Economic Research

KDN No.: PP14787/11/2010(026023)

Malaysian Rating Corporation Berhad
(Company No.: 364803 V)

Country Report: Saudi Arabia

Economics Team

Nor Zahidi Alias
Chief Economist
+ 603 2092 5398
zahidi@marc.com.my

Mohd Afzanizam Abd. Rashid
AVP (Economics)
+ 603 2092 5398
afzanizam@marc.com.my

James Foo Kok Chye
Economic Analyst
+ 603 2092 5398
jamesfoo@marc.com.my

Please read the disclaimer on the last page of this report

Politics and international relations

Politics and Foreign Relations

Saudi Arabia remains politically sound, especially with the return of Crown Prince Sultan bin Abdulaziz to Riyadh in December after a year-long absence which saw him spending several months abroad for medical treatment and recuperation. The country appears poised for greater economic cooperation with the Middle Eastern region, as the 30th Gulf Cooperation Council (GCC) Summit in Kuwait reconfirmed the solidarity between GCC member states. Many vital projects were approved, which will serve the economic and developmental interests of the entire region. The GCC had also reaffirmed their support for Saudi Arabia's right to defend its land and its people's safety in the wake of November's cross-border terrorist attacks emanating from Yemen.

Saudi Arabia has also been exhorted by the Hamas to play a "special role" in resolving the Palestinian-Israeli conflict, by virtue of the Kingdom's considerable influence in the Arab world. Foreign Minister Prince Saud Al-Faisal represented the Kingdom in reiterating the urgent need to stand firm and serious against the settlement policy in occupied Palestinian territories, particularly in Jerusalem. The Kingdom had signed three agreements in December providing close to USD4 million in humanitarian projects to alleviate the suffering of the Palestinian people in Gaza and the West Bank, and had hitherto implemented as many as 64 programs at a cost of close to USD300 million in the West Bank and Gaza.

Prince Saud also reaffirmed the Kingdom's support for the stability and unity of Yemen, calling for the GCC to have a decisive stand with regards to the development of Yemen. The Kingdom also continues to work in close coordination with other countries to combat the threat of terrorism and extremism throughout the world, having authorised its interior minister to negotiate draft memoranda of understanding for cooperation in the exchange of financial intelligence on money laundering and terrorist financing with other nations.

The Saudi government and religious leaders received commendations in October from the United States' Government Accountability Office for issuing strong condemnations against terrorism and implementing extensive media campaigns against extremism. The Office also praised the 2005 establishment of the Saudi Financial Investigation Unit, which monitors suspicious transactions in an attempt to thwart terrorist financing.

To further solidify its stand against terrorism, Saudi Arabia hosted a three-day counterterrorism workshop, which concluded on 23 February 2010, entitled the "International Legal Framework for Combating Terrorism and its Financing Workshop." The conference, organised by the Saudi Bureau of Investigation and Prosecution (BIP) in association with the United Nations Office on Drugs and Crime, was attended by more than 76 national, regional and international experts on terrorism, including the head of terrorist investigations at the U.S. Department of Justice, representatives from the FBI, envoys from the European Commission, and the Chairman of Senior Islamic Scholars, Saudi Grand Mufti Sheikh Abdulaziz bin Abdullah Al-Asheikh. Topics touched on included expanding international cooperation, and developing judicial systems and regulations to confront terrorism.

On an educational front, the Custodian of the Two Holy Mosques King Abdullah bin Abdulaziz Scholarship Program, inaugurated in 2006, has sent more than 23,000 students to colleges and universities in the US. The scholarship program, an integral aspect of the Kingdom's comprehensive education plan focusing on job creation to prepare future generations of Saudis to compete in an increasingly global economy, forms an intricate educational link with the States, one that recognises the superior educational standards in the economic superpower.

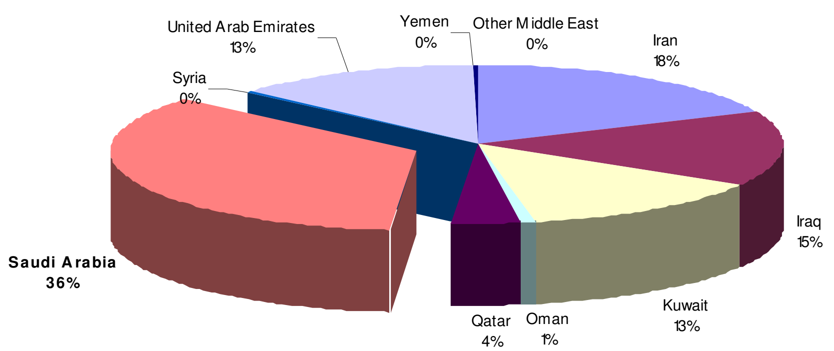
The country also actively seeks to project itself as a philanthropic nation. Saudi Arabia announced in January that it is contributing USD5 million to the Carter Centre to support its Guinea Worm Eradication Program in Africa, in combination with its USD2 million donation made last July to the same program. The program has thus far been successful - commencing in 1986 with an estimated 3.5 million cases of Guinea worm disease in 20 countries in Africa and Asia, the estimated final case total for 2009 is fewer than 3,500.

Saudi Arabia has also pledged USD150 million to Afghanistan over three years to support the creation of programs and institutions to rebuild the country. Earthquake-hit Haiti also received USD50 million from the generous Middle East nation's Custodian of the Two Holy Mosques King Abdullah bin Abdulaziz funds that have been channeled to the United Nations' redevelopment program for Haiti.

The economy and oil

Since its discovery in the early part of the twentieth century, oil has had an increasingly profound effect on Saudi Arabia's economic well-being. The country has the largest proven reserves in the Middle Eastern continent, making it one of the most influential founding members of the Organisation of the Petroleum Exporting Countries (OPEC). Based on the latest available data, Saudi Arabia accounted for 35% of total proved reserves in the Middle-Eastern countries, followed by Iran (18.2%), and Iraq (15.2%) in 2008. The country is also the largest producer of oil, accounting for some 41.4% of total oil produced by the Middle Eastern region.

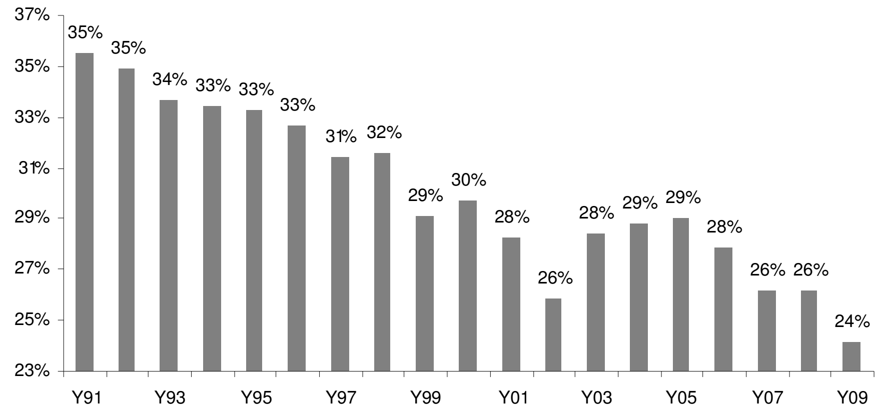
Chart 1: Proportion of proved reserves in Middle Eastern countries in 2008



Source: BP Statistical Review 2009

Although the mining and quarrying sector (which principally includes crude oil and natural gas) accounted for a huge 24% of total GDP in 2009, making it the single largest sector of the economy, this was considerably lower than 1991's 35%, testifying to the efficacy of the government's measures to diversify the economy by promoting domestic-demand activities (classified under the non-oil sector). In adopting the Long Term Strategy (LTS) in its Eighth Development Plan (2004 – 2009), the government acknowledged that oil resources will eventually deplete, and necessary policy responses are thus required to ensure the sustainability of economic development in the future.

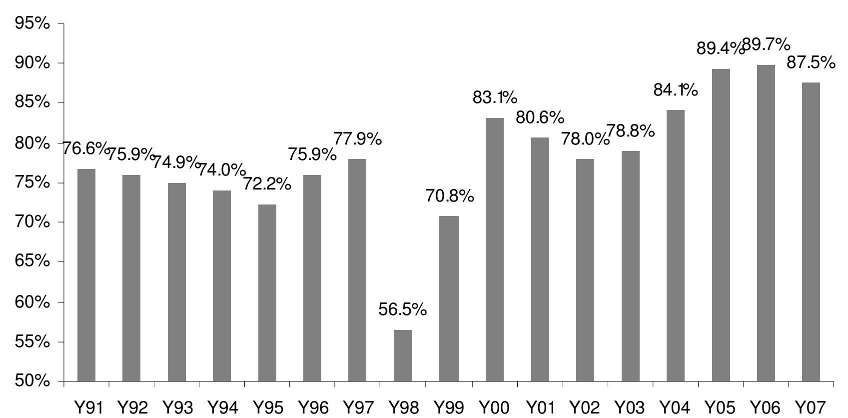
Chart 2: Mining and quarrying as a percentage of GDP



Source: CEIC

Saudi Arabia's government derives its revenue mainly from oil, with its share to total revenue reaching almost 90% in 2007. As such, the government's fiscal strength is very dependent on oil resources which proved to be extremely volatile in recent years, as can be seen from the recent experience where government revenue shot up by 71.3% to Saudi Riyal (SR) 1.1 trillion in 2008 following a surge in crude-oil prices to more than USD100 per barrel compared with only SR643 billion in the earlier year. In contrast, revenue declined significantly in 2009, falling by as much as 54.1% to SR505 billion as oil prices plummeted during the year. This has resulted in budget deficits of SR45 billion in 2009 (about 3.2% of GDP) after recording a surplus of SR176.6 billion (about 35.4% of GDP) in the earlier year.

Chart 3: Oil revenue as a percentage of total government revenue

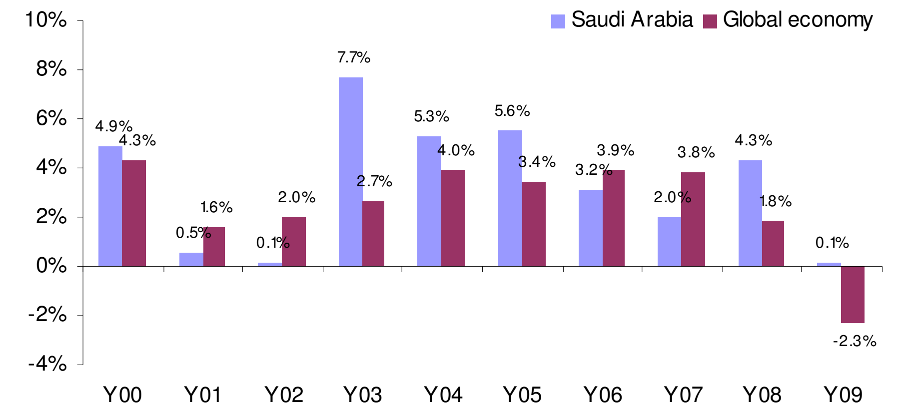


Source: CEIC

Resilient economy amid the global slump

Saudi Arabia is one of the few countries that registered positive economic growth in 2009 as the global economy, particularly the advanced countries, experienced the worst recession post-World War II. According to estimates by the Central Department of Statistics, the economy managed to expand by a marginal 0.15% after growing at a robust rate of 4.3% in 2008. Notwithstanding the minuscule growth last year, strong surpluses in government finances and a sizeable positive current-account balance have enabled the government to respond well during the downturn by implementing various development expenditure programs. Additionally, the Saudi Arabian Monetary Agency (SAMA) reacted aggressively by slashing its reverse-repo rate by a total of 475 basis points (bps) to 0.25% since February 2007.

Chart 4: GDP growth

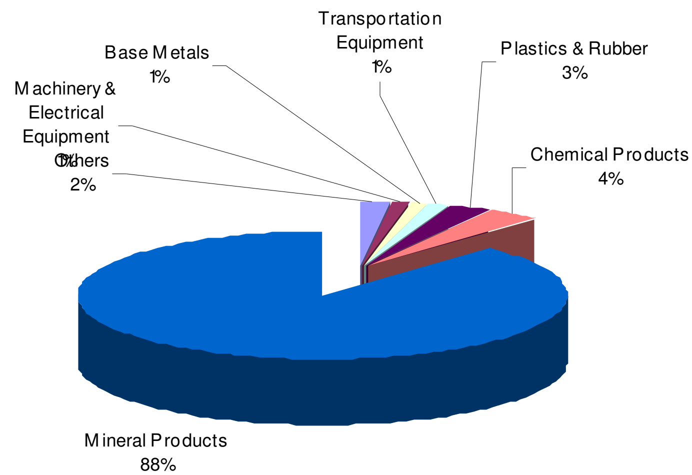


Sources: CEIC & IMF

There were two major factors responsible for Saudi Arabia's economic slowdown in 2009. The first factor was the tight monetary stance adopted by SAMA through rate hikes totaling 400 bps between 2004 and 2007 in an effort to address the problem of a buildup in inflationary pressure that emerged following rapid increases in the price of oil. As oil prices escalated to more than USD100 per barrel, Saudi Arabia's consumer price index (CPI) spiked dramatically during this period, rising from a mere 0.6% in 2005 to 4.1% in 2007 before settling at a jaw-dropping 9.9% in 2008. Apart from that, property prices also went through the roof, with price appreciation hitting the range of 10% to 15% between 2002 and 2005, a classic sign of the emergence of demand-pull inflation in the economy.

The second reason for the slowdown was the collapse of crude-oil prices in 2008, following the onset of the global economic recession. In 2008, global oil consumption fell by 0.5% to 84.5 million barrels per day (mbpd) but quickly rebounded by 0.85% to 85.22 million barrels per day in 2009. This has impacted Saudi Arabia's exports considerably as mineral exports, which include crude oil and natural gas, constitute a big chunk of Saudi Arabia's overseas shipments, amounting to 88% of total exports in 2007.

Chart 5: Exports of major products in 2007



Source: Central Department of Statistics, Saudi Arabia

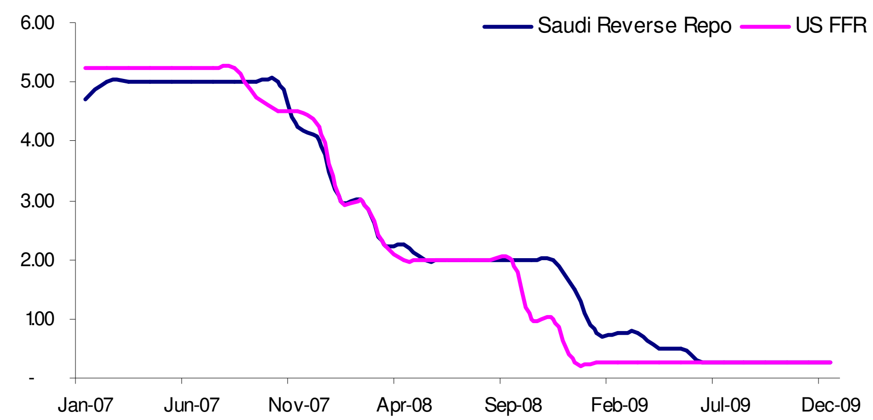
Monetary policy – mimicking US rates

The country's central bank has been pegging its currency to the USD at SR3.75 per USD since June 1986. This effectively means that Saudi Arabia's central-bank policy decisions with respect to interest rates hinge directly on the US Federal Reserve (Fed) as the country seeks to maintain stability in its currency value. This intertwined nature was demonstrated in a recent experience where the SAMA slashed its interest rate by 75 bps to 4.25% in November 2007 following a 50 bps reduction in the US Fed funds rate in September 2007. Thereafter, the SAMA has been active in stimulating the economy through a series of rate cuts which officially ended in June 2009, in line with the drastic cuts in the US rate. The Saudi policy rate is now at a mere 0.25% to match the near-zero rates in the States.

Despite pegging the SR to the USD, Saudi Arabia does not impose any restrictions on the flow of funds in the capital account or on the convertibility of its currency. This has led to flexibility in the flow of foreign direct investment (FDI) as well as portfolio investments into the country. Such policies have resulted in greater job creation, higher lending and borrowing activities in the banking sector, and stronger domestic demand. Notwithstanding its benefits, the currency-peg regime is not without flaws, especially in the environment of rising inflationary pressures in recent years. Prior to the recent rebound in the value of the greenback, the relatively weak USD against major currencies has raised pertinent questions on the viability and sustainability of the riyal peg.

Given this, Saudi Arabia, as well as other Gulf Cooperation Council (GCC) counterparts, is set to establish the GCC monetary union in 2010 with a single currency as a means of exchange of goods and services within the region. This is analogous to the European Monetary Union's (EMU) arrangement with the euro in use amongst member countries. In June 2009, the agreement on the formation of a monetary union between GCC states was signed, with the currency, which has yet to be named, to be pegged to the USD.

Chart 6: Policy rates



Sources: SAMA & Bloomberg

Key risk areas

- **Oil-price volatility**

As mentioned, the government's financial position and the country's economic growth are highly dependent on global oil cycles. As such, oil price volatility could potentially hurt the economy in future years. Additionally, the long-term efforts undertaken by major advanced countries to search for renewable energy could cause the Saudi economy to lose its competitive edge, as fossil-fuel consumption may be gradually reduced in the long term. Nonetheless, we note that the government's efforts in crafting a long-term strategy through a five-year development plan will likely offset the country's dependency on oil. This can be seen from the non-oil sector's share of the economy which has risen remarkably from 51.0% to 73.5% over the past 30 years.

- **Currency peg – an issue of sovereignty**

Saudi Arabia's continuing currency peg to the USD could lead to sovereignty issues, particularly when the anchor currency (USD) is affected by structural imbalances, such as the twin deficits (current account and budget deficits) experienced by the US. Such problems would require the anchor currency to gradually depreciate against other currencies in order to restore the balance in the current account and improve the country's fiscal position.

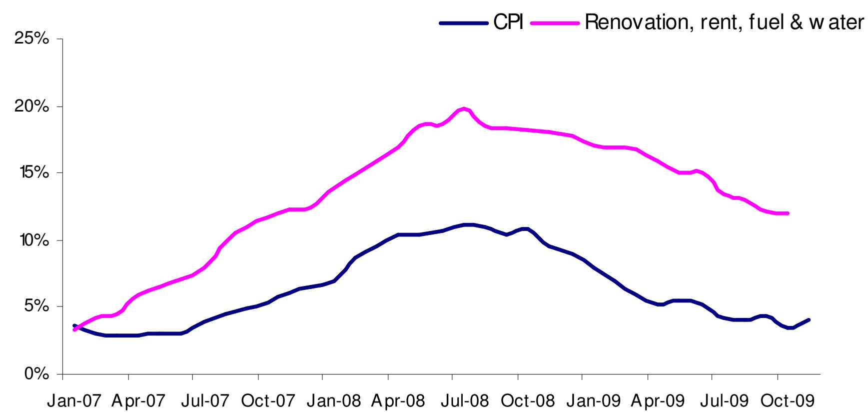
However, should Saudi Arabia opt to maintain its present currency arrangement with the USD, the SR will have to move in tandem with the USD to keep the currency value in line with the latter. To do this, the SAMA will have to forgo some of its monetary sovereignty, which could be disastrous, especially if it needs to address unfavourable domestic economic conditions such as rising inflation or unemployment. As such, the present currency-peg regime will result in greater sensitivity of the Saudi economy to the developments in the US, as demonstrated in the latest down cycle in 2008 and 2009.

- **Rising rental rates likely**

Rental rates are expected to increase substantially going forward, in light of the improved economic activities as well as the tight housing supply following the booming population growth and the decline in household size. Evidence of this can be seen in 2008 when rental rates skyrocketed at a double-digit pace of 17.5% in 2008 from 8.1% in the previous year at a time when the population expanded at a 3.3% pace in 2008 (+1.3% in 2007).

A similar situation could happen in the future and this would have an important bearing on two fronts - monetary policy response and reduced purchasing power. In our view, the latter would be more relevant since the former is tied to US policy actions. Private consumption, in this case, could be seriously affected should the housing-demand-and-supply gap not be addressed accordingly, as rents have a significant impact on the country's general inflation level and hence consumers' purchasing power.

Chart 7: Consumer price index (CPI) and renovation, rent, fuel & water (y-o-y%)



Source: CEIC

THIS PAGE IS INTENTIONALLY LEFT BLANK

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No. : 364803 V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: [603] 2092 5398 Fax: [603] 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my