Country report **SAUDI ARABIA**

Summary

The Saudi Arabian economy is highly reliant on its oil resources. As it possesses a quarter of the world's proven oil reserves and is the world's only "swing producer" since it has considerable capacity to extract more barrels from its sources, the country plays an important international role. The main country risks lie in the geopolitical sphere, as contagion from the Arab spring uprising is a risk, while the threat from Iran and from Al-Qaeda linked militants in Yemen persist. Inflation is creeping up on the back of higher food and housing costs. The political situation remains stable, despite the recent death of the Saudi Crown Prince Abdel-Aziz al-Saud. The current account position is sound due to significant oil exports revenues. The economy is estimated to grow at a moderate 6% in 2011 and forecasted to grow by 5% in 2012.

Things to watch:

- Possible contagion from Arab Spring uprising
- Geopolitical security risks from Iran and Yemen
- Upward inflationary pressures

Author: **Ashwin Matabadal**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21- 61601
A.R.K.Matabadal@rn.rabobank.nl

Saudi Arabia

National facts		
Type of government	Absolute monarchy	
Capital	Riyadh	
Surface area (thousand sq km)	2,150	
Population (millions)	27.1	
Main languages	Arabic	
Main religions	Muslim (100%)	
Head of State (president)	King Abdallah bin Abdel- -Aziz al Saud	
Head of Government (PM)	Crown Prince Nayef bin Abdel-Aziz al-Saud	
Monetary unit (code)	Riyal (SR)	

Economy	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	448	0.72
Nominal GDP at PPP	623	0.84
Export value of goods and services	248	1.33
IMF quotum (in mln SDR)	6986	3.21
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.1	3.0
Agriculture (% of GDP)	3	3
Industry (% of GDP)	62	64
Services (% of GDP)	36	33
Standards of living	*USD*	*% world av.*
Nominal GDP per head	16498	167
Nominal GDP per head at PPP	22969	195
Real GDP per head	13296	167

Social and governance indicators	rank / total
Human Development Index (rank)	55 / 169
Ease of doing business (rank)	12 / 183
Economic freedom index (rank)	54 / 179
Corruption perceptions index (rank)	50 / 178
Press freedom index (rank)	157 / 178
Gini index (income distribution)	n.a.
Population below $1 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Japan	14	China	12
US	13	US	11
South Korea	13	South Korea	6
China	11	India	5
Main export products (%)			
Crude petroleum			75
Refined products			12
Main import products (%)			
Machinery & transport equipment			51
Foodstuffs			15
Chemical & metal products			9
Openness of the economy			
Export value of G&S (% of GDP)			55
Import value of G&S (% of GDP)			37
Inward FDI (% of GDP)			6.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

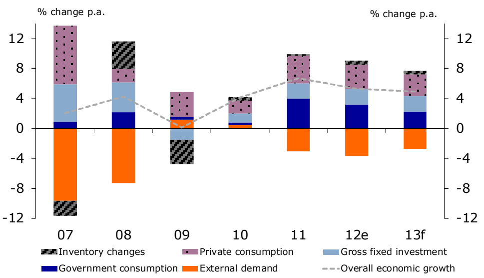
Saudi Arabia has an oil-based open economy with strong government controls over major economic activities. The petroleum sector accounts for roughly 80% of budget revenues, 45% of GDP and 90% of export earnings. The country possesses about 25% of the world's proven petroleum reserves, ranks as the largest exporter of petroleum and plays a leading role in OPEC as 'swing producer' with excess production capacity and huge financial reserves to survive oil revenue declines. This status gives it the market power to manipulate the world oil prices and is the basis for its international clout. Saudi Arabia is making slow progress in encouraging the growth of the private sector in order to diversify its economy and to employ more Saudi nationals, since less than 5% of the workforce is employed in the state-dominated oil-related businesses. Diversification efforts are focusing on power generation (including nuclear), telecommunications, natural gas exploration and petrochemical refineries. The government has begun establishing six "economic cities" in different regions of the country to promote private sector activity and economic diversification. These massive infrastructural works are valued at USD 385bn for the next five years.

On the back of this substantial government spending and also of sustained foreign demand for oil exports, the economy is estimated to grow 6.7% in 2011, up from 4.1% in 2010. Downside risks to this estimate are the slowing of the world economy and impact of the regional turmoil.

The country's main export markets and largest petroleum off-takers are Japan, China, South Korea and the US. Saudi Arabia mostly imports machinery and transport equipment to support the oil

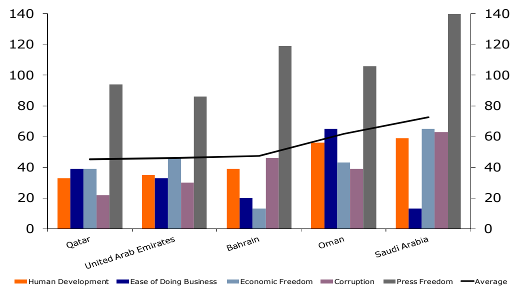
industry while foodstuffs are the country's second-largest import product. The US and China are Saudi Arabia's main import partners.
The banking sector is sound, after the authorities made direct capital injections into banks and explicitly guaranteed bank deposits in 2008 and 2009 during the nadir of the global financial crisis. The large financial reserves of the Saudi authorities lend credibility to the support for the banking sector. Overall bank sector credit growth was 8.2% yoy in September 2011, which is a moderate level but up from 2010 as domestic lending conditions have improved due to strengthening domestic activity. The banking sector has no significant exposure on sovereign debt of Europe's peripheral countries.

Chart 1: Economic growth



Source: EIU

Chart 2: Social & governance indicators



Source: EIU

Political and social situation

Saudi Arabia has no political parties, the monarchy is hereditary and the political decision-making is dominated by the al-Saud clan. Royal decrees of 2003 and 2006 promised some sort of election of a next king, broadening of the electorate and even elections of local and provincial executives, but no such elections have been held or even announced until now. Councillors are elected by the monarch in what is basically a hierarchical feudal political system.
Similarly, the legal system is far from modern, being largely based on Islamist sharia law, although several secular laws have been introduced and commercial disputes are handled by special non-religious committees. In line with the belief in Islamic religious supremacy, the country has not committed itself to accept any jurisdiction of the International Court of Justice.
Succession risks are a risk to political stability in the future, highlighted after the death of Crown Prince Sultan bin Abdel Aziz last October. As his death was anticipated due to a long-standing illness, no political turmoil is expected. His brother, Nayef bin Abdel-Aziz, is likely to become the next crown prince. Moreover, Saudi Arabia faces longer-term challenges, as the princes next in line, which include Nayef, are very old (60-80 years), and unlikely to remain in power very long. As the next generation is eager to step into positions of greater responsibility, future political transitions will likely be more troublesome.
Social tensions have increased recently and the risk of contagion from the Arab Spring uprising in neighbouring countries is a threat, especially in the Eastern Province, which is dominated by the Shi'a minority. Shi'a grievances over poor socio-economic conditions as well as alleged discrimination at the hands of the Sunni Wahhabi authorities periodically trigger protests. However, the risk of an actual Arab Spring like uprising has been quelled in the near term by the authorities by boosting social spending. The government had announced social support packages in February and March 2011 that include the first ever unemployment benefits and greater social security benefits. While we do not expect an actual Arab Spring uprising in Saudi Arabia given the government's response, protests are likely to continue to cause social unrest in the future as long as the Shi'a minority feels disadvantaged.

Saudi Arabia remains very vigilant on a militant threat to the country from neighbouring Yemen. The strengthening of Al-Qaeda militant activity is a particular concern, considering the increase in instability since last February. However, the Saudi forces are considered highly capable of fending off the militant threat and the oil installations are very well protected. Regionally, Saudi Arabia will continue to compete with its arch-rival Iran for influence, whose nuclear capabilities remain a threat to the country's security.

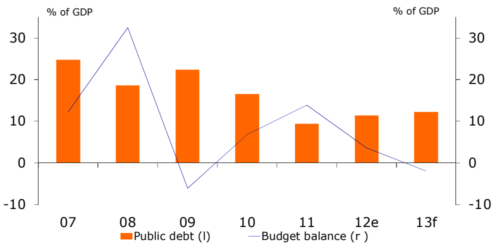
Economic policy

The state is a dominant force in the economy, as it has a strategic monopoly over crude oil production and the oil sector provides the bulk of fiscal revenues. Saudi Arabia' s economic policy is to maintain its grip on the nation's oil and gas economy and expand the economic base into the sectors of power generation (including nuclear), telecommunications, natural gas exploration and petrochemical refineries. It has outlined this strategy in its ninth five year development plan of USD 385bn, which is mostly aimed at drawing in private investment to fuel the expansion of the non-oil sector. The authorities stimulate inward foreign investment not only to fund the non-oil sector expansion, but moreover they hope it will bring in technology and more specialized knowledge for the non-oil sector. FDI mostly takes the form of private sector participation in power generation and the telecom sectors. Saudi Arabia acceded to the WTO in 2005 after many years of negotiation, but this has little impact on the country's main activities as the oil and gas sectors are largely exempt from current WTO rules.

Additional to this plan are the social support packages of around USD 150-160bn, which are aimed to provide better social security conditions and reduce youth employment in order to stem any social unrest. As a result, government spending will rise in 2011 and 2012, but fiscal revenues will rise even more. Mostly on the back of oil export revenues, as global oil prices and demand have been high. Tax revenues also support the fiscal balance, as tax rates are relatively high in the region. Foreign companies are levied a 20% income and capital gains tax, while domestic companies are levied a lower tax rate. Companies in the oil and gas sectors also face higher tax rates. The budget surplus is estimated at 13.9% of GDP in 2011 and 3.6% of GDP in 2012. As public debt is estimated at 9% of GDP in 2011, this results in very healthy fiscal balances in 2011. In 2012, the budget surplus will decrease to 3.6% of GDP as the government's social support packages will be implemented and in addition a mayor railway construction between the Red Sea and the Gulf worth USD 10bn will be financed in 2013. It is forecast this could push the fiscal surplus lower in 2012 and into a deficit in 2013 as the bulk of the spending will take place in the coming two years. However, if oil export revenues do not plummet in the coming years, we expect the budget balance to return into positive territory after 2013.

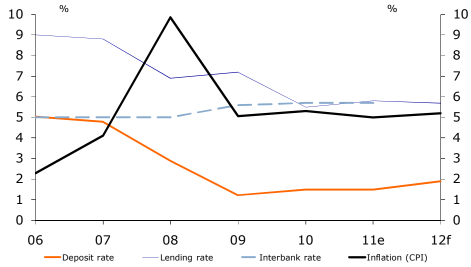
Inflationary pressures are high in Saudi Arabia, reflecting local housing shortages, higher domestic demand induced by large fiscal spending and a rise in global food prices. Around 14% of the

Chart 3: Public finances



Source: EIU

Chart 4: Interest rates and inflation

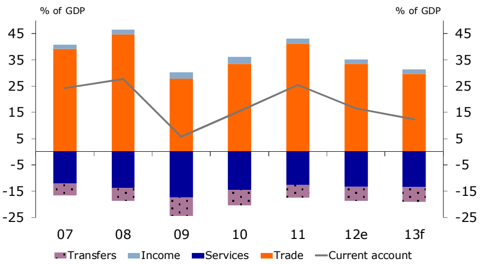


Source: EIU

country's total imports are food imports. Despite decades of food policy efforts and massive desalination plants, the economy will remain structurally unable to feed its population of 27million inhabitants, growing at a rapid pace of 2.5% per year. Long-term food security is thus not assured and imported food price inflation will remain a concern. These inflationary pressures are likely to persist and headline inflation is estimated at 5% in 2011, and forecast to remain above 5% in the coming years.
The domestic currency, riyal, is pegged nominally to the USD at 3.75 SAR/USD. While sticking to the stable peg has served as a credible anchor for monetary policy and the economy as a whole, it makes Saudi Arabia dependent on US monetary policy. Monetary policy is likely to remain accommodative to boost economic growth and lending, despite persistent inflation. The country's central bank, the Saudi Arabian Monetary Authority (SAMA), is likely to wait for a cue from the Federal Reserve before raising rates. The government is likely to implement food subsidies to ease food price inflation, especially given the high risk of social turmoil.
A monetary union of Saudi Arabia with three other of the six Gulf Cooperation Council states has been delayed for political and institutional reasons. Two GCC states (UAE and Oman) opted out earlier.

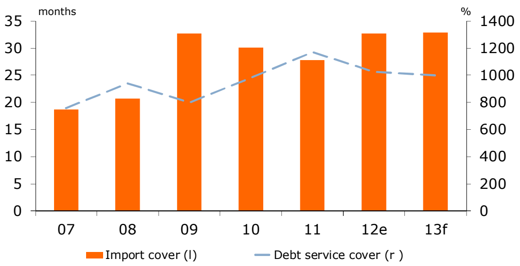
Balance of payments
The current account is in very healthy shape, as it has posted an average surplus of 20% of GDP in the past five years, and a surplus of 17% of GDP is estimated for 2012. These surpluses have come on the back on oil exports, Saudi Arabia's main and almost only export product.
Oil export volumes are regulated by means of production ceilings through OPEC quota or unilaterally by state intervention. These quota are insensitive to nominal and real exchange rates, but effectively aim to stabilise market shares by country of production. Saudi oil policy has been guided by a desire to maintain world market shares. It also seeks to capitalise on its geopolitical role as 'swing producer'. The country may thus opt to use its overcapacity to influence oil prices and increase its markets share at minimal additional domestic costs.
The trade balance is the supporting pillar of the current account. A surplus of 41% of GDP is estimated for 2011, up from 33% of GDP in 2010, due to high global demand for oil as well as high global oil prices. The deficit on the services balance of 15% of GDP in 2011 reflects the need to import most of the sophisticated business services and the substantial tourism expenditures abroad. The income balance shows a small but growing surplus of around 3% of GDP, which is indicative of the net international creditor status of the Saudi economy. The net outflow of transfers are predominantly those made by expat workers to their often Asian countries of origin, but also the government itself has increasingly become an economic aid donor to other less-wealthy Islamic countries.

Chart 5: Current account



Source: EIU

Chart 6: Covers offered by FX-reserves



Source: EIU

As a result of the current account surpluses, no external financing via the financial account is required. The level of official FX-reserves will increase to USD 555bn in 2010, markedly up from USD 444bn in 2010.

External position

Saudi Arabia is a net creditor country and has a very healthy external position. Total foreign debt is rather modest at 17% of GDP, but the portion of short-term debt is rather high at 47%.
With sizeable FX levels of USD 555bn, the liquidity position is extremely comfortable. The import cover amounts to 28 months and debt service cover to 1170%, both indicate an excellent ability to honour all existing short and longer term debt obligations.

Saudi Arabia

Selection of economic indicators	2007f	2008f	2009f	2010f	2011f	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	2.0	4.2	0.1	4.1	6.7	5.3	4.9
Consumer prices (average % change pa)	4.1	9.9	5.1	5.4	5.0	4.4	3.2
Current account balance (% of GDP)	24.3	27.8	5.7	15.6	25.5	16.6	12.4
Total foreign exchange reserves (mln USD)	305455	442249	409694	444722	555605	586666	615949
Economic growth							
GDP (% real change pa)	2.0	4.2	0.1	4.1	6.7	5.3	4.9
Gross fixed investment (% real change pa)	18.8	12.6	-4.6	3.6	6.2	6.5	6.4
Private consumption (real % change pa)	17.7	3.5	6.7	3.2	6.9	6.0	5.3
Government consumption (% real change pa)	2.4	6.0	1.0	1.0	11.2	8.6	5.8
Exports of G&S (% real change pa)	2.7	-4.2	-7.3	8.3	7.3	0.5	1.2
Imports of G&S (% real change pa)	22.2	9.7	-6.3	4.2	10.0	6.6	5.3
Economic policy							
Budget balance (% of GDP)	12.2	32.5	-6.1	6.8	13.9	3.6	-1.9
Public debt (% of GDP)	25	19	22	17	9	11	12
Money market interest rate (%)	5.0	5.0	5.6	5.7	5.7	n.a.	n.a.
M2 growth (% change pa)	20	18	11	5	17	10	10
Consumer prices (average % change pa)	4.1	9.9	5.1	5.4	5.0	4.4	3.2
Exchange rate LCU to USD (average)	3.7	3.8	3.8	3.8	3.8	3.8	3.8
Recorded unemployment (%)	11.0	9.8	10.5	10.8	10.9	10.7	10.6
Balance of payments (mln USD)							
Current account balance	93379	132315	21427	69676	151395	96927	74968
Trade balance	150716	212026	105229	149502	244260	195194	178440
Export value of goods	233311	313480	192307	237851	350721	309213	298274
Import value of goods	82595	101454	87078	88349	106461	114019	119834
Services balance	-46690	-65864	-65242	-64762	-74449	-77507	-81329
Income balance	6396	9165	8612	11837	10905	10907	11107
Transfer balance	-17043	-23012	-27172	-26900	-29321	-31667	-33250
Net direct investment flows	22956	34653	29923	24198	23113	24579	25769
Net portfolio investment flows	-5227	-3545	-20043	-19967	-44236	-27543	-20702
Net debt flows	17782	9997	-6005	8554	20054	17972	13923
Other capital flows (negative is flight)	-49458	-36465	-57856	-47433	-39300	-80818	-64857
Change in international reserves	79432	136955	-32555	35028	111026	31117	29101
External position (mln USD)							
Total foreign debt	70522	79003	72398	80952	101006	118978	132901
Short-term debt	40974	45329	38906	39474	47566	50943	53541
Total debt service due, incl. short-term debt	40263	47119	51261	45282	47492	57200	61563
Total foreign exchange reserves	305455	442249	409694	444722	555605	586666	615949
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	39.2	44.5	27.9	33.4	41.1	33.4	29.6
Current account balance (% of GDP)	24.3	27.8	5.7	15.6	25.5	16.6	12.4
Inward FDI (% of GDP)	5.9	8.0	8.5	6.3	4.5	4.8	4.8
Foreign debt (% of GDP)	18	17	19	18	17	20	22
Foreign debt (% of XGSIT)	27	23	33	30	26	34	39
Debt service ratio (% of XGSIT)	15	14	23	17	12	17	18
Interest service ratio incl. arrears (% of XGSIT)	1	1	2	1	1	2	2
FX-reserves import cover (months)	32.8	36.1	60.9	55.6	50.1	58.5	58.7
FX-reserves debt service cover (%)	759	939	799	982	1170	1026	1001
Liquidity ratio	253	270	284	304	319	319	311

Source: EIU