saudi nationals, as public sector employment pays more and unemployment benefits are higher than private sector salaries.

Socio-political fault lines are deep. Both domestic and international (regional) social and political tensions and conflicts may destabilise Saudi Arabia. Among the key factors driving domestic discontent and potential political instability are the succession of King Abdullah, unemployment, religious intolerance, anger towards foreign involvement in the country, the lack of democratic rights, and gender discrimination. King Abullah has introduced gradual reforms, including allowing women to vote in municipal elections. However, meaningful political reform is not on the agenda. In addition, Wahhabism remains dominant and will make any attempt to free up women's participation in the economy and society highly controversial. Simmering tensions and competing interests between Saudi Arabia and Iran, as well as with Yemen (which harbours Al Qaida in the Arabian Peninsula [AQAP]), could also pose a threat to stability in the kingdom. However, due to its pivotal role as an oil producer and ample fiscal resources, the regime will continue to contain domestic discontent and stave off serious international conflict that could destabilise the monarchy.

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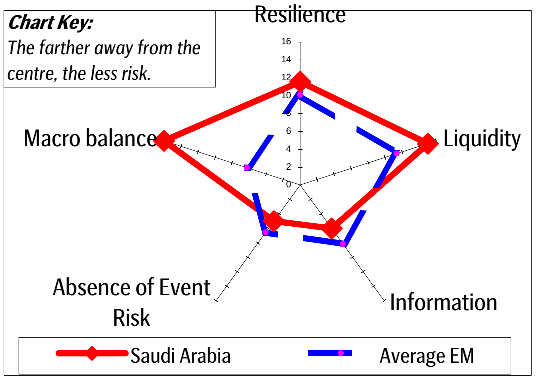
Saudi Arabia: Risk Profile

Key Ratios	2012
Population (mil)	28.7
GDP/capita ($)	21,583
Real GDP (% chg)	4.5
Inflation (%)	5.0
Curr.Acc. Balance (% of GDP)	23.4
Reserves/imports (months)	57
Budget balance (% of GDP)	11.6
Government debt (% of GDP)	6.1



External ratings:
Fitch: AA- / Stable
Moodys: Aa3 / Stable
S&P: AA- / Stable

Peers:
Kuwait
UAE
Czech Rep.

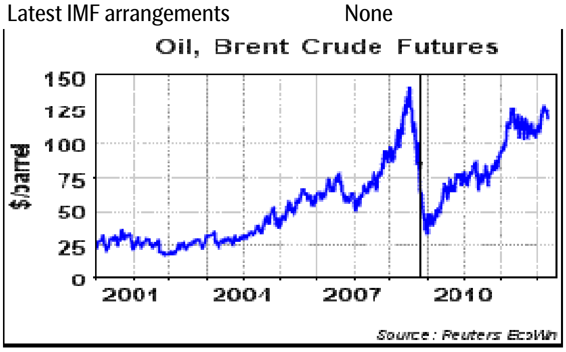
Graph: Strengths include a large current account surplus, healthy budget indicators (macro-balance factors) and high reserves (liquidity). Event risk and the relative lack information are weaknesses.

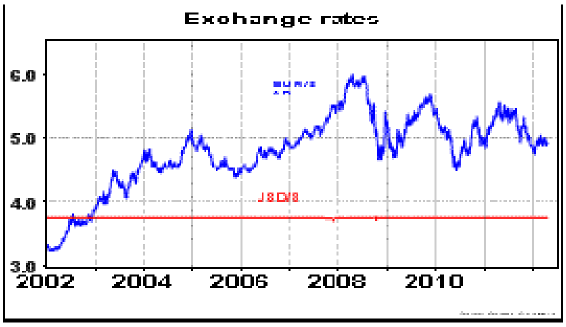
Saudi Arabia: Economic Indicators

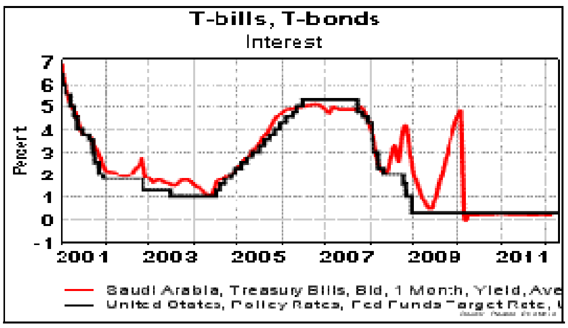
Macroeconomic	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
GDP real (% chg)	4.2	0.1	4.6	6.8	4.5	4.7	4.4	4.2
GDP (bn US$)	476.3	376.7	450.8	576.8	619.1	653.3	688.2	731.1
GDP/capita (US$)	18,260	14,073	16,423	20,552	21,583	22,294	23,002	23,940
Investments/GDP (%)	19	24	21	19	21	21	21	21
Trade/GDP (%)	87	74	77	80	78	71	71	70
Oil production, bpd ('000)	9,261	8,250	8,900	9,463	9,900	10,080	10,171	10,334
Money & Prices								
CPI inflation (%)	4.2	9.9	5.1	5.3	5.0	4.8	3.9	3.5
Money, M2 (% chg)	18.0	10.8	5.2	4.6	23.2	5.5	5.4	6.2
Interest rates (%)	2.9	1.2	2.0	2.5	4.0	4.5	4.5	4.5
Stock prices (% chg)	1.6	-34.9	22.4	7.0	-	-	-	-
Exch. Rate (US$)	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Government Finances								
Budget balance/GDP (%)	32.5	-6.1	5.2	12.7	11.6	4.4	3.3	2.3
Govt debt/GDP (%)	13.6	15.9	9.9	7.1	6.1	6.1	6.1	6.1
Balance of Payments (US$ bn)								
Current account	132.3	21.0	66.8	155.9	145.0	109.6	97.3	97.5
(% of GDP)	27.8	5.6	14.8	27.0	23.4	16.8	14.1	13.3
Export of goods	313.5	192.3	251.1	362.9	375.0	348.7	363.0	381.8
Imports of goods	101.5	87.1	97.4	101.1	106.2	115.1	123.3	131.3
Other current acct flows	-79.7	-84.3	-87.0	-105.8	-123.8	-124.0	-142.4	-153.0
Net FDI	36.0	34.3	17.7	22.6	25.6	27.0	28.5	30.3
Debt service requirement	-7.3	-8.6	-7.7	-8.0	-8.2	-8.5	-8.9	-9.3
Net other capital flows	-24.9	-90.0	-41.3	-83.5	-132.4	-100.2	-91.1	-94.5
Chg in intl reserves	136.1	-43.4	35.3	87.0	30.1	27.9	25.9	23.9
External Debt & Liquidity (US$ bn)								
Reserves	440.1	396.7	432.1	519.1	549.1	577.0	602.9	626.8
Gross external debt (% of GDP)	16.4	21.8	19.1	15.2	14.4	15.9	17.7	19.4
Gross External Debt	78.1	82.1	86.1	87.5	88.9	103.9	121.5	142.0
o/w short term debt	18.7	28.7	31.8	33.0	31.6	35.8	40.5	45.8

*Source: OEF (Oxford Economic Forecasting) and SEB estimates. *IMF forecast*

Type of government:	Absolute Monarchy
Next parliamentary elections	None
Other:	
Latest PC deal	None
Latest IMF arrangements	None







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