Saudi Arabia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **April, 28 2017**

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The economy begins to respond to the government's economic adjustment efforts but there is a long way before achieving its ambitious Vision 2030 program. Some observers question whether the country has the stamina and administrative capacity to follow through on its endeavors.

Country Risk Analysis

At the start of a long slog: The current year will see a continued slowdown of economic activity following last year's rapid deceleration. Real output is set to come almost to a standstill as oil production shrinks in line with OPEC commitments while non-oil activity picks up some of the slack. The latter is despite continued government austerity measures that will bring down the budget deficit to 8-9%/GDP down from a peak of 17% in 2016 when including large government payment arrears to private companies from the year before. For 2018, the program calls for further but milder deficit reduction to 7% on the back of a 5% VAT introduction.

Regained access to capital markets: After a long hiatus, last year the government approached international markets with a syndicated loans and a eurobond issue. Both were well received and the latter four time oversubscribed at a premium of only 120bsp to LIBOR. That was much supported by the country's government's strong assets position and minor debt at only 15%/GDP and with foreign reserves at more than $500bn. covering two years of normal imports and the total of Saudi Arabia's foreign debt. That was also despite of an external balance having turned negative to the tune of 6%/GDP a year since 2015, but set to almost balance in the current year. In one word, Saudi Arabia is still strong in financial terms after a decade of very healthy oil revenues and can continue with measured re-balancing for years to come.

But challenges could overwhelm capacity: So far, the Saudi population has taken the new head-winds in strides. Remuneration for public sector employees more than half of the Saudi population, has plunged by some 20-30% since 2015. But last April, the King gave in to demands for easing and approved new bonuses for public salary earners after hash criticism for austerity. That event should not be exaggerated but even before that observers like the IMF began questioning if the country was too ambitious. Others have pointed to the compact between the ruling family and its subjects that used to guarantee rapid growth in household incomes for loyalty but little work, a situation no longer possible. That is also a concern related to a society of very conservative norms with a large bureaucracy never before having met real challenges. That collides with a rapidly growing younger generation suppressed for decades but now yearning for reforms.

Ratings: the external rating agencies have downgraded the sovereign since 2015 and increasingly on grounds of rising doubts about its reform capacity. Geopolitical and regional security risks are also a part of the more negative outlook for the sovereign. The country, by contrast, may still benefit from a strong and well capitalized banking system so far little dented by a deteriorating environment.

Recent developments:

The current year will see a continued slowdown of economic output after last year's rapid deceleration. Real output is set to come almost to a standstill as oil production shrinks in line with OPEC commitments while non-oil activity picks up some of the slack notwithstanding continued government austerity measures.

Economic slowdown comes to an end: After a rapid deceleration of economic activity in 2016 growth will continue to slow in the current year and barely escape recession. That is mainly due to a cut in oil production -- representing some 30% of GDP -- by about 3% year-on-year (yoy) as Saudi Arabia adheres to last year's commitments to OPEC of reduced oil production. Non oil growth, by contrast, will slightly quicken to 1,4% expansion as the government settles its accumulation of payment arrears with private companies since late 2015. That growth will come in the face of continued fiscal austerity although of a much reduced pace. But, none of this is for sure. Based on new evidence of deteriorating consumer confidence GDP may have contracted again in the first quarter. In February, credit extension slowed to 1% while the consumer price index (CPI) remained negative although that was not only due to weak demand but also base effects of energy and utility price hikes one year earlier. For the current year we project subdued but positive inflation of about 1%.

Labour market deterioration: Up to 1.8m nationals are expected to enter the labour market over next 5 years. That is mainly due to demographic trends but also higher participation rates in particular among women. Last year unemployment among nationals increased one percentage point (pp.) to 12,5% which also hit public sector employees who make up 2/3 of all national employment. In contrast, among non-nationals, expatriates and manual workers mainly from poor countries, total employment went up by 3,9% and unemployment in this category is almost unheard of. Because these employees earn much less than natonals, they are attractive to employers helping keep unemployment low. It has been pointed out that their low wages often reflect lack of mobility between work places thus maintaining a wide wage gap to nationals.

Current account deficit narrows on higher oil prices: In 2016 the current account balance improved to a deficit around 5%/GDP, down from 9%/GDP the preceding year. That was mainly because of a much reduced import bill for the non-oil economy. In the current year, by contrast, the further improvement in the current account balance to less that 2%/GDP is rather on account of higher oil revenues despite the promised production cut vis-a-vis OPEC if prices remain some 20% elevated over the last year. Despite decades of planned divesification of its foreign trade, Saudi Arabia is still heavily dependent on oil to balance its external accounts. Although down from 90% a few decades ago, hydrocarbons dominate three quarters of external receipts.

The balance of payments turn negative: The negative current account balance has combined with diminishing inflows of foreign direct investments (FDI), rapidly rising loan repayments and portfolio outflows from pension funds and banks to produce a balance of payment deficit each year since 2015. That has cost the central bank some $150bn in foreign reserves which will be down to an estimated $45 bn. by the end of the current year. That is still enough to cover the import bill for nearly two years or more than 100% of broad money. By another measure, these reserves could repay Saudi Arabia's total external debt of some 20%/GDP almost three times. .

Policies

The government has showed and heroic effort in bringing down the budget deficit to an estimated 10% GDP for the current year from a peak of 17% in the previous year. Monetary policy has remained more accomodative and eased liquidity conditions when needed for an overall well-managed and profitable banking sector. Structural policies have aided efforts to rein in the fiscal deficit and more may be in store, but have so far not been able to deliver much in terms of privatization and diversification although that may change next year.

Austerity policies continue to pursue ambitious targets: The fiscal deficit for 2015 ended apparently much lower than expected but based on additional information that seems to have been the case because of incomplete budget presentation. In fact the government had delayed payments which caused severe problems in particular for domestic construction companies. These arrears were subsequently settled in 2016, thereby blowing up the deficit for that year to 17%/GDP some 5pp. higher than the underlying deficit without arrears compensation. As such overdues should be out of the way now, most observers believe that the government will be able to lower the deficit to 9%/GDP based on an improved global oil price which is already up around 20% on the year. That is only some 1pp above the government's own target of 7,7%/GDP which, however, seems to imply a more optimistic oil price for a component that dominates about half of total revenues.

New excise taxes and reduced subsidies: The government has also kicked off a major program to rationalize public expenditure and introduce new indirect taxes. Subsidies have been slashed for utilities such as energy and water prompting higher prices for users. The government has cut remuneration for its employees, by some accounts reducing total wages by 20-30%, and hiked excise taxes on soft drinks and tobacco. On its investment budget it has re-prioritized and rescaled infrastructure and other large projects. Its vast defense budget, dominating 20% of all expenses, is now also to be pruned. However, a new tax regime for oil companies, the only entities to pay income taxes in the Kingdom, will cut the tax rate on profits from 85% to 50% effective retroactively from January 2017. That raisesthe challenge to achive the deficit target. By the same token concerns are growing that the government could yield to sharp popular criticism of harsh austerity policies. It recently reversed previous decisions on cuts in allowances and bonuses.

Financing no problem: As in 2016, the budget deficit will be financed by a combination of drawing on the government's vast deposits in domestic banks and by issuance of bonds in the local and international capital markets. Last October it sold $17bn. of bonds at a premium of only 120bsp over LIBOR in an offering that was four times oversold. That followed on the heels of a $10bn. syndicated loan with 5 years maturity from external sources. Both events underpin the argument that the government has an open invitation from global capital markets to return as needs arise.

Growing debt but from a low level: After the noted transactions government debt has begun to rise but from a very low level of only 2%/GDP a few years ago. At the end of next year it is estimated to reach 15%/GDP, still a very low number and dwarfed by its assets in domestic banks valued at som 40%/GDP.

Monetary policies: The longstanding peg to the US dollar makes monetary policy essentially ineffective. However, the central bank, SAMA (Saudi Arabia Monetary Agency), retains a few levers to influence monetary and lending conditions. In 2016, SAMA raised banks' loan to deposit ratio from 85% to 90% to facilitate loans growth and ease liquidity conditions as interbank rates rose to more than 2%pa mid year, up from 0,8% a year earlier. Much of that was related to delayed government payments. In the same vein it injected SAR29bn. as time deposits into the banking system. Tight liquidity conditions is likely to have followed also major interventions in the foreign exchange market to ease pressure on the US dollar peg as reflected in the loss of some

$77bn of reserves last year. SAMA has also banned local banks from selling options on forex forwards, apparently in another attempt to bolster the exchange rate. As to the rational of the peg, the IMF continues to argue for its future as any change would cause more uncertainty with costs for financial markets in terms of volatility that would hardly be offset by any benefits for the economy from a possible devaluation.[1]

Banks remain healthy: Observers commend the banking system for having remained sound so far through the crisis. Non-performing loans (NPL) have begun to rise but are still below 2% of total loans and even if the rise continues it is well taken care of by strong provisions and capital ratios of Tier I capital at more than 17%. This is despite a steep slowdown in credit growth to only 2% yoy in last January from 8% mid-year of 2016 combined with a decline of deposit growth to 4%. This implies that any call on the government for rescue operations seems unlikely anytime soon. Based on past forms, in the unlikley event that it should be needed it would probably be fortcoming in an expeditious manner.

Adequate regulations: Observers also consider regulations as adequate. The banks are implementing Basel III risk-based capital regulations. The authorities have set new limits for large exposure at an aggregate of 400% of capital and single exposure limits have been cut from 25% to 15% of capital They are also introducing a deposit insurance scheme for up to SAR200,000. Shadow banking defined as outside the regulatory perimeter is small Measures to prevent money laundering and terrorist financing are to be assessed by late 2017 for compliance after which FATF will deliberate on application for full membership.

Structural issues: Last June the government published its National Transformation Program (NTP) to corroborate its grand plan Vision 2030 released a few months earlier. The NTP lays out 178 strategic objectives with 340 targets and benchmarks and meets many of markets demand for more details on how the authorities envisage to realize what could otherwise appear as lofty goals. Non-oil revenues are set to more than triple to $141bn. in 2020, that is an increase in the share of GDP by some 15-20pp. while non-oil exports should almost double to 15%/GDP. The NTP also aims at raising educational standards and school participation rates -- although most children are now attending school

Business environment: Such reforms are aimed at improving the business environment which often lags peers in key areas. The latest World Economic Competitiveness report of 2016/17 ranked Saudi Arabia on a respectable 29th place, but that was down from 20th place in 2013/14. On the Worlwide Governance Indicator, by contrast, Saudi Arabia hardly reached beyond the middle of all countries i.e. far below peers. That said, the government have also had successes. It recently shortened custom clearance to 24 hours from 29 days prior and has laid out privatization plans including two airports. It is planning to prise open the retail and whole sales sectors to foreign investors and introduce stronger contract enforcement. A new solvency law will be most welcome by the business community.

Saudi Aramco IPO: Last, but not least, an IPO for a 5% stake in the national oil company, Saudi Aramco, is planned for 2018, with NYSE listing being investiated. The cash-in for the governemnt is estimated in the range of $100bn.

Politics[2]

Domestic politics -- a restive young population: The line of succession is now clearly defined but observers note that rivalries within royal family could still

[1] SaudiArabia, 2016 Article IV Consultation, October 2016, Washington DC

[2] For a more elaborate analysis we refer to our report on Saudi Arabia on these pages of April 2016 which we belive is still relevant on key issues.

become source of instability. That may reflect the demographics changes going on in the country. Expectations among the generation of younger adults are growing as internet and other means of communication opens the window to the outside world and displayes the often stark contrasts to daily Saudi life. Younger people are yearning for a reality of less boredom which often drives them to drugs and acohol abuse or even extremist recruitment.

Entertainment Park: Apparently cognizant of these societal developments, Vision 2030, the brain child of the new and assertive deputy crown prince (DpCP) and the elderly son of King Salman, has earmarked entertainment, culture, sport and exercies as development priorities. Last April, He announced plans to build an entertainment park near Riyadh likely reflecting his aim to consolidate support among the country's youthful population. That would tramp on many soar toes among older generations and the clergy. The latter has since the early 1980s insisted on a ban on movie theatres. That may increasingly seem as an anachronism but was nevertheless repeated last February as the grand mufti denounced concerts and films within the Kingdom. However, the clergy has also seen its powers encumbered. In early 2016, the powers of the moral police were curbed as it lost the right to arrest people on the street. In contrast, the DpCP may now be in a position to overried dissent from conservative clerics. Religious leaders have so far refrained from criticizing him directly and reports are that they often admire his on-going war against Shias in Yemen. Nevertheless, it could still be risky for him to alienate these constituencies through rapid social reforms including any legal changes that would benefit women.

External security risks to remain low burning: Over the last year the US-Iran agreement has remained in force despite the promise of the new US president to have it cancelled from first day in office. Its survival could be a sign of easing regional tensions. But at the same time dangers are rising of next Iranian elections resulting in a new hard-line President replacing the incumbent, Mr. Rouhanni who signed the US deal. The proxy war between Saudi Arabia and Iran could then become a more open conflict between the two major regional states. Anyway, as we argued on these pages a year ago, it is hard to see any of them deliberately heading for war against the other at least for economic gains. Both would stand to loose significantly, not least Iran. The Yemen proxy war could remain so for a long time as it serves the domestic political theatre in Riyadh.

Problem of returnees: A new problem of returnees should ISIS be flushed out of Iraq and Syria will probably be solved as effective as after the first Iraq war in the middle of the 2000s. As they returned to their homeland in Saudi Arabia, they were dealt with unceremoniously by Saudi security forces. They are likley to have the capacity to deal with them again which may discourage them from returning in the first place. There seem to be a myth in certain circles that the alternative to the present regime in Saudi Arabia is chaos and political/religious extremism. Such kind of myths often suit autocratic regimes but may be groundless as for instance proved to be the case after apartheid in South Africa.

Outlook

After two years of fiscal austerity the Saudi government have proved more up to the task that many had expected. From a surplus of 10%/GDP in 2012, the fiscal balance turned into a 15%/GDP deficit in 2015, a turn around of 25%pp as more than half of the revenue basis, taxation of hydrocarbon production – oil and gas – plummeted due to the price effect. Fortunately that happened after a decade of fat years, when the government could build ample reserves to meet a rainy day. Unfortunately they went too far in using windfall revenues to also prop up the economy. A part of that has now to be rolled back, hurting growth but so far steering clear of recession.

Already next year, three years after thr crisis broke out, growth should recover and continue at a modrate pace around 2,5% a year to the end of the decade eventually restoring external and internal balances although observers are sceptical that the budget deficit can be eliminated thus fast.

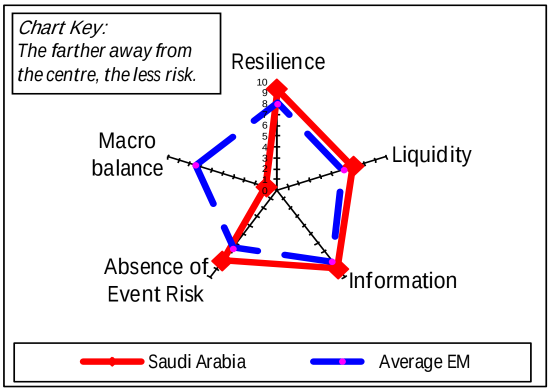
Much of Saudi Arabia's fortunes depend on the oil price. Saudi Arabia used to be the global master of that game. However, that ended with the new fracking technique. Try to squeze the market by cutting off oil supply and you open the floodgates of oil and gas from huge deposits trapped in porous rock formations in North America. Flush the market with your oil and some of the American producers shut down their fields, while others hunker down and learn how to be more efficient -- and once they have learned that you can not undo it. The reason why the oil market could be so easily manipulated in the past was that it took a decade or more to develop new fields and once commissioned very high investment costs prevented companies from shutting down if the price undercut expectations. That created a lot of uncertainty about the "right" oil price, giving rise to potentially wide variations that a big producer could exploit to his/her own advantage.

The future oil price will therefore likely move within a more narrow window which at the present time could be between $40 ad $60/barrel. At $60/barrel, the average price from now to the end of the decade), Saudi Arabia should do reasonably well, growingnby some 3% a year. (Conf. attached tables.) At $50, the country will still manage but struggle more to consolidate the budget as annual growth slows to slightly above 2% a year.[3] At $40/barrel debt dynamics may no longer be sustainable at it may be very difficult to maintain market confidence and thefore costly to defend the peg while harsher austerity may prompt reform fatigue and popular impatience that can be exploited against the regime for political ends.

But even in such a scenario everything may not be lost for the present order. Next year the government plans an IPO for a 5% stake in the national oil company, Saudi Aramco. That is very likely to be welcomed by international investors and could fetch as much as $100bn. -- sufficient to cover almost two years of fiscal deficits at the current level. By gradually selling down its crown jewel the government may be able to extend its hold-on to power for another generation, provided there won't be a second "fracking" revolution or new super-efficient batteries for electrical cars, etc. Shaik Yamani, the colourful oil-minister in the 1980s once chipped about the future of his country: "the stone age did not end for the lack of stones".

Saudi Arabia

Key Ratios	2017
Population (mil)	33
GDP/capita ($)	20 951
Real GDP (% chg)	0.2%
Inflation (%)	1.2%
Curr.Acc. Balance (% of GDP)	-1.3%
Reserves/imports (months)	39
Budget balance (% of GDP)	-8%
Government debt (% of GDP)	19%



External ratings:
Fitch: A+
Moodys: A1
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] According to our run on the global Oxford-model

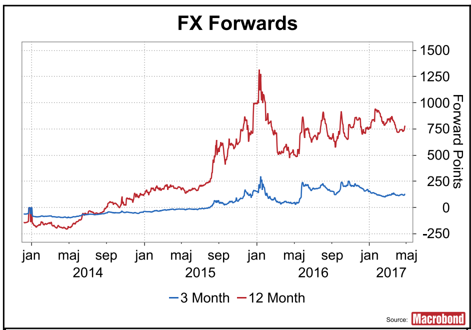
Key data:	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP (mill.US$)	736	747	756	652	640	684	731	802	884
GDP/capita (US$)	24973	24756	24517	20664	19922	20951	21980	23735	25712
GDP (real change)	5.4%	2.7%	3.7%	4.1%	1.4%	0.2%	3.0%	3.0%	3.0%
Investments/GDP	26%	26%	27%	27%	26%	27%	28%	29%	29%
Budget balance/GDP	13.6%	6.4%	-2.3%	-14.8%	-16.8%	-8.2%	-7.2%	-5.1%	-2.2%
Govt debt/GDP (*)	4%	2%	2%	5%	13%	19%	24%	26%	25%
CPI inflation (%)	2.9%	3.5%	2.7%	2.2%	3.4%	1.2%	4.5%	3.5%	3.5%
Money demand (%)	9.6%	1.4%	1.3%	-13.8%	-1.9%	7.0%	6.7%	9.8%	10.1%
Stock prices (yearly avg.)	29471	30161	30850	31540	32106				
Interest rates	0.7%	0.7%	0.9%	1.0%	0.9%	0.9%	2.1%	2.1%	2.4%
Exch. Rate ($)	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Trade/GDP (%)	72%	71%	66%	56%	48%	49%	49%	49%	50%
Oil price (Brent)	$112	$109	$99	$52	$44	$52	$52	$59	$68
Millions US $									
Export of goods	388	376	342	204	180	206	215	245	285
Imports of goods	142	153	158	159	127	133	140	149	158
Other:	-82	-87	-110	-101	-83	-82	-86	-92	-100
Current account	**165**	**135**	**74**	**-57**	**-30**	**-9**	**-12**	**4**	**27**
(% of GDP)	22.4%	18.1%	9.8%	-8.7%	-4.7%	-1.3%	-1.7%	0.5%	3.1%
FDI	8	4	3	3	3	4	5	6	7
Loan repayments	-57	-48	-61	-50	-65	-80	-92	-102	-106
Net other capital flows	0	-22	-7	-11	16	16	53	55	42
Balance of payments	**115**	**70**	**8**	**-115**	**-77**	**-68**	**-46**	**-37**	**-30**
Reserves (yearly avg.)	641	710	719	604	527	458	412	375	345
Total debt (yearly avg.)	88	89	89	81	107	131	151	168	175
o/w short term debt	44	34	48	37	49	60	69	77	80
Oil Prod. (mn.barrels/day)	9.8	9.6	9.7	10.2	10.5	10.1	10.3	10.3	10.5

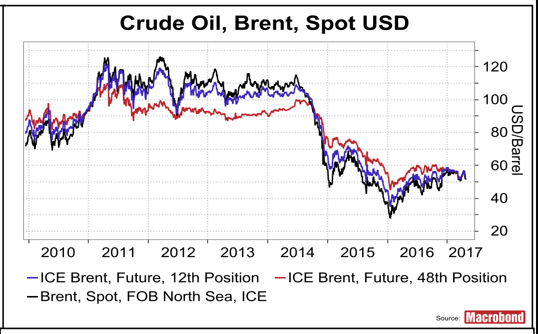
(*) Central government only

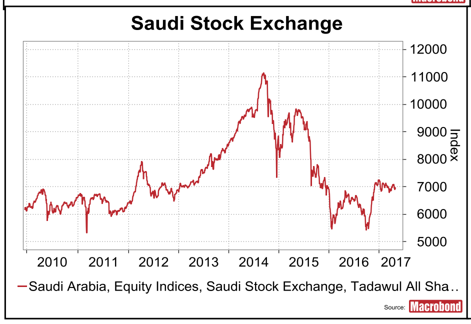
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

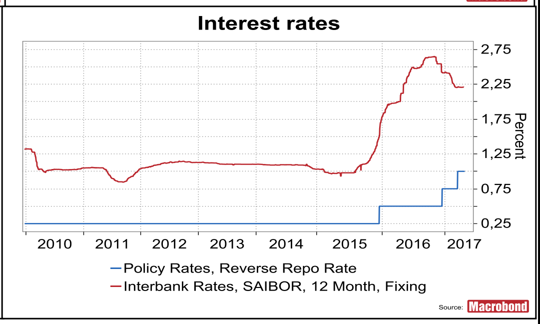
Rating history					
Fitch (eoy)	AA	AA	AA	AA	AA-
Moody's (eoy)	Aa3	Aa3	Aa3	Aa3	A1

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









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