# Saudi Arabia

**SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS** **April, 18 2018**

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*Despite technical recession as the OPEC-freeze on oil constrained growth, the economy performed well in 2017 in terms of improved external and internal balances. Political events, by contrast, have left new question marks; Last June, the King ignored long-standing family traditions by promoting his son, Mohamed bin Salman (MbS), to heir apparent. Then, last November, the latter took advantage of new powers to launch a severe anti-corruption campaign against other princes and the business elite.*

## Country Risk Analysis

**Caps on oil production made the economy shrink in 2017, but this year growth is set to resume:** Last year oil production dropped 3% in compliance with OPEC quotas forcing a drop in overall GDP of almost 1%. For the current year, oil output should remain unchanged while the non-oil economy picks up speed to raise GDP by at least by 2%. The momentum is seen as holding up on growing consumer demand and government spending despite political events that could fuel investor fears.

**External and internal imbalances narrow**. The fiscal deficit is still large but dropped to 9%/GDP in 2017, from almost 13% of the year before. This was easily financed including by two foreign bond issues that attracted much investor interest. For the current year, budget estimates point to a further sharp reduction to less than 5% helped by the introduction of a new VAT. The external current account, by contrast, ended 2017 in a virtual balance and is set for a decent surplus of more than 3%/GDP in the current year based on reasonable oil price assumptions. Like in Russia, macro-economic balances have been pared back although by different methods: Russia used the exchange rate as buffer while Saudi Arabia persevered with a hard exchange rate policy but attacked government overspending directly.

**Structural issues are Saudi Arabia's Achilles heel**. The new Saudi leader in all but name, MbS, has inherited a country with a working force formed by decades of abundance and a cradle to grave welfare state with debilitating effects on work ethics. Most Saudis occupy comfortable government jobs with lifetime security and much higher salaries than equivalent positions in the private sector where expatriates dominate the workforce. Combined with skills mismatches this has produced high unemployment among Saudis, 12%, with a significant concentration among youths.

***Vision 2030***: MbS's bold reform program, aims at tackling these and other structural issues by the end of the next decade. Combined with his young age, 31, this is an endeavor that should sit well with a young population. But he is also facing opposition from vested interests among conservatives and an elderly elite which may fight hard to hold on to status quo. Should the confrontation MbS instigated last 2017 against these elites fail, he may either have to rescind on bold goals or face rumbling political unrest.

**Outlook and ratings**: over the last year macroeconomic stabilization has been credit positive for both the sovereign and the country and rating actions have stabilized or turned cautiously positive. That has subsequently been undermined by political events with the potential to upset the country's fine-tuned social and political balances.

## *Recent developments:*

**2017 marked the trough of recent economic weakness:** Despite stepped-up growth of the non-oil economy to 1,7%, overall GDP nevertheless shrank by 0,7%. That reflected a 3.5% drop in oil output as Saudi Arabia cut production to 10mbpd (million barrels per day) to comply with reduced oil quotas agreed with OPEC and a few other global producers including Russia. The fall was cushioned by growing consumer demand and rising confidence as the King restored allowances for government workers early in the year just a few months after they had been cut in late 2016. But then again part of that confidence was undermined after the newly anointed Crown Prince, Mohammed bin Salman, took advantage of new powers to clamp down on the country's political and business elite on charges of corruption.

**2018 -- Recovery takes hold but sentiment could be dented**: The incarceration last November of some 200 influential persons for more than a month prompted rapid capital outflows in its wake with the effect to dent the current year's growth prospects. These are nevertheless likely to represent an improvement on the year before as pent-up consumer demand continues underpinning the spending of households. In contrast, investments including from abroad could suffer more than expected. That said, also the government is set to loosen its fiscal purse more than first planned As a result, most observers hold on to estimates of a 2% overall growth spearheaded by the non-oil economy, while oil production stays put. That should help maintain a lid on price pressure in the current year with overall inflation remaining around 3% in response to the new VAT at a rate of 5%, in contrast to the mild deflation experienced in 2017.

**Unemployment grows worse**: Since the oil price crisis three years ago weak growth has triggered a gradual rise in unemployment among Saudis. Last year it exceed 13%, up from 11,5% in 2015 of which 7% were males and 33% females while youth unemployment among both genders aged 20-29, topped 28%. Unemployment among young cohorts increasingly reflects faster growth than for other age groups. Over the next five years the labor market has to prepare for some 1-2mn. new entrants. Unemployment among expatriates is insignificant as residency permits are linked to employment status.

**Current account balance back in surplus:** Last year the current account ended in a virtual balance having gradually improved from deep deficits over the two preceding years. This development was mainly due to higher global oil prices which helped offset the cuts to oil quotas since 2016. It also reflected a sharp drop of the import bill for the non-oil economy which last year was still 19% lower compared with 2015. For the current year the current account is expected to end in a surplus of more than 3%/GDP mainly reflecting higher oil-prices in the range of $60-$65 but also a 4-5% annual trend-wise growth of non-oil exports. This should now help slow the decline of central bank reserves to an estimated $457bn – equivalent to 42 months of import cover – at the end of 2017 down from a peak of $631bn in 2015. The decline reflected in part on-going repayments of foreign loans to the tune of $80-90bn a year. These are set to continue well into next decade. Bouts of capital flight by residents into foreign bank accounts as reported in recent months may also reoccur.

## *Policies*

**Fiscal consolidation goals pushed back:** Over recent years the government has persevered with consolidating policies. Last year it succeeded in reducing the budget deficit to 9%/GDP, 4pp (percentage points) lower than the year before. That was mainly as a result of cuts to capital expenditures but also new sources of incomes such as new excises on soft drinks and tobacco of last June and the ongoing rationalization of energy and water prices provided by the public sector. The final deficit was nevertheless somewhat higher than first planned as the government significantly loosened its purse string towards the end of the year partly in response to recommendations of the IMF to push back on too ambitious consolidation efforts. As a result, the government is now targeting a balanced budget by 2022, two years behind original plans.

**2018 budget foresees further consolidation**: The budget presentation of last fall estimated a further drop in the deficit to 7%/GDP, on a global oil price of $60/barrel implicitly calculated by outside observers and unchanged oil output. That was also assuming GDP growth of 2,7% for the year driven by a 3,7% increase of the non-oil economy. That would be supported by additional off-balance fiscal expenditures financed by drawings on the PIF and other public funds. The deficit would narrow further, however, to an estimated 3,6%/GDP should high oil-prices as seen through the first four months of the current year continue. These estimates are also based on full implementation of the four times higher expat levy as of next June despite private sector protestations. The government is also mulling introduction of personal income taxes and general profit taxes which thus far have been charged only foreign individuals and companies.

**Budget financing and debt**: The budget deficit of recent years were first financed by drawing on the government's large reserves held at the central bank but as of late 2016 also by international bond issues and syndicated loans. The government's foray into international borrowing has been met with interest and success among foreign investors seeing the solid progress in deficit cutting while foreign reserves of the central bank remain impressive. They help guarantee against any sovereign default and dwarf government debt by a factor of at least two. The health of the Saudi banking system also contributes by lowering contingent liabilities on the government.

**Accommodative monetary policies**: Given the constraints on monetary policies due to the effective peg of the Saudi Rial (SAR) to the US dollar since the mid-1980s, monetary policies have overall remained accommodative. Since the second half of 2017 that has been also supported by the settlement of $11bn. of government arrears to mainly domestic contractors. However, the latest hike of the repo rate to 2,25%pa a week ahead of the anticipated Fed hike may herald some tightening. Observers see reasons for the central bank , Saudi Arabian Monetary Agency (SAMA) to be vigilant against new bouts of capital flight and not to fall "behind the curve" until signs of political tensions abate.

**Is the peg still appropriate**? In its latest country report of November 2017 the IMF argues that while always an issue of consideration, the peg still represents then best option for Saudi Arabia. Admittedly, a more flexible rate might have supported a faster budget consolidation and underpinned non-oil tradeable sectors' adjustment efforts, but a sharp devaluation or a more tumultuous exchange rate development might have ensued risk given the longstanding anchor provided by the peg. The counter argument presented by the Institute of International Finance is that the peg may also now hinder diversification of trade and possibly impede other market based adjustments in the economy. Apart from political considerations that none of the institutions mention explicitly, namely that holding on to the peg perhaps represents continuity and stability in the eyes of many nationals, outside observers tend to believe that a flexible exchange rate will help crystalize market signals, that a peg can easily mask and that such signals have become more important at the present stage of the Saudi reform process. A peg may give a false impression of stability until it eventually breaks.

**Well managed banks**: Observers agree that Saudi banks are well managed and supervised by SAMA and that the central bank's financial supervision stood its test during the Global Financial Crisis nearly 10 years ago. The level of bad loans (NPL) has barely moved up from a stable level of less than 1,5% despite recent years' very weak loan growth. Moreover, capital and loan loss provisioning can adequately cover existing NPL levels. Banks – including systemically important ones -- recently withstood a Financial Sector Stability Assessment (FSSA) test with flying colors. They should be able to meet regulatory capital requirements in the event of new economic shocks including a deep fall of oil prices. SAMA has enhanced risk based supervision and is cutting single borrower exposure limits from 25 to 15% of capital as of next year when it also plans to introduce a Deposit Protection Fund organized by Saudi commercial banks themselves. – SAMA has continued to strengthen regulations against money laundering and terrorism financing.

**Ambitious reform program**: In 2016, shortly after the oil market collapse MbS -- still only deputy CP -- launched an ambitious reform program named *Vision 2030*. This focused on three major objectives: first, to wean the economy off high oil dependency through diversification; second, to reform the business climate to make the non-oil economy more independent of government support and more attractive to domestic and international investors: and third, to re-establish macroeconomic balances, in particular the budget balance.

**Diversification**: Recent years have seen a deep decline in the share of oil in the total economy. In 2016, oil and related products accounted for 22%/GDP and 77% of exports, down from 45% and 90% in the 2011-14 period. However, that was almost entirely accounted for by the drop in oil prices and as such reflected only a nominal, not a real transformation of the economy. The apparent changes also belies the fact that the bulk of new non-oil exports consists of petrochemicals and base metals mainly produced of state-owned enterprises (SOE) and dependent on low-cost energy.

**Improving the business climate**: Inflows of long term foreign investments have declined further, although from a low level. That in part reflects investors' fading interest in Saudi Arabia as a production hub, in sharp contrast to their view of neighboring UAE. According to the World Bank's annual *Doing Business Report*, Saudi Arabia has now dropped to 92nd rank, while for the sake of comparison; the UAE was ranked at 24th place among the 190 countries in the survey. That said, it is also noted that the World Economic Forum's Competitiveness index ranked Saudi Arabia much higher at 30th place among 140 countries. Disregarding the sharp differences of ranking levels, they have in both cases suffered significantly in recent years. To improve such negative developments the government has planned for broad privatization of airports, utilities, healthcare, education and infrastructure among other initiatives.

**Box 1. Labor-market reforms**: The real challenge lies in reforms to the labor market. According to the IIF (Institute of International Finance: "Diversification requires deep and Sustained Structural Reforms", Washington DC, Feb. 7, 2018) the Saudi Labor force needs structural changes in wages, work incentives and in the educational and skill formation system. Saudis occupy 90% of public sector jobs but only 19% of private sector jobs. Saudi job seekers favor jobs in the public sector due to rapidly rising public sector salaries – up almost 10% pa -- during the past decade and virtual security of life-time employment. Adding to the problems is an educational system that has fallen much behind changes in market demand for skills and job qualifications. A 2015 survey ranking of 8th grades Saudi students in science and mathematics was at the bottom among a sample of 47 developed and developing countries. The IIF ends its analysis by commenting that "Experience shows that rote learning and authoritarian methods of teaching represent obstacles to the development of citizens with inquisitive and open minds able to navigate their way productively through modern and complex economies".

**Oil policies:** As the world's second largest oil producer and, perhaps more importantly, with the largest excess production capacity of any country, Saudi Arabia is still paramount to global energy balances and the world economy at large. Its energy minister recently stated that OPEC might need to keep coordinating supply cuts to reduce global inventories. That has been interpreted as an invitation to continued cooperation with Russia and other major non-OPEC producers. But the rationale for the Saudi concern may be closer at heart. Speculations are that the delayed sale of a minority stake in the national oil champion, Aramco, first scheduled for last fall, was prompted by the desire to prime the market for a better sales price. By contrast, a more choppy market in particular combined with a softening oil price, could easily have deterred many investors from such a big IPO. In that case, Saudi Arabia may relax its attempt at steering the global market once the Aramco deal is clinched, already hurt by its bad experience of attempts at controlling markets several years ago which only ended in US producers finding new techniques for upstream activity, i.e. shale oil.

## *Politics*

**Two unprecedented events**: Last year was marked by two unusual events without precedence in Saudi Arabia's modern history. In last June, King Salman promoted his son. Mohamed bin Salman (MbS) to crown prince and as such heir apparent. Then in the following month of November, the MbS made a raid against other important princes of the vast royal family and incarcerated them and prominent members of the country's business elite.

**The new heir apparent**: Traditionally since the days of modern Saudi Arabia's first king, Abdulazis, a tradition had been established to choose a new king among half-brothers descending from Saudi Arabia's founding father. The latter had many sons and visitors were often explained that this was a way to keep some check on meritocracy: You shouldn't just be borne into this position. When King Salman ascended the throne in 2015, he first promoted Prince Muhammad bin Nayev from a competing branch of the family to crown prince, but two years later overturned this decision to the advantage of his son while Prince Nayef was shut out of the process. But prince Nayef had served his country well for many years as Interior Minister and was reportedly respected as a trusted anti-terrorist soldier in the western intelligence community. His demotion could therefore not be seen as justified on poor merits. By the same token, however, MbS is also respected as an extraordinary capable young leader. It is noted that so far no repercussions have been detected as direct reactions to this change in the line of succession.

**Incarceration of the elite**: However, that may not be said about the second event. It has been speculated that the incarceration – although at a luxury hotel in Riyadh, of some 200 royalties and business leaders last November was an effort of the new CP to strengthen his position against any would-be opposition. They were accused of corruption and the whole episode lasted more than a month before finally released -- after having paid heavy penalties for a total of more than $100bn. and in some cases seeing their bank accounts freeze. In the case of the bin Laden group, a major domestic construction company, the authorities even took over managerial control. That scarred many investors and seems to have triggered the capital flight which took place in following months creating a liquidity squeeze in the banking system. This was followed by a rise in short term interest rates by 50bsp and a temporary spike in CDS spreads of 23bsp. None of that was dramatic in itself, but observers see signs that Saudi Arabia's risk profile has taken a hit and that risk of a future backlash from branches of the royal family can no longer be ignored.

**External threats**: Saudi Arabia's war against the Shia population in Yemen has become long-drawn against expectations that MbS would finish it off quickly when he first intervened in the sectarian conflict a few years ago. That could be bad for his reputation but the war is otherwise unlikely to mean much for the life of ordinary Saudis. A military conflict with Iran could be in the making should the US break the Obama anti-nuclear deal with that country. The likelihood of such a conflict, however, is much reduced when factoring in consequences for the global oil market and the world economy in general. Most of Saudi Arabia's oil export passes through the Hormuz Strait which could be controlled by Iran in case of a conflict.

# *Outlook*

**The gains of last years' stabilization politics is now coming to fruition**. In this year and sometime into the next decade, annual growth rates could gradually rise to more than 3% a year as long as the oil price remains at the present level between $60-70/barrel or higher and Saudi Arabia takes its share of global oil demand rising trend wise by at least 1% a year. In such a scenario, the current account balance will remain quite solid, while the budget should consolidate as planned within four years from now. That does not solve the country's long term structural issues, but gives the country time to implement reform policies in a more gradual manner.

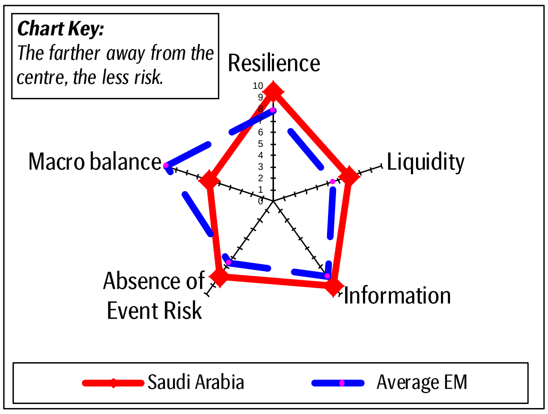
**The reform process is by no means a done thing**. The Vision 2030 rightfully paints a large canvas of the challenges lying ahead. While in many ways different, these can be compared with the reform needs of the former communist states of Eastern Europe when their societies broke down. While much richer, the Saudis have also been raised into a mentality where the government takes full responsibility for their lives and financial well-being -- a compact between rulers and subjects that kept the latter accept an extremely uneven income distribution. It will remain to be seen if this compact can withstand the challenges ahead. At least, it must be tempting for anybody in the elite to try put spanners in the works of this reform process as a payback for their misfortunes including during the recent raid on their wealth.

**The demographic challenges** of Saudi Arabia are quite different from those of most other middle income countries. An unusual high fertility rate over several decades has left the country with a favorable demography provided the country can generate enough jobs to everyone at wages markets can support without government subsidies as such may be in short supply over the next decade.

**Ratings and market views**: The rating agencies have so far taken a wait-and-see attitude to the recent political events pending indications of rising strains either among those targeted by the Crown Prince or in capital markets. Other observers have been more forthright, pointing out rising political risk of a kind that has seldom figured in Saudi risk assessments of the past. So far market consensus appears to be balancing potential political risk with reduced economic/financial risks.

## Saudi Arabia

| Key Ratios | 2018 |
|---|---|
| Population (mil) | 33 |
| GDP/capita ($) | 22 168 |
| Real GDP (% chg) | 2,0% |
| Inflation (%) | 4,0% |
| Curr.Acc. Balance (% of GDP) | 3,3% |
| Reserves/imports (months) | 34 |
| Budget balance (% of GDP) | -5% |
| Government debt (% of GDP) | 21% |




**External ratings:**
Fitch: A+
Moodys: A1
S&P: A-

**Peers:**
Italy
UAE
Peru

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

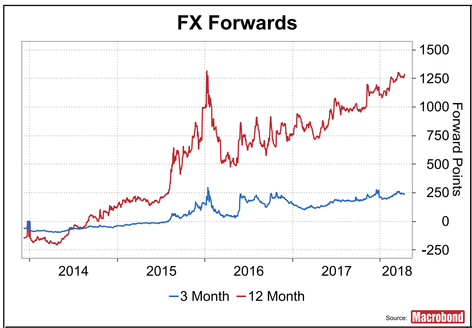
| **Key data:** | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|
| GDP (US$ bn) | 736 | 747 | 756 | 654 | 645 | 684 | 738 | 780 | 836 |
| GDP/capita (US$) | 25310 | 24968 | 24612 | 20733 | 20037 | 20837 | 22062 | 22901 | 24088 |
| GDP (real change) | 5,4% | 2,7% | 3,7% | 4,1% | 1,7% | -0,7% | 2,0% | 2,8% | 3,8% |
| Investments/GDP | 26% | 26% | 27% | 27% | 23% | 21% | 22% | 22% | 23% |
| Budget balance/GDP | 13,6% | 6,4% | -2,3% | -14,8% | -12,9% | -9,0% | -4,6% | -2,8% | -1,0% |
| Govt debt/GDP (*) | 3% | 2% | 2% | 6% | 13% | 21% | 24% | 26% | 25% |
| CPI inflation (%) | 2,9% | 3,5% | 2,2% | 1,3% | 2,0% | -0,9% | 3,2% | 3,0% | 3,5% |
| Money demand (%) | 9,6% | 1,4% | 1,3% | -13,5% | -1,4% | 6,0% | 7,9% | 5,8% | 7,1% |
| Stock prices (yearly avg.) | 6962 | 7628 | 9651 | 8490 | 6327 | 7221 | | | |
| Interest rates | 0,7% | 0,7% | 0,9% | 1,0% | 0,9% | 0,9% | 2,1% | 2,0% | 2,2% |
| Exch. Rate ($) | 3,75 | 3,75 | 3,75 | 3,75 | 3,75 | 3,75 | 3,75 | 3,75 | 3,75 |
| Trade/GDP (%) | 72% | 71% | 66% | 55% | 48% | 48% | 52% | 53% | 53% |
| Oil price (Brent) | $112 | $109 | $99 | $52 | $44 | $54 | $71 | $70 | $67 |
| **Billions US $** | | | | | | | | | |
| Export of goods | 388 | 376 | 342 | 204 | 184 | 210 | 247 | 269 | 287 |
| Imports of goods | 142 | 153 | 158 | 159 | 128 | 119 | 137 | 145 | 154 |
| Other: | -82 | -87 | -110 | -101 | -80 | -86 | -86 | -92 | -100 |
| Current account | **165** | **135** | **74** | **-57** | **-24** | **4** | **24** | **31** | **33** |
| (% of GDP) | 22,4% | 18,1% | 9,8% | -8,7% | -3,7% | 0,6% | 3,3% | 4,0% | 4,0% |
| FDI | 8 | 4 | 3 | 3 | -1 | -4 | 1 | 2 | 2 |
| Loan repayments | -57 | -48 | -61 | -49 | -58 | -73 | -81 | -86 | -88 |
| Net other capital flows | 0 | -22 | -7 | -12 | 6 | 4 | 10 | 20 | 30 |
| Balance of payments | **115** | **70** | **8** | **-115** | **-78** | **-69** | **-46** | **-33** | **-23** |
| Reserves (yearly avg.) | 641 | 710 | 719 | 604 | 526 | 457 | 411 | 379 | 356 |
| Total debt (yearly avg.) | 88 | 89 | 88 | 81 | 124 | 155 | 172 | 183 | 187 |
| o/w short term debt | 44 | 34 | 48 | 37 | 40 | 50 | 55 | 58 | 60 |
| Oil Prod. (mn.barrels/day) | 9,8 | 9,6 | 9,7 | 10,2 | 10,5 | 9,9 | 9,8 | 10,0 | 10,5 |

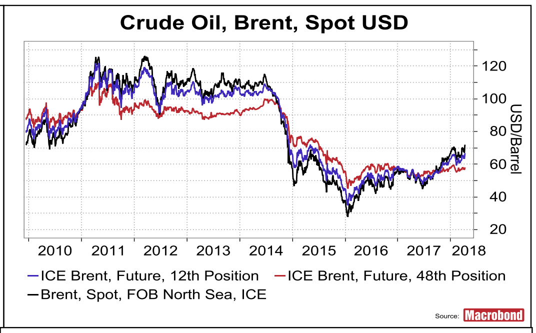
(*) Central government only

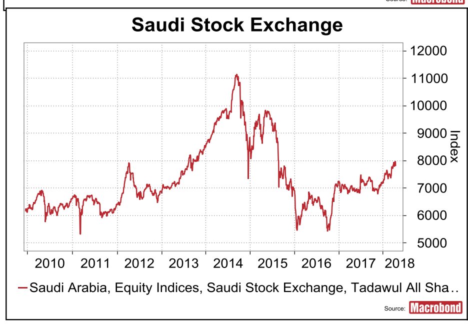
*Source: OEF (Oxford Economic Forecasting) and SEB estimates.*

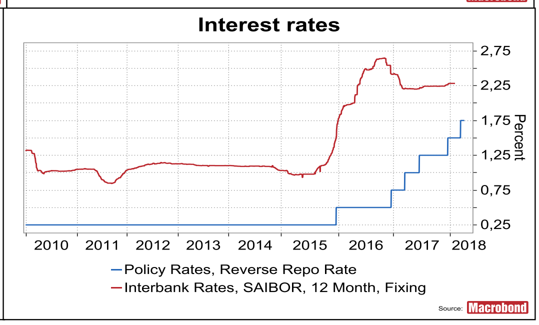
| **Rating history** | | | | | | |
|---|---|---|---|---|---|---|
| Fitch (eoy) | AA | AA | AA | AA | AA- | A+ |
| Moody's (eoy) | Aa3 | Aa3 | Aa3 | Aa3 | A1 | A1 |

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



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