Saudi Arabia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS | April, 28 2016

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In 2016, Saudi Arabia finally began the long path of adjustments toward the new global oil reality. While these are still baby steps few observers doubt it will eventually do what is necessary to restore economic balances. However, new ambitious plans for rapid restructuring to wean the economy off its oil addiction could put the society and political stability to a serious test.

Country Risk Analysis

The economy yields to tumbling oil revenues: The high oil revenues that for decades fuelled the domestic economy plunged 50% last year and is set to decline further. While high government spending continued unabated in 2015 helping maintain domestic demand, this year's budget execution is likely to show more restraint thereby cooling growth to only 1% as private sentiment suffers.

Growing external imbalances: Last year the current account balance turned into a deep red deficit of 8%/GDP which is set to weaken further to a record 14%/GDP in the current year. That has been accompanied by sporadic pressures on the exchange rate prompting the central bank to intervene. However, reserves are still very large and enough to cover the deficit comfortably for years going forward. Most observers are confident the central bank will remain committed to its longstanding dollar peg.

Correction of government largesse. While the government also can finance its deficit for coming years by drawing on deposits in domestic banks it has now clearly signaled a turn to less largesse. For the current year the projected deficit is still huge at 14%/GDP, but price hikes of heavily subsidized fuel and utility prices combine with the winding down of government mega projects including infrastructure while pruning growth of public sector salaries. Officials have mulled plans for partial privatization even of the national oil company, Aramco, to help finance the deficit.

Political developments demand heightened investor attention: Having overruled his predecessor's succession recommendation and then compounding matters by promoting his young son to deputy Crown Prince, the new King, H.E. Salman, has started his reign of late 2014 in an extraordinary manner. His son has even been given broad powers over foreign and economic policies. One rating agency notes that this may have accelerated the decision process but also reduced its predictability and continues: "The degree of support for this accumulation of power from other parts of the royal family is uncertain." In addition, the regional rivalry, in particular the tensions with Iran, seems to be growing in intensity.

Ratings: Over the last 12 months one rating agency has downgraded the sovereign within a still strong investment grade, while the two others have issued warning of future negative rating actions mainly on growing economic and financial concerns. As before, country risk is naturally slightly weaker as the private sector cannot boast the same financial resources nor to the same degree rely on government backing. It is still clearly in investment grade, though, but also affected by the same forces that is hitting the sovereign.

Recent developments:

The high oil revenues that for decades fuelled the domestic economy plunged 50% last year and is set to decline further. While high government spending continued unabated in 2015 helping maintain domestic demand, this year's budget execution is likely to show more restraint thereby cooling growth to only 1% as private sentiment begin to suffer.

Growth plunges: While it was clear from the beginning of last year that the economy had encountered chilly headwinds, it still managed to grow 3,4%. That was better than expected and almost as fast as the year before, mainly due to non-oil expansion. This was in large part supported by private consumption on the back of two months bonus payments, one to celebrate the new King and the second representing the odd-year compensation for the difference between the Hijji and the Georgian calendar years. In 2016, by contrast, this will not be repeated and expectations are now for non-oil growth to reduce to only 1%, which will translate into 0,8% growth for the whole economy factoring in also 0,2% higher oil production which make up some 40% of total GDP. That steep deceleration largely reflects announced austerity measures in the new fiscal budget, including cuts in subsides for fuel and utilities. The economic slowdown would have been sharper without the cut to the external deficit in real terms reflecting the compression of imports.

Unemployment edging up: Despite employment growth of more than 3% a year, unemployment remains an important economic and social issue due to very strong population growth at almost 5% pa. Saudi Arabia has since long had a dual labor market with very low unemployment among the dominant expatriate labor segment because residency is tightly linked to employment. Among nationals, by contrast, 11,7% of the labor force was unemployed in 2015 and the prospects for them are unlikely to improve in the current year. The problem is mainly related to female labor where one in three reports looking for a job. Next are youngsters where some 30-40%, depending on registration method, are unemployed. Various reasons are cited for this, including unrealistic employment expectations among job-seekers but also a minimum wage of some SR3000/month, higher than salaries offered many expatriates who otherwise face even lower wages in their countries of origin. To ease the situation for job-seeking nationals Saudi Arabia has introduced unemployment insurance and job-programs.

Inflation still high: Despite slowing activity inflation shot up to 4,3% year-on-year (yoy) in last January triggered by the noted hikes of government regulated prices. Projections are for price pressure to remain around this level in 2016 before gradually easing to around 2% pa. in coming years, i.e. the normal accepted as a part of the social compact in a country where many people do not claim interest on bank deposits.

Rapidly falling trade surplus: For the first time in decades Saudi Arabia is set to record a diminishing trade surplus stemming from the steep drop in the oil price of more than 60% over two years and also reflecting the dominating 80% share of crude in total exports. Other exports are dominated by oil related products, including refined products and petrochemicals, with prices closely correlated with global oil prices. In all, estimated export value for the current year is 30% lower than in 2015 and 60% lower than in 2013, the last year of high oil prices. On the import side, by contrast, the decline is less dramatic but at 8% still significant. As a result of the shrinking trade surplus and the underlying wide deficit of services, income and transfers stemming from the continuous outflow of money from expatriates, the current account balance has turned into a large shortfall which is set to double in the current year to 20%/GDP. Only a few years ago, Saudi Arabia used to sport current accounts surpluses of the same magnitude.

Falling but still large reserves. Estimated transactions on the capital account are subject to weak statistics. The reporting of in- and out-bound foreign direct investments (FDI) has apparently gone missing in recent years while private estimates show declining numbers. However, since June, 2015, Saudi Arabia has opened for limited inflows into its equity market which has received with a warm welcome from foreign investors. Foreign reserves, in return are published on the balance sheet of SAMA – Saudi Arabia Monetary Authority (central bank). In 2015, reserves fell by $40bn in part due to evaluation effects to end the year at $600bn. enough to cover four years of imports at the current level. SAMA reportedly lost some $10bn at the beginning of the current year, as it intervened to support the Rial.

Policies

While the government can finance its deficit for coming years by drawing on deposits in banks it has now clearly signaled a turn to less largesse. For the current year the projected deficit is still huge at 14%/GDP, but price hikes of heavily subsidized fuel and utility prices combine with the winding down of government mega projects including infrastructure while pruning growth of public sector salaries. Officials have mulled plans for partial privatization even of the national oil company, Aramco, to help finance the fiscal deficit. As to the exchange rate most observers believe the government does not plan any break with its long-standing de-facto peg to the dollar at this stage.

The government announces austerity: The fiscal deficit for 2015 ended apparently much lower than expected but was still huge at almost 15% and much higher than the first budgeted shortfall of only 6%. This outcome was affected not only by the larger than expected drop in oil revenues which represents some 80% of the total, but also by the two bonus packages to a cost of some 4% of GDP. The first package was linked to the ascension to the throne of the new King, H.E. Salman, a longstanding tradition in the Kingdom, while the second package was a regular one related to wage compensation for the difference between the Hijri and the Gregorian calendar every three years. However, a 12% drop in expenditures also helped to limit the damage to the budget balance. This was the result of stepped-up execution pruning for many of the government's large-scale infrastructure and construction projects, sport stadiums etc., as they were either slowed or not replenished when commissioned. In recent years, overspending above budget allocations have reached extraordinary proportions of more than 25% prompting observers to doubt if any budget control was still in place.

2016 promises more austerity but remains a far cry from what is needed: The budget presentation for of last December was built around further cuts in current spending of 2,3%. By hiking prices up to 70% for fuel and utilities the government can reduce subsidies. After this, a gallon of gasoline will rise to almost $1 but the main contributor are still further cuts to project overspending which should fall from an estimated 13% in 2015 to only 3% above budget allocations of the current budget. However, wages for the 1 mn public sector employees and the defense budget have so far not been touched in any major way despite the rapid rise of the latter. In recent years the government has ramped up defense to an estimated $85bn. the third largest in the world of any single country after the US and China.

Deficit down but still at a threatening high level: While the budget stipulates a deficit around 13%/GDP for 2016, observers believe it will likely end somewhat higher at around 14%/GDP. That is mainly due to failure to contain the noted project overspending but also uncertainty about the timely implementation of new taxes. They include higher sin-taxes and new taxes on unused land. The principle of no income taxes other than the 2,5% zakat on profits (as ordained by the Quaran), however, still appears to be respected. Assuming an oil price around the present level, $45, as the full year average, the budget situation could improve with the deficit falling further one or two percentage points (pp). It is notable that the new fiscal approach, albeit still shy of eye-popping measures, has gradually reduced the break-even oil price for budget balance from $106/barrel in 2014 to $80 in the present budget.

Deficit financing: As the budget has not been in deficit for almost two decades, the first reaction of the government was to draw on its ample savings of accumulated surpluses to finance the short-fall. Realizing that the deficit situation may persist last summer the government began to issue debt in the local market, eagerly greeted by banks and pension funds. For 2016, it has been mulling plans to extend issuance to foreign markets and recently negotiated a $10 bn. syndicated loan with international banks. The reason for this is hardly that the government is running out of cash mainly held as deposits with SAMA, although doubts have been raised as to the liquidity of these deposits taking into account that SAMA's foreign reserves are their main counterpart. At the end of 2015, government claims on SAMA stood at SR1130bn, about half of SAMA's foreign reserves. That is still down almost SR400bn since 2014 indicating that without new borrowing the government would run down its deposits with the central bank in about five years at the present rate of depletion. However, with a debt at only 1,5%/GDP at the outset, the sovereign should for the time being meet no major challenges in raising money from local and international markets.

Monetary policies: Having a peg to the dollar in a currency board arrangement, with virtually no restrictions on capital transfers for monetary policy purposes, Saudi Arabia is basically tied to US monetary policies. Nevertheless, last December SAMA reciprocated Fed's 25bsp interest hike by lifting its own policy rate by 50bsp. While technical considerations may have played in, the sharper rate hike could also have been in response to incipient new pressure on the Rial. That said, most observers disagree with many markets participants that a break with the peg could be imminent. The IMF argues that while a more flexible exchange rate would have benefitted stability of fiscal revenues in Rial term (like in Russia), the country's predominantly small scale import competing industries "..would have very limited benefits for competitiveness and could increase volatility of inflation." And concludes: "We expect Saudi Arabia to remain committed to its dollar-peg."[1]
It may be intervened, though, that what else could an official organization like the IMF say? The almost 14% real appreciation of the Rial (REER-terms) since 2014 combined with a 30% ToT (terms-of-trade) drop certainly represents a challenge.

Healthy banking system: The banking system has since long recovered from the times some twenty years ago when the government had no other means of financing its deficits than by forcing banks to buy government debt. Today, capital adequacy stands at 18% while non-performing loans (NPL) is down to 1,1%. That said, 40% of lending goes to sectors traditionally related to the country's oil revenues, including

[1] "Staff report for the 2015 Article IV consultation, IMF Washington DC, July 2015.

construction and commerce, and while mortgages still account for only 12% of total loans, they have been rising rapidly in recent years. All this means that bad loans could start accumulating and rise by a factor of 2,5 times in coming years at present low oil prices according to IMF calculations, although they should still prove manageable.[2] An oft-cited event risk for Saudi banks is linked to large single client exposures and corporate opacity in particular among large family owned conglomerates. That risk should now subside as the government recently capped the limits of such exposures from 25% to 15% of banks' capital. It has also introduced a general deposit guarantee, normally regarded as a stabilizing factor for the banking system of a country.

Structural policies

Diversification: Structural policies and reforms have been on the agenda since the 1990s but seldom moved far off the drawing board. Diversification of export revenues has come some way and now makes up about 20% of the total from less than 5% two decades ago. However, as noted above, much of this diversification has gone into products closely related to the oil industry, including petrochemicals and refined petroleum products. The modest success stems in part from the lack of motivation among private sector entrepreneurs and the authorities as long as oil revenues remained high enough to "gloss" over the problems. The same goes for privatization plans, restrictive labor regulations and meagre education standards among many nationals.

Privatization: As necessity is the mother of all inventions, the new winds of the global economy are forcing Saudi Arabia to rethink old behavior. The latest budget policy mulled privatization of ownership in sea and airports, the national airline, the stock exchange and even the country's only oil company Aramco, which controls oil fields that could be worth trillions of dollars. Even more ambitious reforms were recently presented by the Deputy Crown Prince, H.E. Muhamed bib Salman, in his "Saudi Arabia Vision 2030" plan for a radical transformation of the economy and society at large. Key results are to be achieved already before the end of the current decade including balancing both the budget and bringing more women to the workforce.

Politics

Internal – the grooming of a new ruler? The new king began his reign by reorganizing his administration and introducing two new high level councils, one for the economy and the other for political and security affairs. He let his son, H.E. Muhamed bin Salman, in charge of both and also promoted him to head the defense ministry after he had rearranged the succession to the throne by reappointing a new Crown Prince, H.E. Najif, and then his own son as the deputy CP thereby overruling the decision of his predecessor and half-brother, King Abdullah.

This is unprecedented but new winds have also been blowing through the royal family, the House of Saud. Transfer of power to a younger generation of princes could no longer be delayed but potentially grooming people as young as the deputy crown prince (age 34) for the throne was unlikely expected. It has generated comments among analysts such as while this may accelerate the decision process it may also reduce its predictability, because "The degree of support for this

[2] IMF Working Paper WP/16/22, An Empirical investigation of Oil-Macro-Financial Linkages in Saudi Arabia, Washington DC, 2016

accumulation of power from other parts of the royal family is uncertain." In fact to preempt controversies King Abdullah established the Allegiance Council as the top decision making body on the succession issue several years before he died, and it was this council that in early 2014 decided on the successor anointing Prince Muqrin as the new deputy crown prince. Then under the new king, H.E. Salman, about one year later, the Allegiance Council was convened to sideline Crown Prince Muqrin to the benefit of Prince Nayef. Procedurally this may give rise to many questions, but the main point is rather the new powers vested with the new deputy crown prince, Muhamed bin Salman.

External security:
Operation Decisive storm: Soon after the new responsibilities were bestowed upon the new energetic Crown Prince, now also defense minister, he opened war against the huthi rebellion in neighboring Yemen to restore political calm in that country. For a long period the Saudi forces failed to achieve a swift victory, but recent developments indicate that at least a truce could be within reach. The war has so far cost around an estimated $5bn. More importantly, some observers have seen this as a litmus test of the young heir apparent. That is underscored by the fact that huthis are shias and suspected of receiving support and arms from Iran. To win the war is also paramount to Saudi Arabia as the chaos caused by the conflict has reportedly presented fertile recruiting fields for al-Quaida and such terrorists could eventually return to Saudi Arabia. Most observers still see that threat as limited taking solace from the effective elimination several thousand terrorist "returnees" from Iraq in the late 2000 by Saudi security forces.

Saudi Arabia - Iran: Over the last decade the rivalry between Saudi Arabia and Iran has intensified. Some ten years ago the leaders of the two countries visited each other for regional and Islamic conferences. Last February, by contrast, Riyadh broke the diplomatic relations to Tehran alleging that the police of that city had shown insufficient effort in protecting the Saudi embassy from the mob when this reacted against the execution of a shite cleric in Saudi Arabia. Last December, Riyadh launched an Islamic alliance to combat terrorism without inviting Tehran claiming Iran was itself a supporter of terrorist organizations including Hezbollah. It soon after broke off the annual financial support to Beirut of some billions of dollars to the protestation and chagrin of Washington which feared Lebanon could fall deeper into the hands of Iran and Hezbollah. In fact, many observers see the new assertiveness of Saudi Arabia as a reaction to the perceived US detachment from the Middle East and rebalancing of its support among the countries of the region prompting is to aspire for a clearer regional leadership role.

Could the worsening between Riyadh and Tehran lead to war? A common argument against such an outcome is the high economic costs to everybody involved and the loss of oil-market shares to actors outside the region. However, a war would not necessarily hit all the gulf countries equally hard which could motivate those less affected to a first-strike. While Iran would have few alternative export routes should free passage through Hormuz be under threat, Saudi Arabia might still be able to maintain more than 60% of its exports by utilizing free capacity in its East-West oil pipeline to Yanbu on the Red Sea while the rise in the oil price would likely compensate the country for any loss of export volume.

Outlook

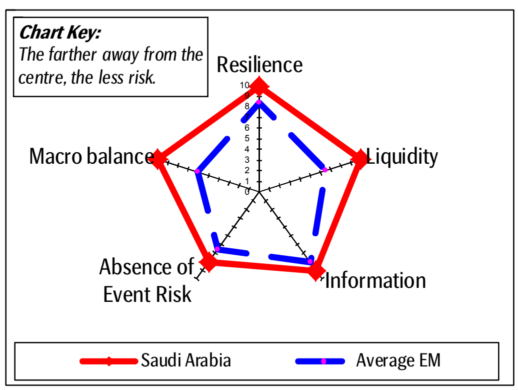
The near term outlook of Saudi Arabia is still reasonably strong. The lower oil prices have hit the country hard and the oil market is unlikely to return to its previous heights anytime soon. Actually, market control is now leaving Saudi Arabia and OPEC into the hands of North American producers. Vast finds of frackable geological formations on land means that for coming years marginal development cost estimated at around $60/barrel in Texas. Dakota etc. will set a ceiling for medium to long term oil price trends although short term disruptions may still occur. In contrast, the lower end of that price span is set by the global low-cost producer, Saudi Arabia, but that is hardly a very attractive market position.

Still most observers believe that Saudi Arabia will be able to adjust in a gradual manner to new market conditions aided by large reserves which means that economic shock therapies can be avoided. As such it should be able to maintain growth for the current and the next year of around 1-2% as fiscal austerity bites harder before yielding to some recovery at a 2-3% growth trajectory. In that scenario one would also expect a gradual consolidation of both the current account and the fiscal balances toward a sustainable path.

Medium term risks to this scenario include first of all political events. The tensions among the rivaling powers in the region, in particular Iran and Saudi Arabia, could end in outright hostilities with uncertain prospects although Saudi Arabia may not be the worst affected. Second, it may not be all clear that the new rulers have completely consolidated power. Should that be the case and internal power struggle erupts the world outside the royal court may not see anything more dramatic than a return to slow "old-man rule". But that may not be what the young Saudi population is expecting according to the recent Annual Arab Youth Survey based on interviews with 3500 Arab youths including Saudis.[3]

Saudi Arabia

Key Ratios	2016
Population (mil)	32
GDP/capita ($)	18 687
Real GDP (% chg)	1.2%
Inflation (%)	2.6%
Curr.Acc. Balance (% of GDP)	-20.2%
Reserves/imports (months)	48
Budget balance (% of GDP)	-17%
Government debt (% of GDP)	19%



External ratings:
Fitch: AA/neg.
Moodys: Aa3/under review
S&P: A+

Peers:
Mexico
UAE
Peru

Graph: Strengths include a traditionally strong macro balance and liquidity, in contrast to our assessment of in particular higher event risk. Resilience is slightly stronger than the average EM.

[3] http://www.arabyouthsurvey.com/en/home

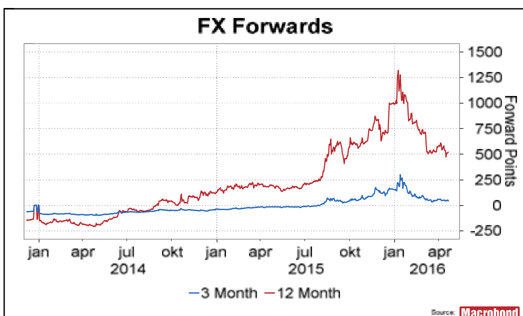
Key data:	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (mill.US$)	670	734	744	754	653	600	663	736
GDP/capita (US$)	23262	24905	24679	24435	20711	18687	20288	22132
GDP (real change)	10.0%	5.4%	2.7%	3.6%	3.4%	1.2%	2.4%	2.7%
Investments/GDP	25%	25%	25%	25%	24%	22%	22%	23%
Budget balance/GDP	11.6%	13.6%	6.5%	-2.3%	-14.8%	-17.0%	-12.6%	-8.5%
Govt debt/GDP (*)	5%	4%	2%	2%	6%	19%	25%	27%
CPI inflation (%)	3.7%	2.9%	3.5%	2.7%	2.2%	2.6%	3.2%	3.5%
Money demand (%)	27.1%	9.6%	1.4%	1.3%	-13.3%	-8.2%	10.5%	11.0%
Stock prices (yearly avg.)	28781	29471	30160	30850	31540			
Interest rates	0.9%	0.7%	0.7%	0.9%	1.0%	0.9%	0.9%	1.2%
Exch. Rate ($)	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Trade/GDP (%)	72%	72%	71%	66%	57%	49%	50%	51%
Oil price (Brent)	$111	$112	$109	$99	$52	$32	$40	$49
Millions US $								
Export of goods	365	388	376	342	214	148	180	216
Imports of goods	120	142	153	158	155	143	151	161
Other:	-86	-82	-87	-107	-121	-127	-133	-139
Current account	**159**	**165**	**135**	**77**	**-63**	**-121**	**-105**	**-84**
(% of GDP)	23.7%	22.4%	18.2%	10.2%	-9.6%	-20.2%	-15.8%	-11.4%
FDI	13	8	4	3	3	3	3	3
Loan repayments	-42	-57	-47	-60	-96	-166	-227	-275
Net other capital flows	-36	-1	-23	-11	77	245	303	350
Balance of payments	**93**	**115**	**70**	**8**	**-79**	**-40**	**-25**	**-5**
Reserves (yearly avg.)	526	641	710	719	640	600	575	570
Total debt (yearly avg.)	88	84	83	84	134	231	315	382
o/w short term debt	29	44	34	48	76	132	179	217
Oil Prod. (mn.barrels/day)	9.3	9.8	9.6	9.7	10.2	10.3	10.4	10.5

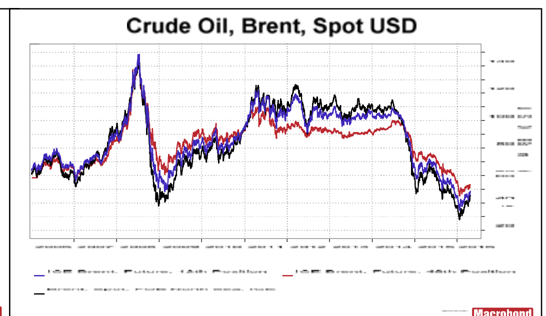
(*) Central government only

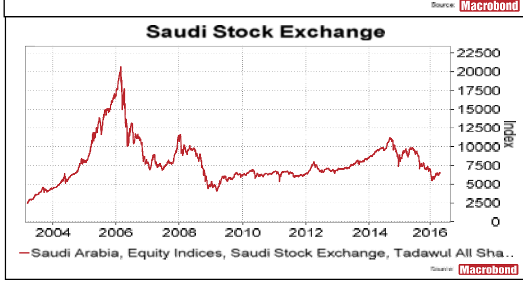
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

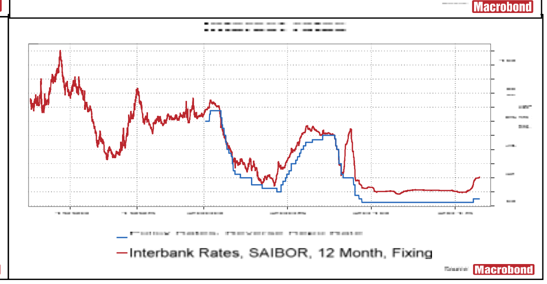
Rating history					
Fitch (eoy)	AA	AA	AA	AA	AA
Moody's (eoy)	Aa3	Aa3	Aa3	Aa3	Aa3

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









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