

COUNTRY REVIEW

Saudi Arabia



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EULER HERMES COUNTRY RISK GRADE: BB

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.**

Strengths

- The country is of strategic importance as it is the world's leading crude oil producer (12.6% of global annual output) and possesses 21% of known reserves, which will last for a further 69 years at current rates of extraction
- Natural resource abundance guarantees close relations with the US, as does...
- ...the country's wealth (asset based) and therefore regional authority
- Long-standing, stable exchange rate peg underpins monetary stability (see also Weaknesses)
- Current account surpluses
- Net external creditor position mitigates transfer risk
- Relatively sound and well-regulated banking sector

Weaknesses

- High unemployment (and under-employment) and a lack of political representation have fuelled increased militancy among a largely disenfranchised and frustrated population
- Regional uncertainties, with a land border with Iraq and Iran as close neighbour
- Exposure to oil price and output cycles contributes to export volatility and wide variance in fiscal and current accounts
- Although the long-standing, stable exchange rate peg to the USD underpins monetary stability in times of dollar steadiness, use of domestic policy instruments (interest rates) is limited when the USD is volatile and the Fed is manipulating its own key rates
- Data transparency is below average for a high income economy, with some statistical gaps and late supply of other information

Key Risks

- Collapse in oil prices to around USD30/barrel, or under, for a sustained period
- Given its strategic regional importance, military action or nuclear attack elsewhere in the Middle East could result in active Saudi participation

Country Risk Assessment

Ratings	Saudi Arabia		Median Grade BB	Israel	Peers	
	Latest	Previous			Kuwait	Qatar
Systemic Political Risk:	P2-	P2-	P2+	P2-	P2-	P2-
Systemic Economic Risk:	E3	E3	E3	E3	E3	E3
ME rating:	ME3	ME3	ME3	ME3	ME3	ME3
<i>Structure</i>	5.0	5.0	3.3	1.6	5.0	5.7
<i>Policy</i>	5.2	3.8	3.8	2.8	5.6	4.2
<i>Solvency</i>	1.0	1.0	1.3	3.2	1.0	1.9
<i>External Liquidity</i>	3.3	3.8	3.6	4.8	1.7	2.3
SBE rating:	SBE2	SBE3	SBE2	SBE2	SBE2	SBE2
COUNTRY GRADE:	BB	BB	BB	BB	BB	BB

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Riyadh
Population:	25.2 mn (2008)
GDP:	USD 480000 mn (2008)
Currency:	Riyal (SAR)
Form of state:	Kingdom
Head of government:	King Abdullah bin Abdel-Aziz al-Saud
Next elections:	None

Major Industries (% of GDP at market prices, 2008)		Global Assumptions	2008	2009f
Agriculture	3.0%	Real GDP grth (% yr/yr) *	0.7	-3.0
Industry	62.0%	Inflation (% , av) *	3.4	1.0
Services	35.0%	Dated Brent (USD/b)	98.0	55.0
		* Major economies		

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Crude petroleum	77.0%	Machinery & transport equipment	44.0%
Refined oil products	14.0%	Foods	14.0%
		Chemicals & Metals	7.0%
Lead Export Markets (% of total exports, 2008e)		Lead Import Markets (% of total imports, 2008e)	
US	18.0%	US	12.0%
Japan	16.0%	China	11.0%
China	10.0%	Japan	8.0%
South Korea	9.0%	Germany	8.0%

Basic indicators

Selected economic indicators	2005	2006	2007	2008	2009f
Nominal GDP (USD mn)	315,580	356,630	381,734	480,000	373,333
Population (mn)	23.61	24.15	24.68	25.20	25.80
GDP per capita (USD)	13,366	14,767	15,467	19,048	14,468
Real GDP growth (% yr/yr)	5.6	3.2	3.4	4.5	-1.0
Inflation (% , ave)	0.7	2.2	4.2	9.9	3.0
Fiscal balance (% of GDP)	18.4	21.0	12.3	32.8	7.1
Current account balance (% of GDP)	28.5	27.8	24.9	26.0	13.4
External debt/GDP (%)	13.9	12.8	17.0	15.4	16.1
External debt/Exports of goods & services (%)	22.8	19.9	25.3	22.4	30.0
Debt-service ratio (%)	1.9	1.9	2.0	1.8	2.4
Foreign exchange reserves (USD mn)	24,074	25,971	32,308	28,223	28,000
Import cover (months)	3.9	3.3	3.0	2.3	2.6
Exchange rate assumption, SAR:USD (av)	3.75	3.75	3.75	3.75	3.75
f: CRU central forecast					

Sources: SAMA, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

The al-Saud family retains strong control over the central levers of power, including the military and the National Guard, as well as holding all the key cabinet positions. Crown Prince Abdullah bin Abdel-Aziz al-Saud was de facto head of government from 1995 when King Fahd suffered a major stroke. Following the king's death in 2005, Abdullah officially became monarch in August of that year, with the royal family ensuring that the succession was smooth and that policy continuity was enshrined. Abdullah favours gradual reform but appears more intent on real progress, despite having to accommodate the views of more conservative family members. He is further constrained by the al-Saud's dependence on the religious establishment for legitimacy in what remains **an ultra-orthodox Wahabbist Islamic state**. Accordingly, the overall pace of change remains slow and key structural challenges such as high unemployment among young people (38% of the population is aged less than 15 years) have not been addressed effectively. Lack of a representative political system through which grievances can be aired has contributed to radicalisation of the young (especially in poorer rural areas) and increasing support for radical Islamist groups that offer more militant alternatives.

In March 2009, King Abdullah appointed his half-brother Prince Naif bin Abdulaziz as second deputy prime minister, placing him behind only Crown Prince Sultan in terms of succession. As Sultan's health remains poor, Naif (who held the interior ministry for many years) now seems favourite to become the next crown prince. The appointment removed some lingering political uncertainties but Naif is 74 years of age (Abdullah is 84) and the handover to a younger generation has therefore yet to be signalled. **The innate conservatism of the current leadership suggests policy continuity** in the short- to medium-term but, also, that the reform process will be slow and political reforms will only be countenanced after much deliberation.

In early 2009, a cabinet reshuffle replaced staunch conservative forces with relative moderates in the justice and education ministries. This should not be taken as an indication that the influence of radical clerics has been diminished significantly and that reforms will now be introduced more quickly. Indeed, **in May, municipal elections were postponed for two years**. These local polls are a tentative step towards a more inclusive political system but the 178 councils have few powers and electoral choice is limited as half the seats are government appointments. Key members of the royal family continue to indicate that some voting rights for women may be allowed and that partial elections to the Consultative Council (Majlis al-Shura) will be contemplated. However, as ever with Saudi Arabia, such developments will be adopted only slowly and only if the vested interests of the royal family will not be damaged by any changes. In the interim, **expectations of the largely disenfranchised and frustrated youth present a risk for further demonstrations and resort to terrorist action**.

Occasional terrorist attacks within the kingdom, particularly on US targets, have resulted in concerted attempts by the Saudi authorities to tackle militant religious extremism through a show of force. A number of arrests and violent clashes between well-armed extremists and security forces provide evidence that the crackdown is being successful, although further incidents should be expected.

There is a **long-standing strategic relationship between Riyadh and Washington**, based on the exchange of oil supplies for assistance with national security. Relations are periodically strained, as was the case following 9/11 and revelations that 15 of the 19 hijackers were Saudi nationals and when Saudi Arabia opposed Israel's invasion of southern Lebanon in 2006. Diplomatic ground is usually restored and both parties are aware of the necessity of mutual support. Withdrawal from the kingdom in 2003 of the majority of US troops used in the war with Iraq provided some respite for the regime in Riyadh, which faced considerable domestic opposition to the presence of non-Muslim forces on Saudi soil. Although relations will continue to be strained, at times, particularly in the event of further terrorist attacks, **the Riyadh-Washington axis is likely to prevail (and perhaps strengthen) under the new Barack Obama leadership in the US**. Regionally, Saudi Arabia is **the leading force within the Gulf Co-operation Council (GCC)** and has become involved in attempts to broker regional conflict resolutions, including the ongoing Arab-Israeli tensions and the political impasse in Lebanon. **Saudi Arabia also plays a lead role within OPEC**.

Economic Stability

Saudi Arabia is **the world's leading crude oil producer** (12.6% of 2007 global output) and possesses 21% of known reserves, which will last for a further 69 years at current rates of extraction. Gas reserves are the fourth largest in the world and will last for 94 years, although production, as yet, represents only 4% of world output. As a result, **the economy is highly dependent on oil and gas**

revenues for around 50% of GDP, approximately 80% of government revenues and over 90% of exports. Principal markets for the country's exports are the US and Japan (18% and 16%, respectively by value), as well as the emerging industrial powers in Asia, including China. Economic performance therefore follows closely international oil price and output cycles. Major volatility in these markets, as well as rapid population growth, has resulted in real GDP per head improving only by an average 0.9% per year over the long term. Nevertheless, estimates of per capita GDP classify the country within the World Bank's high income bracket.

Annual average real GDP growth was only 2.3% between 1991 and 2002 but around 5% between 2003 and 2008, a period of strong expansion in the global economy and in world trade. Much of this latter period of growth reflected buoyant markets for hydrocarbons. High oil prices in the international energy markets resulted from geo-political supply concerns (including Russia, Nigeria, Venezuela, Iran and the wider Middle East) and high demand from the US and emerging Asian markets (China and India, in particular). Through this period, and in support of calls on OPEC members to pump increasing volumes of crude oil, Saudi Arabia was the principal beneficiary of strong oil prices, although Saudi crude is relatively poor quality and trades at a discount to benchmark prices. Indicative Brent oil prices averaged USD98.5/barrel in 2008, having traded at below USD30/b in 2000-03. However, we now forecast that Brent oil prices will average only around USD55/b this year, reflecting the rapid slowdown in the world economy and in world trade. Accordingly, **Saudi GDP is forecast to contract by around 1% in 2009, although government spending should boost growth back to around 3% in 2010.** Despite official attempts to diversify the economy, dependence on oil will continue into the medium term, at least.

As with all aspects of the economy, **public finances rely on oil revenues** and therefore on the vicissitudes of international energy prices. With outgoings including a high wage bill, subsidies and large domestic interest payments, the fiscal balance can vary between a deficit (almost 4% of GDP in 2001) to large surplus in years of high oil prices (we estimate over 32% in 2008). Government policy is to use some 'windfall' earnings in periods of high oil prices to reduce the stock of public debt, which was estimated to be around 85% of GDP in 2003 but declined to below 20% last year. **In 2009, we forecast a budget surplus of around 7% of GDP but public debt will rise to around 22% of GDP,** although remaining comfortable. Moreover, large FX inflows in recent years extended the country's large foreign asset base and improved its net external creditor status.

The cornerstone of monetary policy is the LT fixed peg of the riyal to the USD at SAR3.75. This acts to reduce inflationary pressures when the USD is steady, but it also reduces the possible actions of the local monetary authorities in sterilising large inflows of petrodollars through independent movements in interest rates. The real effective exchange rate of the riyal depreciated in 2007 and the first half of 2008, despite inflationary pressures. The central bank, SAMA, suggests that the current exchange rate peg to the USD is appropriate and the Saudi authorities view the mechanism as having provided decades of macro-economic stability (almost all exports and around 70% of imports are denominated in dollars). Independent assessments indicate that **the riyal is only moderately undervalued.** Recent speculation that the LT fixed peg of the riyal will have to be altered has subdued, partly because inflationary pressures are easing and partly because of heightened uncertainties in global economic and financial markets. We expect that the Saudi authorities will be very reluctant to abandon the peg and will resist such moves unless the GCC states as a whole agree on concerted action. Monetary union within the GCC, including a common currency, had been scheduled for 2010 but, with Oman and now the UAE opting out, it seems unlikely that the timetable will be met. Accordingly, **we do not envisage a change in the exchange rate system in the ST and monetary policy will continue to be dictated by actions of the Fed.**

Reflecting the period of sustained high oil prices, the **current account surplus averaged over 26% of GDP in 2005-08 but will halve to around 13% in 2009,** reflecting weak global demand for oil (and reduced earnings from exports of hydrocarbons). Merchandise exports are estimated to have reached a record level of around USD300bn last year but are forecast at around USD200bn in 2009. However, reduced world commodity prices will ease import costs and the merchandise trade balance will remain firmly positive at USD90-100bn. With only modest debt repayments, a financing surplus will be recorded, which will be used for minor reserve accumulation and boost to foreign asset holdings. Saudi Arabia's FX reserves are currently around USD28bn and provide import cover of less than three months, which is the internationally-recognised safe minimum. However, this apparent weakness is offset by Saudi's large sovereign wealth fund and other foreign assets, providing a total fund of around USD400bn. Accordingly, **the country is a substantial net creditor.** External debt ratios are low, with total foreign debt stock at 15-16% of GDP and 20-30% of export earnings, and the debt service ratio is 1-3%, suggesting that external payments of such obligations will not be problematic.

Structural Business Environment

The business environment is generally sound and above average for the countries we assess. The Heritage Foundation's 2009 Index of Economic Freedom (IEF) classifies Saudi Arabia as "moderately free" and ranks it 59 out of 179 countries covered, above South Africa, Uganda and France but below the UAE, Peru and Malaysia. The IEF records high scores for freedoms in areas such as fiscal stance (there are very few individual or corporate taxes), labour markets and the overall regulatory freedom to conduct a business but Saudi registers relatively poorly in terms of government interference in financial markets and the legal system, as well as state domination in the hydrocarbons sector. Although foreign investment in some non-oil sectors is encouraged at official levels, the extensive royal family has vested interests that it will continue to protect. In terms of trade policy, tariff rates have fallen in line with GCC customs harmonisation and WTO accession in December 2005 but **non-tariff barriers** (such as inconsistent implementation of regulations and standards and domestic bias in government procurement) **may hinder some commercial transactions**. Exporters should check for periodic import restrictions, particularly in relation to shipments of live animals and foodstuffs.

The World Bank's Doing Business Survey 2009 ranks Saudi Arabia highly in terms of ease of doing business, scoring it 16th out of 181 economies assessed. Saudi rates best in the world in relation to registering property but the Survey notes that the number of procedures involved in contract enforcement equates to the regional average and the costs incurred are higher. However, the insolvency process takes less time and the recovery rate is higher than regional averages. Transparency International's Corruption Perceptions Index 2008 ranks Saudi Arabia as 80= with Brazil, Morocco and Thailand, out of 180 countries assessed, below China, Mexico and Peru but above India, Madagascar and Panama.

The **banking sector is generally sound and well regulated** by the Saudi Arabian Monetary Agency, but its over-exposure to the health of the oil sector and government finances provides some volatility. Most large banks have a strong capital base and deposits carry a government guarantee.

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Charts

