Saudi Arabia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS April, 6 2015

Analyst: rolf.danielsen. Tel : +46 8 763 83 92. E-mail : rolf.danielsen@seb.se

The recent steep drop of the global oil price is facing Saudi Arabia with mounting challenges of financial, political and social nature. Barring a near term rebound the country is likely to feel rising pressure on its present strong investment grade rating within one or two years.

Country Risk Analysis

Rising with the global thirst for oil: For more than a decade Saudi Arabia has been riding on the back of strong oil revenues buoyed by unexpectedly high global oil prices. Solid government and external balances fostered an environment of fiscal largesse supporting rapidly rising living standards for the local population. The steep drop in the oil price toward the end of last year, however, is now presenting the country with new realities.

Much now depends on the oil price. In a scenario where this gradually recovers towards $80/barrel at the end of the decade, the country can see light in the tunnel but will still have to adjust government expenditures to avoid too rapid growth of government debt and challenging deficit financing in the meantime. The external accounts, by contrast would still remain in surplus, albeit a much reduced so.

Should the present oil price become the new normal: With oil prices at the present low level at $55/barrel and continued global market glut preventing Saudi Arabia boosting oil production, the situation would look much more challenging. Unsustainably high annual budget deficits in the range of 10-15% of GDP would force through rapid and painful adjustments. In this case the external balance would also dip into the deep red with potential ramifications for Saudi Arabia’s long-standing currency peg to the US dollar.

Such a situation could put pressure on the social compact:. So far the relationship between rulers and subjects has passed the test for more than hundred years. The recent royal succession following the death of King Abdullah with the subsequent ascendance of Crown Prince Salman to the throne, proved as smooth as could be wished. Nevertheless, gradual opening to the outside world through internet and travel for common people presents a new element in this relation. The country may also face challenging choices in a region in growing turmoil. In recent weeks, Saudi Arabia has become involved in a proxy war with Iran in neighboring Yemen

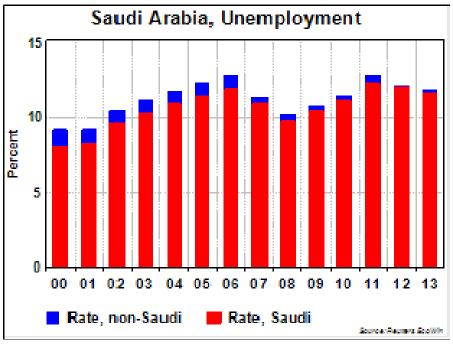
Ratings: So far only one rating agency has issued a warning of a possible future sovereign down grade. Others have held back on such a decision pending economic policy reactions and the further oil market development. That may seem reasonable for the time being but the next budget presentation in December for 2016 is likely to present a crucial test without an improvement to present oil market conditions

Recent developments:

Trailing growth: Coming from several years of high growth rates of more than 5% a year, the economy has started to trail and last year achieved only 3,6% expansion of activities. That was mainly due to weakening non-oil private sector activity while rising output of crude to 9.6mbd (million barrels a day) and added refinery capacity increased value added of the oil sector. Weakening non-oil momentum has continued into the first months of the current year with less buoyant PMI readings of January and February. Private sector growth is set to decline slightly to 5% still upheld by the ongoing commissioning of new industrial complexes including the large Sadara petrochemical industrial complex. In return, oil production, dominating 44% of the economy, could fall somewhat back reversing last year's modest expansion. That will leave GDP in 2015 up only 2.2% on last year's result. The situation would have been worse without steady growth of government spending -- the traditional driver of non-oil activities -- at 3,5% a year. A generous two months bonus salary to all government employees from the new King, Salman, as of last January, should present a temporary boost to private consumption. -- It is noted that some of the apparent performance weakening compared with previous estimates is due to new national account statistics as explained in Box 1.

Box 1: New National Accounts: Recently published National Accounts based on a new base year shifted from 1999 to 2010 present an economy more dependent on the oil sector. The share of the latter has more than doubled to 44% of GDP largely due to higher prices of crude. By the same token the growth rate for the entire economy has been re-estimated and adjusted down from 6,4% to 5,7% for the 2010-2013 period. The shares of oil in total export earnings and government revenues have remained unchanged at more than 80% and 90% respectively.

Unemployment declines in particular among women. Overall unemployment declined slightly in 2014 to 11,5% as a result of lower unemployment among women. That reflected higher female labor market participation which has jumped from 12% to 18% over the past five years. These labor market statistics refer to the Saudi labor force. Unemployment among expatriates is significantly lower as residency is tied to employment. Most expatriates earn only a fraction of the salaries of their Saudi colleagues and as such are popular among private employers. However, in part for demographic reasons the standing policy is to gradually replace expatriates with Saudis – so called *saudization*. In 2011, the government launched a new effort introducing subsidies for Saudi workers financed by fees on expatiates. Since then, *saudization* has proved successful in raising the share of Saudis in manufacturing from 11% to 15%, against objections from many foreign businesses, however.. Even so, none of this appears to have made a meaningful dent on still very high 28% youth unemployment.



Price pressure abates. Because of the longstanding and firm peg of the Saudi Rial to the US dollar, the rate of annual consumer price inflation has largely followed its US counterpart for more than a decade. Recently, however, it has remained in the 2-3% range and consequently somewhat departed from the lower annual price deflation in the US. That is in part due to higher prices of foodstuff and rapidly rising rents and house prices in Saudi Arabia. .

The trade balance weakens sharply. In 2014 export receipts fell 5% to $356 bn. their lowest level in four years as the global oil price collapsed toward year-end. With recent months' continued oil price decline and oil exports counting for 80% of total merchandise exports, we estimate an accelerated fall to $217bn based on an average oil price of $51 at Saudi export terminals, equivalent to $55 for Brent quality out of Rotterdam. Among other exports petrochemicals account for 60% and rising shipments should compensate for some of the loss from crude exports. . Imports, by contrast, continued to rise at a moderate pace in 2014, ending 2% up at $156bn.. We expect this trend to continue into the current year fueled by ongoing fiscal largesse. As a result of opposing export and import developments, the weakening of the trade balance in 2014 will accelerate rapidly in 2015 leaving a much reduced surplus of some 12%/GDP down more than 16 pp (percentage points) from the year before.

Current account balance turns red: Also net exports of services and income payments turned sharply negative in 2014 as labor market conditions including *saudization* prompted many expatriates to leave with their savings out of the country. Continued generous official support for poorer regional countries including Egypt, Jordan, Yemen and the West-bank/Gaza contributed to the negative income balance. Combined with the smaller trade surplus this produced a reduced but still positive current account balance in 2014 of some $90bn, equivalent to 12% of GDP. . In the current year, these developments in the income and services balance are set to continue. Combined with a sharply reduced trade surplus they will turn the current account into a non-negligible deficit of $27bn. or 4% of GDP.

Capital transactions help maintain reserves. Continued moderate levels of FDI inflows (foreign direct investments) at $5bn a year and a stable situation as regards loan repayments and other capital flows, we estimate reserves to fall in line with the current account deficit in 2015. That means a break with recent years' trend of rapidly rising foreign reserves held at the Saudi Arabia Monetary Agency (SAMA), the *de facto* central bank. Last year, they peaked at almost $800bn. exceeding the value of annual GDP. They were also sufficient to cover more than five years of merchandise imports. At the end of the current year they could decline to about €730bn., still representing one of the largest official foreign reserves in the world, behind only China, Japan and Norway.

Saudi capital markets pointing upward: The stock market stayed strong during most of 2014 until a minor correction occurred at the end of the year probably in sympathy with the oil price drop. So far in 2015, the market has seen a rebound and sentiment indicators suggest the upbeat mood to prevail for more months unless the authorities impose measures too cool the rapid rise of bank lending for equity purchases. With a price/earnings ratio around 20, many observers comment that the market is about to look "frothy", but others point out that plans to open the market for more categories of foreign investors suggests more miles to run for the present bull market.

Policies

The budget balance dips into the deep red: Early in the current decade, annual fiscal results exceeded budget projections by a wide margin. The surplus run up to 14% of GDP, riding on buoyant oil revenues which normally account for almost 90%

of total government receipts. That prompted fiscal laxness with overspending eventually rising to 25% above budget allocations in 2014. This began to eat into the budget surplus, which came down to less than 7% in 2014 and is now set to deteriorate sharply in the current year as brisk overspending continues while oil revenues nosedive. Provided our whole year estimate of the global oil price holds stay at $55 in Brent terms the deficit may rise to a high level of 8% of GDP. That estimate is still rather moderate compared with other observers (Conf. Box 2) as the authorities are assumed to rein in capital expenditures as new government projects are postponed when others come on-stream before year end. According to IMF calculations and without budget adjustments the break-even oil price for the budget in 2015 has reached $106 -- up from $80 in 2012 and clearly above current prices.

Box 2: Estimates of budget balance, 2015:

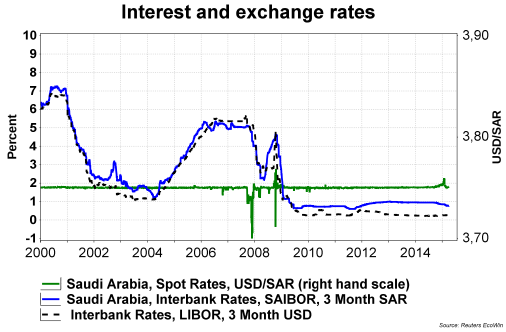
Source	Budget balance %/GDP	Oil price $/barrel	Publication date
Government	-5%	$60[1]	December 2014
Moody's	-5%	$80	December 2014
Fitch Ratings	-10%	$70	March 2015
IMF	-1,6%[1]	$102	September 2014
Jadwa Invest	-6%	$79	January 2015
SEB/Oxford model	-8%	$55	March 2015

Do we see the entire deficit? In contrast to other parts of financial and economic statistics of Saudi Arabia, IMF notes that fiscal accounts as disclosed publicly still leave much to be desired in terms of clarity and transparency. In this context we note some apparent confusion as to whether the deficit estimates referred to above include all expenses which in one way or another can be attributed to fiscal policies. That is in particular relevant as regards capital expenditures. Public pension funds apparently co-invest in government projects which would be a concern as regards their ability to meet future liabilities in case these projects are not undertaken on a pure commercial basis. That is important as demographic projections indicate a steep rise in number of persons above the retirement age toward the end of the decade.

Deficit financing: Many investors and observers express great confidence that Saudi Arabia's large foreign reserves and government deposits in SAMA present a *Blanco* guarantee to the solvency of the government and that of the country itself for many years going forward. The belief is often expressed that reserves will secure the capacity of the government and the country to meet future payment obligations for a long time. Nevertheless, last September the IMF noted that should the oil price fall $25/barrel below its baseline projection of $97/barrel as the assumed average at that time of the period 2015-19 government's reserves at SAMA would last to 2018 only, without significant adjustments to the fiscal budget. In addition, we note that if such financing should take place by drawing down reserves at the central bank, i.e. monetizing the deficit, the banking system would be inundated in liquidity to an extent that would present a potential destabilizing threat to domestic financial markets and ultimately the banks. An extension of the present low oil price would shorten such a "grace" period by a half, meaning that the government could feel pressure on deficit financing already in 2017.

Government debt: Instead of financing the deficit by drawing down reserves at SAMA, the government can issue bonds and would be in a strong position to do so. This is what it did last time when it experienced fiscal deficits in the 1990s. Government debt is now down to a miniscule 3% of GDP and many investors would presumably be happy to buy into new issues and receive exposure to the sovereign. However, should the total deficit be financed over the bond market, where local banks have normally been the main takers of government issues, the market would probably be saturated after a few years only. The government would then be forced to offer higher rate of interest to attract a wider public. Failing to do that 20 years ago eventually prompted reluctance among banks to buy more government debt. At the end the government at that time resorted to partial financing by payment arrears to suppliers. A mixed approach would probably be optimal and extend "easy" deficit financing to the end of the current decade.

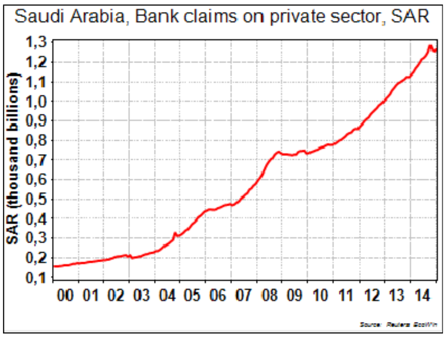
Monetary policies: The *de facto* peg of the riyal to the dollar for several decades (formally since 2003) has in principle made monetary policy redundant. However, since 2009 SAMA has held its two policy rates vis-à-vis the banks, i.e. the repo rate and the reverse repo rate, unchanged at 0,25% pa. and 2% pa. respectively despite more frequent changes by the US Fed. That may explain some of the difference between Saudi and US interbank rates for similar maturity of recent years, despite the relative freedom to make payments and capital transactions across the respective borders. Some capital transactions, including sales and purchases of stocks are not yet completely free from the Saudi side, however.



Reform policies: With a score at 49, Saudi Arabia is just below the average among the total of 175 countries surveyed worldwide on Transparency Internationals Corruption Perception Index. In 2011, in order to improve this poor result the government set up a national Anti-Corruption Commission. Another issue often criticized with regard to economic efficiency is the low cost of energy charged the country's citizens which is widely blamed for encouraging excessive use of energy for air conditioning in houses and desalination of water for industries and agriculture. It is estimated that forgone fiscal revenues from low domestic energy prices cost the government 10% of GDP every year. However, as a political and social issue this appears still far from being addressed in a fundamental way by present policies. – Political reforms have made progress in terms of female participation. General suffrage will be granted women in next municipal elections and female representatives have also been accepted to the *Majlis al-Shura* – the consultative council to the government. (for other structural issues or risks pls. conf Box 3)

Box 3: Doing business in Saudi Arabia: World Bank produces the results of an annual survey "Ease of doing business" based on the responses from a large number of companies world-wide. For many years Saudi Arabia has scored reasonably well on this indicator, although below most peers. That is also the case with another indicator: "Rule of law". Against that background, the authorities' reaction to recent statements regarding Saudi Arabia by two Swedish politicians -- one of them in the capacity of government minister, may seem surprising. The Saudi immediate response was to ban all travel to the Kingdom for Swedish business people. While the statements were clearly critical and held in a somewhat derogatory non-diplomatic language, the response was nevertheless unusual. When the Nobel Committee of neighboring Norway, an independent body consisting of many former active politicians, awarded the Peace Prize to the dissident Liu Xiaobo in 2010 the negative response of the Chinese government did not affect business, at least not overtly. The unusual and unexpected Saudi response against a third party will probably show up in the results of the next World Bank survey "Easy of doing business". **The latest development in this case indicates, however, that the crisis in the Saudi-Swedish relation may have culminated and that the Saudi Embassy will resume processing visa applications for Swedish business.**

Brisk credit activities from solid banks. Over the last 7 years credit to the private sector has doubled and last year grew by an extraordinarily high rate of 13% – more than 10% in real terms. This banking activity has prompted the regulatory authorities under SAMA to curb lending activities in particular for real estate, including mortgage lending, by imposing a minimum down-payment worth at least 30% of the value of the house. Recently, they have mulled plans to slow credit expansion for stock investments. Despite this intense activity and rapid expansion banks are considered robust with non-performing loans (NPL) standing at only 1.5% system-wide of their total loan books. Moreover, that is covered more than 1.6 times by provisions. The weighted capital to output ratio (CAR) stands at a strong 18% for the system and all banks are Basel III compliant since 2013 -- ahead of many peers including OECD countries. That said, however, it is not unusual that banks look strong in any country following a long economic boom and the litmus test is how banks will perform in the down cycle. Saudi banks also benefit from interest free funding from piety customers which may not hold should economic circumstances prompt depositors to seek higher remuneration by investments in other assets.



Politics

King Salman ascends to the throne: Last January, King Abdullah died and Crown Prince Salman ascended the throne. In an act not in accordance with traditions, King Abdullah, had already anointed Prince Muqrin as deputy crown prince and as such foregone the traditional right of the new King to appoint his successor. However, this had apparently been agreed with Salman as Crown Prince at that time, and the new king confirmed Prince Muqrin as the heir to the throne. Observers have rationalized this act against the background of the high age of both men, Abdullah is believed to have been 90 years old at the time of his death and Salman is now believed to be close to 80 years of age – combined with the common desire within the Royal family to maintain calm about the future line of succession.

Who will become the next deputy crown prince? Observers are now focused on the choice of the next deputy crown prince. Prince Ahmed, king Salman's brother would seem a natural choice. He is the youngest remaining of the Sudeiri brothers, the seven sons of King Abdulazzis – Saudi Arabia's founder – and his preferred wife, Sudeiri. That is even more so as King Abdullah – himself not a Sudeiri brother -- had anointed another not-Sudeiri brother, Prince Muqrin, to the immediate royal succession. However, Prince Ahmed is still three years Muqrin's elder, and high age does no longer seem a premium in the Saudi Royal succession line. Speculations are rather turning to the next generation of princes. While the new king is rumored to be of frail health, the new crown prince is not known to have any serious ailings. It may still be pointed out, though, that to preserve political calm it is imperative to anoint a deputy crown prince in order to quash potential rumors about disagreement within the family over the immediate succession line.

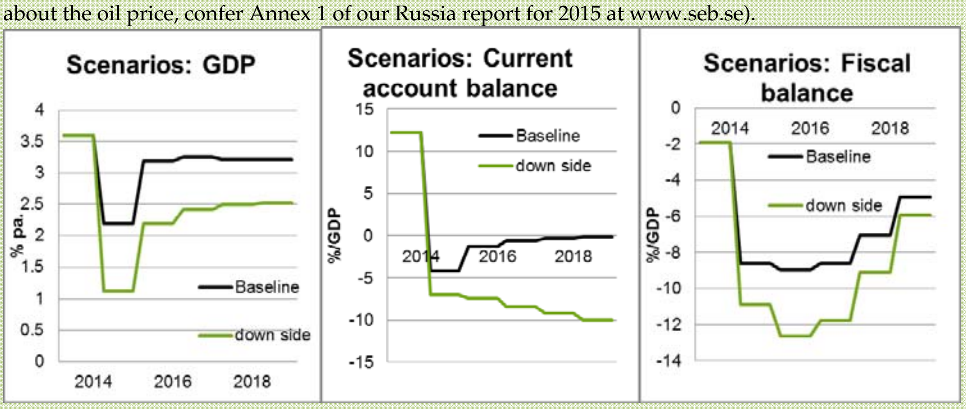
External security threats: The recent overthrow of President Hadi in neighboring Yemen by the Houthis is a new element of the larger power game in the Middle East along religious fault lines. The Houthis are Shias and clearly supported by Iran. By contrast, President Hadi and two thirds of the Yemeni population are Sunnis. Over recent weeks the Saudi air force has intervened on the side of President Hadi by bombing Houthi strongholds including in populated areas. This has raised popular ire against Saudi Arabia in Yemen's northern Houthi areas along the common border. Saudi Arabia has already been in conflict with the Houthis before and fought an inconclusive war against them in 2010. Focus is now on the new agreement between the US and Iran on the nuclear program of the latter. Will this encourage or restrain Iran in the on-going proxy war with Saudi Arabia in Yemen? Under such circumstances, should suspicion arise that Iran is abusing the agreement to cover up for a continued clandestine nuclear arms program, speculation are that Saudi Arabia will retaliate by acquiring its own bomb probably purchased from Pakistan. Barring outright war, hostilities alone could block the passage of most Saudi crude export.

Outlook:

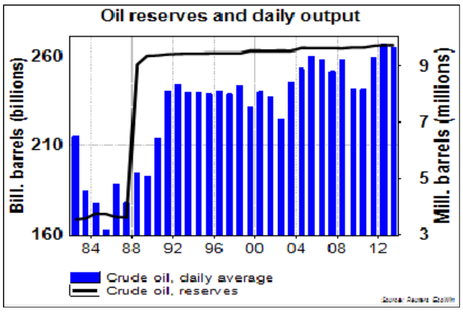
Short to medium term: Slightly lower oil production combined with weakening investor and consumer sentiment as it becomes obvious that lower oil revenues may force the government to stop its generous spending binge will almost halve the rate of economic expansion to 2,2% in 2015. Further on, much depends on the global oil market which, should one believe last year's assurances from Saudi officials, is something the Kingdom no longer will attempt to manage. That could prove a bluff if the Kingdom within a year or so makes a new shot at saber rattling with threats of deep production cuts. But the risk is that restoring order in terms of higher oil prices will prove short lived in any case. In a low price scenario around $55/barrel to the end of the decade, economic growth will not rebound to previous highs but stay sluggish. (Conf. Box 4.) For another country that might not have been a disaster but in the case of Saudi Arabia growth could prove too low to generate enough jobs for a rising population with already high youth unemployment.

Box 4: Low oil price scenario: Our baseline scenario see the oil price move up toward $80/barrel at the end of the decade. This is compared with a downside scenario run on the Oxford Model where the global oil price and Saudi oil output remains flat. Chart 1 below shows a relatively moderate effect on GDP shaving off about 1pp of growth in each year through the rest of the decade mainly reflecting reduced government investment demand and weak public sector wage growth.[1] The budget balance weakens more than 3%/GDP for several years which could begin to challenge the government's deficit financing toward the end of the decade. The current account deficit, by contrast, would escalate rapidly, still leaving, however, reserves at a high level of $500bn. in 2020 provided no escalation of capital outflows in the meantime.

Our take on this is that technically the country can sustain reasonable creditworthiness even in a down-case scenario with the oil price at the present level of $55/barrel thru the rest of the decade but will struggle hard to avoid downgrades to its present high sovereign ratings. (For a further discussion about the oil price, confer Annex 1 of our Russia report for 2015 at www.seb.se).

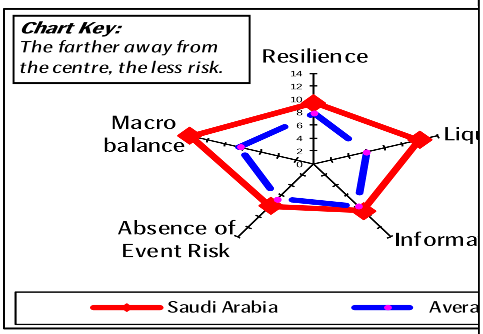


Long term: As noted above: Saudi Arabia's economy is highly dependent on oil. Crude represents nearly 90% of export revenues, and among the remaining 10% some two thirds are petrochemicals and other derivatives of hydrocarbon production. Over the decades attempts have been made to reduce this dependency on one commodity but with unimpressive results. With some 260bn barrels of oil in the ground the country has enough reserves to continue production at the present level for another 70 years at a cost often estimated at less than $10/barrel. The oil price, however, is likely paramount to the present political and social order. Over recent decades Saudi citizens have become increasingly accustomed to government largesse financed by an ever higher global oil price.



Recent months' steep drop of that price proves that this situation may not last forever. Even though external balances are not immediately under threat due to large foreign reserves, government deficits will rise fast and their financing can come to challenge financial stability or crowd out the private sector. Reining in the deficit too fast, however, could break a silent compact between rulers and subjects. So far the Kingdom has defeated all doomsayers but that may be thanks to a long history of isolation and suppression of dissent. But the spread of the internet to an estimated 60% of the population thus far and with higher income making foreign travel increasingly affordable to common Saudis, eyes will inevitably open to alternative forms of societal relations and governance. As has happened numerous times in other countries, deep cuts in disposable real household incomes can open an existential challenge to the existing social order unless this has been the outcome of the expressed popular choice in free elections.

Key Ratios	**2015**
Population (mil)	30
GDP/capita ($)	22 274
Real GDP (% chg)	2.2%
Inflation (%)	2.6%
Curr.Acc. Balance (% of GDP)	-4.1%
Reserves/imports (months)	55
Budget balance (% of GDP)	-9%
Government debt (% of GDP)	2%



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

Peers:
Kuwait
UAE
China

Graph: Strengths include a traditionally str
balance and liquidity, in contrast to our ass
high event risk and some lack of informatic
Resilience is slightly stronger than the aver

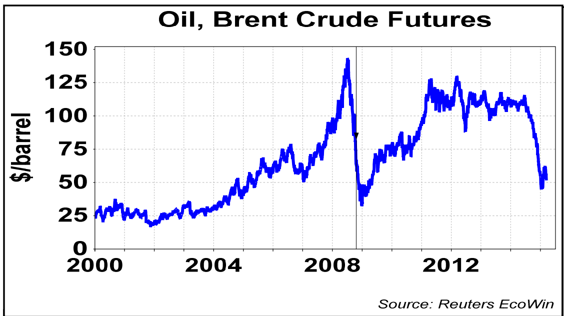
Key data:	2010	2011	2012	2013	2014	2015	2016	2017
GDP (mill.US$)	527	670	734	744	752	666	733	794
GDP/capita (US$)	19327	24095	25922	25807	25620	22274	24126	25722
GDP (real change)	4.8%	10.0%	5.4%	2.7%	3.6%	2.2%	3.2%	3.3%
Investments/GDP	24%	25%	25%	25%	25%	26%	27%	28%
Budget balance/GDP	4.4%	11.6%	13.6%	6.5%	-1.9%	-8.6%	-9.0%	-8.6%
Govt debt/GDP (*)	8%	5%	4%	3%	2%	2%	2%	1%
CPI inflation (%)	3.8%	3.7%	2.9%	3.5%	2.7%	2.6%	3.3%	3.5%
Money demand (%)	5.2%	27.1%	9.6%	1.4%	1.1%	-11.5%	10.1%	8.3%
Stock prices (yearly avg.)	27258	27786	28314	28842	29370			
Interest rates	3.4%	0.9%	0.7%	0.7%	0.9%	1.0%	0.9%	1.1%
Exch. Rate ($)	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Trade/GDP (%)	66%	72%	72%	71%	68%	60%	61%	60%
Oil price (Brent)	$80	$111	$112	$109	$99	$61	$70	$74
Millions US $								
Export of goods	251	365	388	376	356	241	275	297
Imports of goods	97	120	142	153	156	158	169	181
Other:	-87	-86	-82	-90	-107	-111	-115	-121
Current account	**67**	**159**	**165**	**133**	**92**	**-27**	**-9**	**-5**
(% of GDP)	12.7%	23.7%	22.4%	17.8%	12.2%	-4.1%	-1.3%	-0.6%
FDI	25	13	8	4	5	5	5	5
Loan repayments	-49	-42	-57	-47	-50	-63	-67	-69
Net other capital flows	-8	-36	-1	-21	-38	144	127	119
Balance of payments	**35**	**93**	**115**	**70**	**8**	**59**	**56**	**51**
Reserves (yearly avg.)	432	526	641	710	719	778	834	885
Total debt (yearly avg.)	91	88	84	83	89	111	118	122
o/w short term debt	36	29	44	34	37	46	49	50
Oil Prod. (mn.barrels/day)	8.2	9.3	9.8	9.6	9.7	9.7	9.8	9.9

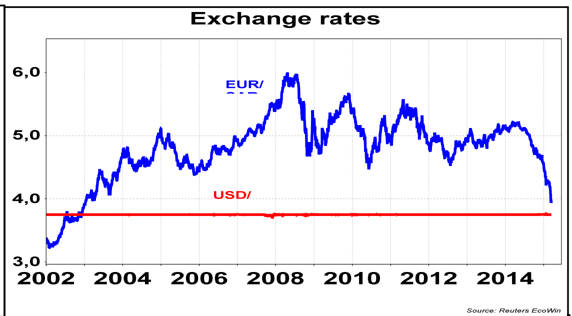
(*) Central government only

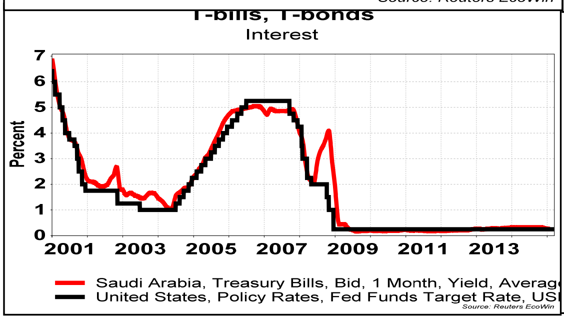
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	AA	AA	AA	AA	AA
Moody's (eoy)	Aa3	Aa3	Aa3	Aa3	Aa3

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







Disclaimer

Confidentiality Notice

The information in this document has been compiled by SEB Merchant Banking, a division within Skandinaviska Enskilda Banken AB (publ) ("SEB").

Opinions contained in this report represent the bank's present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.