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Bracing for Greek contagion

Saudi exports could suffer minimally from fallout, overall impact restrained

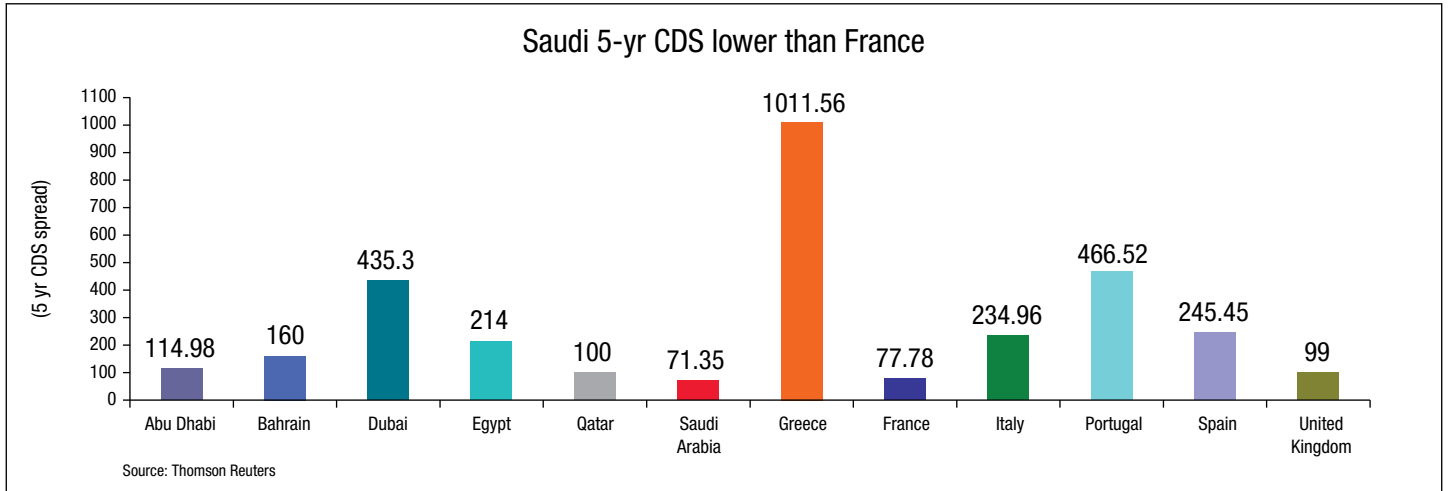
- **Saudi banking sector shielded from Greek contagion, but oil prices and equities face sharp tests from escalating European debt troubles**
- **Trade with Europe – source of almost a third of Saudi imports and destination of 10.6% of exports – could get slightly shaken by debt woes, but impact on trade balance minimal**
- **Saudi CDS lowest in region, supporting kingdom's investment case based on strong fiscal fundamentals; even with oil averaging at \$65, Saudi would post twin surpluses in 2010**

Concerns are escalating over the spread of Greece's debt crisis into other European nations and to what extent this could wreak havoc on the euro, which is facing its biggest test since its inception more than a decade ago. Any contagion from intensifying troubles in European financial markets will inevitably unfold across the globe, hurting equities, commodities and currencies alike – and the Gulf region is no exception. Once the dust has settled, however, the fallout for the Saudi economy will most likely be restrained; the kingdom is better insulated than other states in the region due to a solid macroeconomic backbone.

Greece's debt troubles and the tangible odds that it could spread through other less indebted European nations such as Spain and Portugal, has the potential to trigger a new round of de-leveraging by banks across the euro zone. Given the moderate level of direct involvement of European banks in Saudi Arabia, any implications on the kingdom's development plans from de-leveraging would be tempered in our view.

Saudi Arabia's public and private sectors are not very heavily reliant on European leverage for financing various expansion projects. Banks are awash with plenty of liquidity and the state has taken a major burden in funding strategic projects, which will continue to happen as Europe works to navigate its way out of the debt quandary.

Taking cues from global peers, local banks could hold off a bit longer on abandoning the risk aversion tendencies that have in the past year prompted them to vet new lending with a fine tooth comb. This contributed to stagnancy in bank credit growth and profit declines, which are poised to continue if the global economic recovery falters. Some concerns among Saudi banks could surface if there are signs any businesses face financial difficulties stemming from heavy exposure to Europe, although we suspect this would be an improbable scenario. The private sector, already struggling to regain ground, would not be unscathed by a double-dip global recession, although we are not currently envisaging this scenario.



Oil, equities face tenuous test

Still, the second round effects from the Greek debt tragedy, namely shocks on oil and equity markets, would carry important implications for Saudi Arabia, the world's top exporter of crude oil, depending on how much prices drop. Having held above \$80 a barrel for two months, oil tumbled more than \$10 last week to this mid-\$70 level, weighed by worry that the euro zone debt crisis could derail the tenuous global economic recovery.

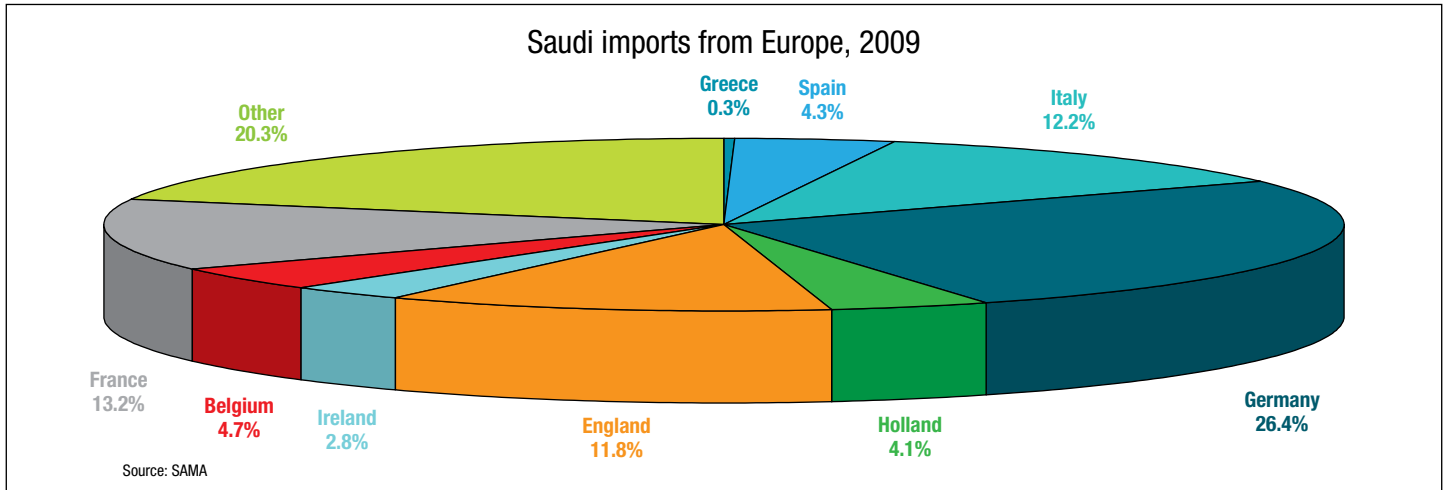
Saudi Arabia regards \$75 oil as a perfect price to serve the prevailing economic conditions globally. The price enables it and other heavily oil-reliant economies to keep investing in building energy output capacity for the medium term. Fiscally speaking, Saudi Arabia will remain on firm footing, able to generate a budget surplus this year so long as oil prices average \$65 a barrel. Should oil breach \$65 a barrel, this could prompt OPEC action to put a floor under declines. With ameliorating trade flows in the first quarter, meanwhile, the kingdom is poised to comfortably achieve a current account surplus in 2010 exceeding the nearly SR100 billion surplus it generated last year despite global economic jitters.

Yet, since a large degree of investment activity occurs due to psychology rather than fundamentals, any sustained drop in oil prices will affect investors' perceptions and lead to broad sell-offs in equity markets, particularly the ones most sensitive to oil price movements such as petrochemical companies.

The Saudi Tadawul index is positively correlated with global measures, such as the Dow Jones Industrial Average and the S&P 500. Therefore, local shares cannot avoid being caught in any downdraft, not due to fleeing foreign investors but because perception plays a big part in shaping retail investor behaviour that dominates the trading floor. De-leveraging flows would also likely move away from emerging markets should Europe's crisis worsen, carrying some implications for the Gulf.

Testing trade links

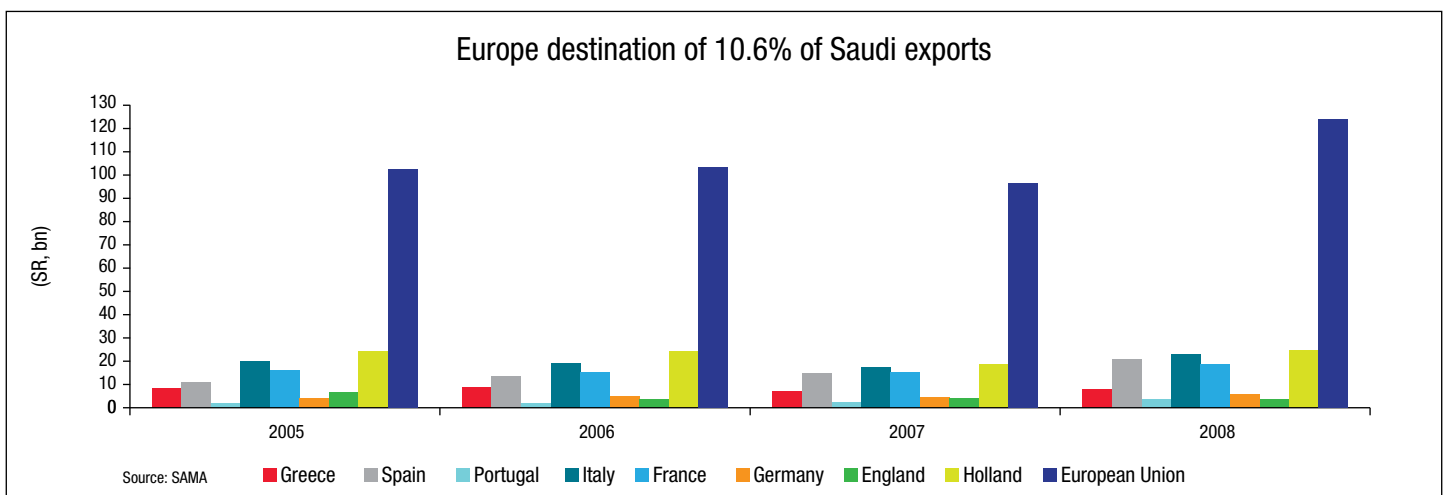
We do not foresee the Saudi banking system or the dollar-pegged riyal currency facing any systematic risks as a result of Greek contagion. Saudi trade with Europe is important, although the bloc is not as crucial to its balance of payments as it is for other states in the region, such as North African nations Tunisia, Morocco, Algeria and Egypt. More than 63% of Tunisian exports, a majority of Morocco's exports and close to 50% of Algerian exports are destined for Europe. In the last fiscal year, moreover, 34% of Egypt's exports went to the EU, also the source of about half of its tourist arrivals, although Egypt's remittance flows are centred more heavily in the Gulf than Europe.



Still, trade with Europe is extremely important for Saudi Arabia. Almost a third of Saudi Arabia's 2009 imports came from Europe, although Greece's contribution was a negligible 0.3% of the European total. Spain and Italy are far more important trading partners for the kingdom, accounting for 4.3% and 12.2% of European exports to Saudi Arabia, respectively.

Saudi exports to Europe, primarily of oil and petrochemicals, more than tripled between 2003 and 2008, although their ratio to total Saudi exports has fallen gradually as Asia countries gained greater prominence as trading partners. In 2008, exports to Europe accounted for 10.5% of total Saudi exports, with Greece accounting for 6.3% of that.

Weakness in European economies will mean a slowdown in export growth and in tourist visits but this should be felt more in the tourist-reliant North Africa than Saudi Arabia. Saudi importers would benefit from a weaker euro for such goods as machines, specialised equipment, personal vehicles and luxury items. But about 70% of imports are dollar-based so the overall macro-economic and lower price pass through effect consequences of a weaker euro would be felt, although not aggressively. Non-oil exports, comprising mainly petrochemicals, are unlikely to be hurt by the currency situation, although they could face downward pressures should Asian demand dynamics change in the coming months.



Aftershocks in the global recovery also risk hurting foreign direct investment into the region. Gulf countries account for roughly 1% of FDI from the European Union, on par with India, according to Eurostat's EU foreign direct investment yearbook for 2008. That compares with 2.3% of total EU FDI destined for North Africa and 3.6% to South America.

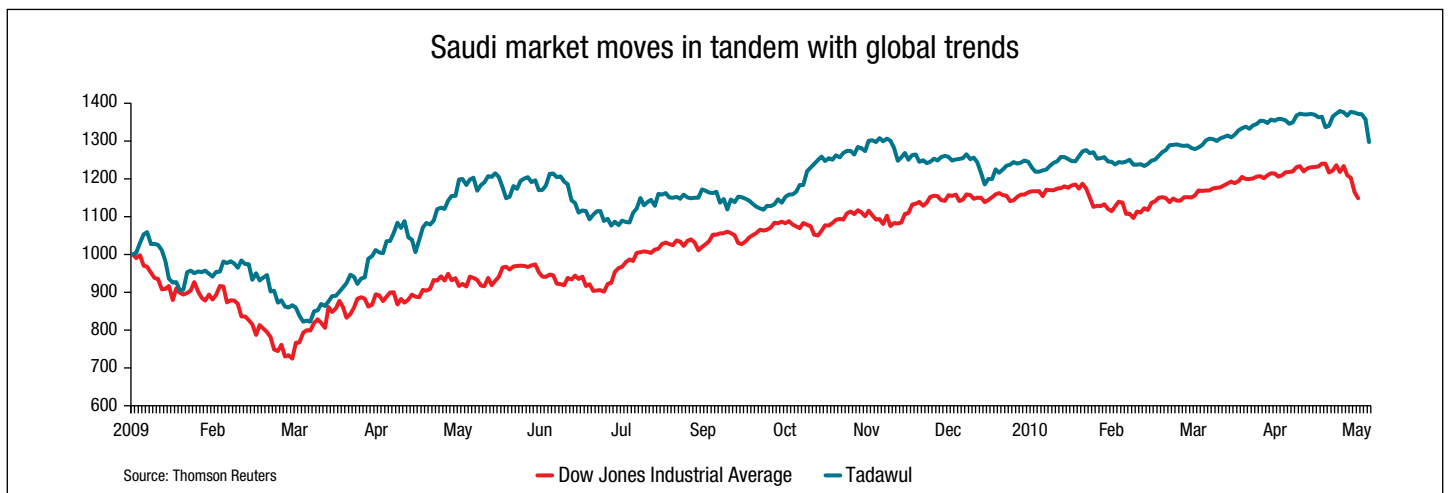
The weakening euro would also reduce European purchasing power in the region, a fact that would hit countries in the Middle East that attract large numbers of European tourists, such as Egypt, Tunisia and Morocco than the Gulf. In our view, the euro will continue to depreciate after falling below \$1.30 last week, and could dip further to the low \$1.20 levels by year-end. Should the crisis be allowed to spread beyond Greece into Spain, Portugal and Italy, this euro-dollar level risks being breached within a matter of days. A sustained fall in the euro contributes to the downward pressure on the Egyptian, Moroccan and Tunisian currencies, which could risk stoking inflation but we do not foresee such a scenario at this stage, especially in Egypt.

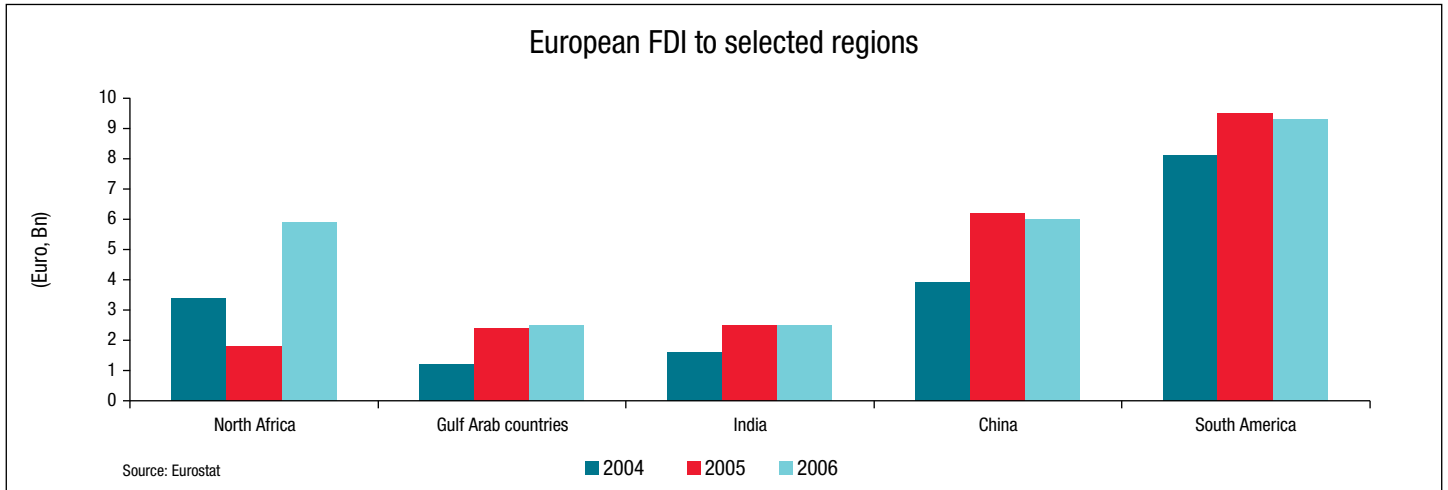
The fragility of sovereign issuers during the current crisis has been priced in more thoroughly in Europe than in the United States, where the deficit situation is distressing to say the least. Everything taken relatively, Europe currently looks worse than the United States, largely because economic growth and policy response has been more solid in the latter's case. As markets price in the risk of worsening global liquidity, peripheral assets and currencies will fall out of favour, supporting the dollar and, as an extension, the Saudi riyal.

Preserving its investment case

Saudi Arabia is on the whole well-insulated from European contagion. During 2009, project financing from Europe into the kingdom was subdued and this scenario is unlikely to change; any European de-leveraging will provide more opportunities for Asian banks. Trade finance links between Saudi and European banks will continue to exist and are not likely to face any grave risks although as European banks deleverage appetite for financing will decline. Meanwhile, Saudi commercial banks, traditionally more risk averse than their regional peers, stand to gain from their conservative investment policy.

Among emerging markets, Saudi assets are well placed to absorb funds in search of safer corporate bond investments. As we have stated in the past, Gulf states are slowly being re-categorised such that Saudi Arabia – with its large indigenous population fuelling domestic demand, plush foreign assets supporting twin surpluses, and noticeable lack of asset price bubbles – looks like a decidedly healthier investment prospect than its peers. Corporate bond issuers could take advantage of this as markets search for fundamental value.

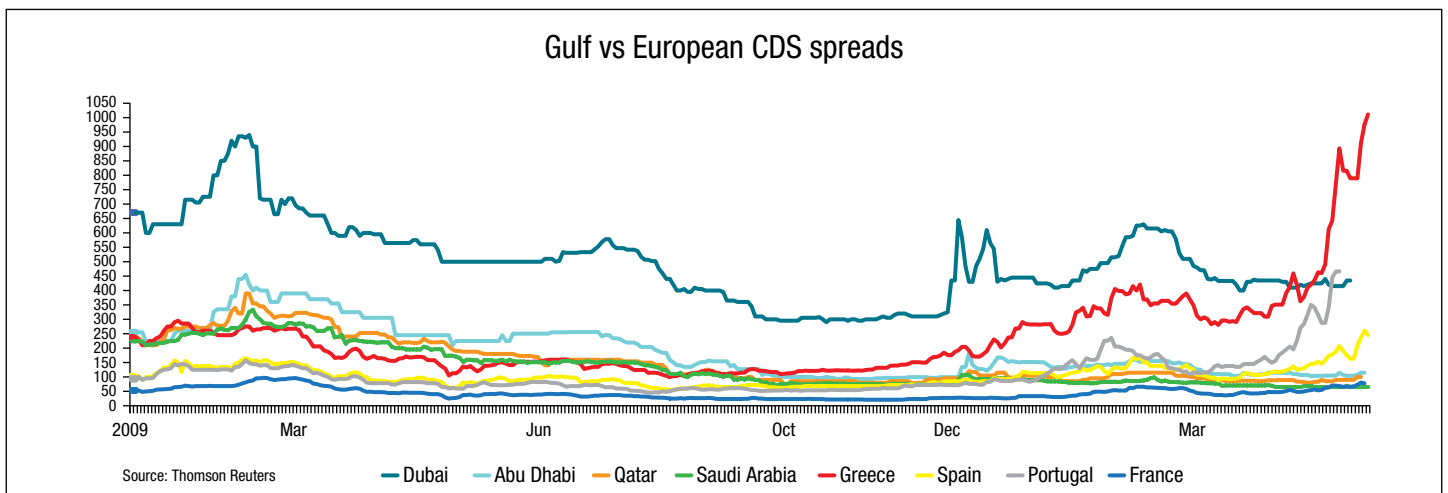




The cost of insuring Saudi debt against default remains low relative to regional peers. At the end of last week, five-year credit default swaps (CDS) for Saudi sovereign debt stood at 71.35, almost 30 basis points lower than Qatar and 44 bps less than Abu Dhabi. Compared with Europe, where Greek CDS surpassed 1,011, Saudi CDS are lower than France's.

Direct exposure to Greece by Saudi businesses, meanwhile, is not large. If the European crisis spreads into Spain, Portugal and Italy, Saudi exposure would widen, although not in a way we would deem threatening. The Gulf will also have to watch EU crisis management techniques, which could have implications for its own beleaguered monetary union plan. The Gulf would look to assess the institutional mechanisms needed to support members who run into fiscal and liquidity problems.

Saudi Arabia and its Gulf neighbours will need to be vigilant in facing what is increasingly becoming clear is a fragile global recovery that is holding ground only on the grace of hefty state stimulus intervention. Investors will continue to be anxious as they contend with Europe's serious fiscal debt problems, poised to hit Middle Eastern countries with varying degrees of intensity. How well the EU defends its single currency and the success of efforts to fend off a global sovereign debt crisis that would drag the world back into recession will underpin policy responses in the coming months. Saudi Arabia is well-placed to respond to possible headwinds coming its way.



Disclosure appendix

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Additional disclosures

- 1 - This report is dated as at 10 May 2010.
- 2 - All market data included in this report are dated as at close 9 May 2010, unless otherwise indicated in this report.
- 3 - Banque Saudi Fransi has procedures to identify and manage any potential conflicts of interest that arise in connection with its Research business. A Chinese Wall is in place between the Investment Banking and Research businesses to ensure that any confidential and/or price-sensitive information is handled in an appropriate manner.

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