Saudi Arabia

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The economy has recovered and as such proved resilient to steep falls in the global oil price. However, politics have become less predictable with risks potentially rising both on the internal and external arena. That could provide a less supportive environment for new policy initiatives needed to solve underlying demographic problems with large numbers of new entrants to the labor market each year.

Country Risk Analysis

Recovery continues: Following a year of cuts to oil production and weak domestic demand the economy staged a strong comeback in 2018 which is poised to continue in the current year and into the next decade albeit at a more moderate pace of 2% annual growth. Depending on the oil price the external balance should show a decent surplus around 2%/GDP while the budget deficit should continue to creep down in a gradual fashion to clearly less than 5%/GDP. With exceptionally high reserves at the outset, sufficient to make up for years of any hypothetical worst case scenario of zero oil export revenues markets are likely to take any economic/financial deterioration in strides. The country has so far adjusted reasonably well to a new era of a lower oil price with any hopes for higher prices effectively quelled by the US oil-shale sector.

Stalled reforms and growing state violence: Reforms have continued under Vision 2030 focused on infrastructure and social security. The government has also initiated legal changes to the business environment. Other parts of the envisioned reform programs, by contrast, seem to have stalled including the much touted partial milestone privatization of Aramco – the national oil company. It may be speculated whether that is related to the apparent battle for influence between the old business elite and parts of the Royal family on the one side and the young and assertive new heir apparent, Crown Prince Muhamad bin Salman on the other. Rising state violence including mass executions against minorities and the murder of the journalist Kashoggi, may also fall into this picture.

Outlook: The near term outlook for the economy over the next few years is reasonably risk free having already showed resilience to deep drops of the global oil price. The risks lie more in regional security including a smoldering military confrontation with Iran that could have consequences for oil exports. Internal politics may also come more into focus. While the Kingdom was never seen as a human rights paradise, reputational risks could start to weigh on business interests. Least but not last, for the health of society and the economy, the growing numbers of young entrants into the labor market needs to be tackled without delay in terms of attitudes and skill mismatches.

Ratings: None of the three major rating agencies have announced rating changes over the last 12 months period as regards the sovereign.

Recent developments:

Continued recovery: Following a year of cuts to oil production and weak domestic demand the economy staged a strong comeback in 2018 which is poised to continue in the current year and into the next decade. Last year activity quickened to 2,2% expansion as output of crude increased by almost 3% and the non-oil economy expanded by 2%. That pattern is likely to change in the current year as the non-oil economy is set for a boost of 2,7% on new fiscal stimuli while the oil sector moderates to a growth rate of 2% following OPEC cuts of last December -- so far decided for a six months period. A sharp rise in the PMI (Purchasing Managers Index) in February has combined with soaring business optimism to kick start the non-oil economy now that the government has settled its payment arrears vis-à-vis private contractors. As always, that story much hinges on calm in global energy markets such that production quotas can be normalized in the second half of the year.

High unemployment: Notwithstanding improving growth outlook, high unemployment at 13% is set to continue. The government, the traditional employer of some two thirds of Saudi nationals is seeing coffers shrinking from the highs of past times and cannot boost payrolls forever. While attempts at addressing the problem are becoming imperative, including levies to discourage employers hiring foreign workers, skill mismatches between what employers need and what most new entrants can offer will probably prevent a solution for years to come.

Low inflation: Last year price pressure jumped to 3% on the Consumer Price Indicator (CPI) mainly in response to government cuts to consumer subsidies (power and gasoline) and the VAT hike at the beginning of the year. In the current year expectations are for price pressure to fall back again to 1%, just within the central bank's target rate.

The external balance turns into a steady surplus: Since the commodity crises in 2014, when the oil price collapsed and the Saudi external balances turned negative, the country has made significant adjustments. As a result, the current account has turned into a surplus again and is likely to remain so for the current year and well into the next decade barring a new period of ultra-low oil prices from the present level of $60-70/barrel.

Inclusion into global share indexes: Towards the end of last year the trade surplus combined with a growing surplus on the capital account with and signs are good this will continue into the current year as the Saudi stock exchange main index will be included in two major global equity portfolios, the FTSE/Russel and the MSCI. As a result, and despite hefty debt repayments by Saudi entities, reserves will stay flat but for possible valuation changes. At less than $200bn, about a quarter of annual GDP, total external debt is low compared with peers and less than 40% of official reserves valued at almost $500bn. held by SAMA (Saudi Arabia's Monetary Agency) – the country's *de facto* central bank. These reserves can also cover more than three years of imports, a very solid number by any measure.

Policies

New fiscal stimuli partly offset by new taxes and subsidy cuts: Last December the government unveiled a more expansive fiscal stance for 2019 with spending growing 7%. That came on top of the stimuli announced in the Royal Decree from early 2018 for infrastructure, housing etc. which has been extended to 2021. The additional spending which also includes SAR32bn for the new mean-tested social security contribution, the Citizen Account Program, will be financed by cuts in subsidies for power and gasoline and the new value added tax (VAT) rate of 5% on most goods and services. Previously expected proceeds from the partial privatization of

Aramco, the state owned Saudi oil company, will not materialize anytime soon, by contrast, as the operation has been pushed forward to at least 2021. Nevertheless., the budget deficit is expected to narrow further, but by how much depends ultimately on the budget's income from oil which in normal years make up more than three quarters of total government revenues. The IMF in its latest country report estimates the budget shortfall to only 1,7%/GDP for 2019, down from around 5%/GDP the year before on an oil price of almost $70/barrel. On a less optimistic price of $64/barrel, the deficit would rather rise to5,6%/GDP.

Structural reforms taking a pause: Vision 2030, the structural reform program launched in early 2018 continues with a focus on infrastructure, investor rights and relaxed restrictions on inbound foreign investments even though its privatization part has begun to suffer, most prominently evidenced by the shelving of the Aramco sale. That is despise a newly established National Privatization Committee and shows in the view of one rating agency the complexities the government is facing in opening up it public sector to private interests. In return the government has apparently begun to focus more on its Public Investment Fund (PIF) and old establishment with large holdings in key Saudi sectors worth some SAR840bn. about a quarter of annual GDP. However, its growing role in the Saudi economy is hardly an alternative to more privatizations. On the contrary that may rather lead to a larger government footprint crowding out the private sector.

Box 1: The oil sector. Saudi Arabia contends with the US and Russia for being the world's largest oil producer all of which pump more than 10mbpd (million barrels per day) of crude and condensates (the latter associated with crude). Saudi Arabia is the supreme leader within OPEC but as the latter has seen its influence curbed by the meteoric rise of the US in global energy production, it has begun to cooperate on an informal basis with Russia (and other non-OPEC producers, i.e. "OPEC+") in keeping the global oil market in equilibrium and by that oil prices reasonably stable. Last December seeing oil prices fall by 30% over a few months, OPEC agreed to renew previously agreed supply cuts for a total of 1,2mbpd (about 1,3% of global demand). That was after an earlier June decision to raise output by 1mbpd which allowed Saudi Arabia to hike production by 6% to 10,5mbpd. After the latest December agreement Saudi output fell back to 10,1mbpd in last February. A new agreement is expected in OPEC+ next June, and speculations are that present cuts will be sustained.

Longer term objectives: The government would do well in stepping cautiously on this issue. According to the IMF the government believes the public sector needs to play a catalytic role in developing new economic sectors where large upfront investments are needed but has no intention becoming more involved in the economy on a longer term basis. Rhetorically, that sounds good but the danger is that the government gets trapped with the deepening of its footprint in the economy and that the bureaucracy become vested at least in the first part of that strategy. That is even more so when seen against the background of a battle that apparently goes on behind the scenes between the existing establishment of successful business people and the new king-in-waiting.

New laws and regulations: For the record we note the following changes to the law codex and the licensing procedures affecting business and foreign investments in the Kingdom:

- New insolvency law
- New procurement law
- Simplification of the regulatory and licensing framework

- Activities banned to foreign investments cut to 9 from formerly 13 sectors
- Increased length of licenses from 1 year to 5 years.

The two last bullets are based on a survey conducted by the OECD which found Saudi Arabia the most restrictive country to foreign investments among the G20s.

Politics

Politics turn less predictable: Many observers comment that under the new *de-facto* ruler, Muhamed bin Salman (MbS), crown Prince since 2017 and heir apparent until his father (age 83) dies Saudi politics has changed in character and become less predictable. The establishment under his tutelage of a high level anti-corruption committee soon after his promotion was succeeded by the incarceration of some 200 of the nation's wealthiest business elite until they paid large sums of money to the government. This disruptive event in a country known for stoicism has combined with public mass executions of representatives of the country's Shia minority charged with terrorism and spying for Iran. While public executions took place also in the past they involved much smaller numbers and were seldom against Saudi nationals but rather targeted poor expats. In the last execution against more than 100 individuals, one of the executed bodies was reportedly crucified and displayed as a scarecrow to warn potential sympathizers.

Reputational problems? On the one side the new Saudi regime has acted in favor of women's right and allowed them to drive a car against opposition from the religious establishment. On the other, it has raised violence as a method to drive through its will. The rise in state violence has soured the relationship to many Western countries. Last year Saudi Arabia broke diplomatic and economic relations with Canada following comments by the Canadian foreign minister on the human rights record of the Kingdom.

Risks of political destabilization? After last year's murder of Mr. Kashoggi -- a prominent opposition journalist with Saudi passport writing for the Washington Post -- in a Saudi Consulate in Turkey, many international business leaders withdrew from a high profile investment conference in Riyadh. In the same vein, the UAE/Saudi war in Yemen has attracted negative publicity for its humanitarian costs resulting in the US and EU imposing travel bans on Saudi officials and stalled arm sales from Germany. Like Pr. Xi in China, the Saudi anti-corruption campaign and the violent clamp down on minorities has so far seemingly strengthened the position of the Crown Prince against potential challengers but he may also have produced hardened opposition among survivors.

Outlook

Economics -- more of the same: For the current and the next few years Saudi Arabia is likely to continue moderate growth around 2% a year combined with further macro-economic stabilization. As before, the detailed results in terms of growth rates, external and internal balances will depend on the global oil price, but extreme outcomes are unlikely. As such, Saudi Arabia may have achieved more resilience against shock. Never before has the country experienced such a steep oil-price shock and only a few years later the current account is already in surplus while the budget deficit is brought down from alarmingly high levels right after following the price collapse. That is in part thanks to still very large foreign reserves calming market fears of any payment difficulties but also fast adjustments to correct no longer sustainable policies.

Politics – less predictable: The change of leadership style under the new Crown Prince and *de facto* ruler since the last couple of years has surprised many both inside and outside the Kingdom. So far it appears that the Crown Prince has gained the upper hand against rivals and other opposition, but at the price of tough measures with potential repercussions in the future.

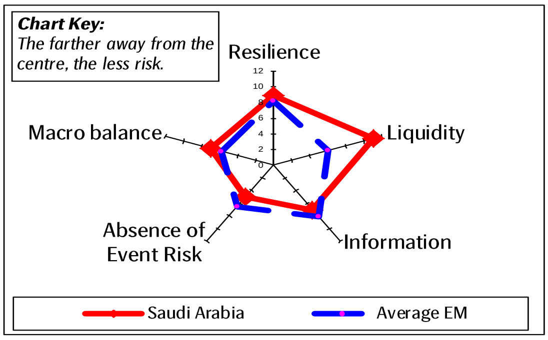
Regional security: This is an event risk that may strike on short notice. The US continues to hike the pressure on Iran which could be a pretext also for Riyadh to tighten the screw further against its regional arch rival. That could lead to unforeseen events – accidents -- triggering military confrontations with consequences for Saudi Arabia's oil exports. Such might outweigh any benefits in terms of skyrocketing global oil prices. Neither militarily not economically is it obvious who will escape less damaged out of such events.

Demographics: For decades Saudi Arabia has been advantaged with high birth rates and a growing working age population but as long as oil the economy could grow even faster on the back of rising oil revenues, any demographics problems could be pushed into the future as the government had money to employ new entrants into the labor market. That can no longer be relied on and given the long time it may take to correct attitudes and skills mismatches it is crucial that actions are taken now for political and social stability.

Ratings: None of the main agencies have acted with any rating changes over the last year as none of recent events have much changed the outlook for the Kingdom's repayment capacity. However, in a relatively strong investment grade one might expect agencies and private investors beginning to take notice of underlying changes to the profile of Saudi Arabia’s credit worthiness

Saudi Arabia

Key Ratios	2019
Population (mil)	34
GDP/capita ($)	22329
Real GDP (% chg)	2%
Inflation (%)	2%
Curr.Acc. Balance (% of GDP)	2%
Reserves/imports (months)	40
Budget balance (% of GDP)	-6%
Government debt (% of GDP)	21%



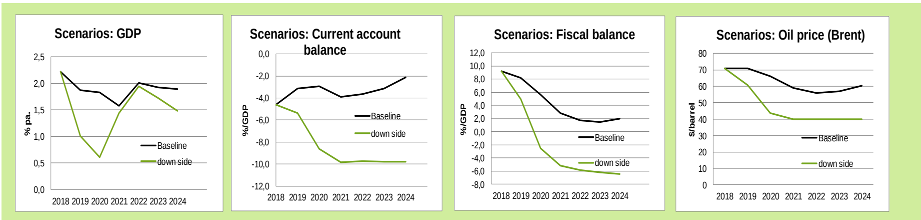
External ratings:
Fitch: A+
Moodys: A1
S&P: A-

Peers:
Spain
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.

Appendix

The oil price: Using the Oxford global economic forecasting model a scenario until 2024 shows Saudi Arabia’s GDP first reacting sharply to a steep drop in the global oil price (Brent) but then recovering as the government cushions the fall by letting the fiscal deficit rise rapidly while the central bank accommodates these policies by financing a sharp weakening of the current account balance by selling dollars from reserves. However, while reserves are large at the outset, the central bank cannot afford to continue depleting them forever and after some five years the level will approach the bare minimum -- given the currency peg -- to prompt market reactions. This indicates that Saudi Arabia has the reserves to withstand market forces for perhaps as much as 3-4 years, before being forced to change macro policies abruptly. It would be wise, though, to start making contingencies for that at an earlier stage.



Key data:	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP (US$ bn)	747	756	654	645	687	722	761	827	897
GDP/capita (US$)	24968	24612	20733	20037	20926	21584	22329	23823	25464
GDP (real change)	2,7%	3,7%	4,1%	1,7%	-0,8%	2,3%	2,1%	2,7%	2,7%
Investments/GDP	26%	27%	27%	23%	22%	22%	23%	23%	24%
Budget balance/GDP	5,6%	-3,5%	-15,8%	-12,9%	-9,3%	-5,0%	-5,7%	-2,3%	-1,4%
Govt debt/GDP (*)	2%	2%	6%	13%	17%	21%	26%	26%	25%
CPI inflation (%)	3,5%	2,2%	1,3%	2,1%	-0,8%	3,2%	2,0%	2,0%	2,0%
Money demand (%)	1,4%	1,3%	-13,5%	-1,4%	6,5%	5,1%	5,4%	8,7%	8,5%
Stock prices (yearly avg.)	7628	9651	8490	6327	7221	7562			
Interest rates	0,7%	0,9%	1,0%	0,9%	0,9%	2,1%	2,0%	2,2%	2,7%
Exch. Rate ($)	3,75	3,75	3,75	3,75	3,75	3,75	3,75	3,75	3,75
Trade/GDP (%)	71%	66%	55%	48%	50%	50%	50%	49%	48%
Oil price (Brent)	$109	$99	$52	$44	$54	$71	$61	$66	$67
Billions US $									
Export of goods	376	342	204	184	221	236	246	262	274
Imports of goods	153	158	159	128	119	128	134	146	156
Other:	-87	-110	-101	-80	-87	-88	-94	-102	-110
Current account	**135**	**74**	**-57**	**-24**	**15**	**19**	**17**	**15**	**8**
(% of GDP)	18,1%	9,8%	-8,7%	-3,7%	2,2%	2,7%	2,3%	1,8%	0,9%
FDI	4	3	3	-1	-4	0	0	0	-1
Loan repayments	-48	-61	-49	-58	-65	-74	-84	-88	-91
Net other capital flows	-22	-7	-12	6	15	52	63	71	87
Balance of payments	**70**	**8**	**-115**	**-78**	**-39**	**-2**	**-3**	**-3**	**3**
Reserves (yearly avg.)	710	719	604	526	487	485	481	478	481
Total debt (yearly avg.)	89	88	81	124	141	159	181	190	196
o/w short term debt	34	48	37	40	44	50	56	59	61
Oil Prod. (mn.barrels/day)	9,6	9,7	10,2	10,5	10,0	10,3	10,4	10,8	11,0

(*) 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

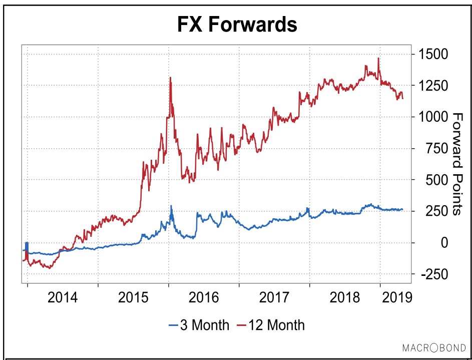
Type of government: Absolute Monarchy

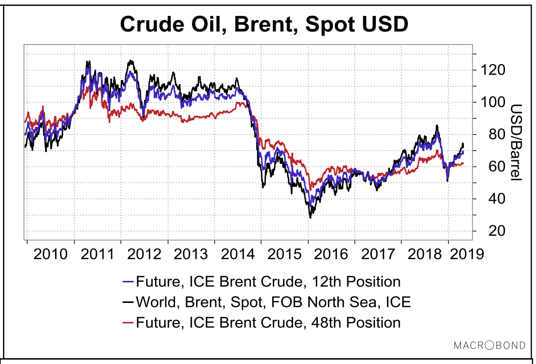
Next parliamentary elections None

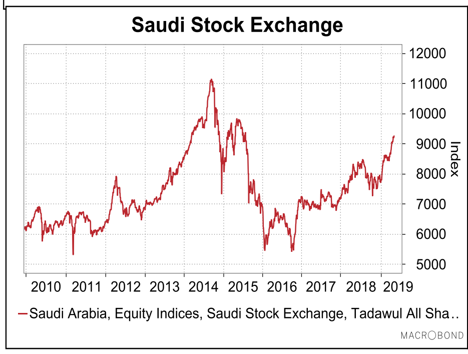
Other:

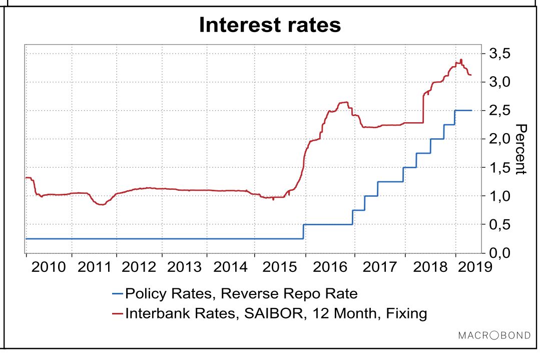
Latest PC deal None

Latest IMF arrangements None









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