General Political Environment:

Political power in the Kingdom rests squarely with the al-Saud dynasty which has ruled Saudi Arabia since the state was created in 1932. The dynasty's legitimacy is underpinned by the backing of the ultra-conservative Wahhabi religious establishment. Members of the 22,000 strong royal family hold most important business, government, military and judicial positions.

Following a long period of illness, 84-year old King Fahd passed away on August 1 2005. Shortly thereafter and as widely expected, his half-brother Crown Prince Abdullah bin Abdel-Aziz al-Saud succeeded him as the country's new monarch. Defence Minister Sultan bin Abdel-Aziz al-Saud (a half-brother of Fahd and Abdullah) was appointed Crown Prince.

The advanced age of the highest-ranking royals has raised concerns about succession and future stability in Saudi Arabia. In October 2006, the King announced the formation of an "allegiance commission" of the surviving sons of the kingdom's founder (Abdul Aziz bin Saud – Abdullah's father) to vet potential successors. This mechanism is an attempt to add some flexibility to what has been a strictly age-based process of fraternal succession. In theory, the commission could propose a member of the next generation (one of Abdul Aziz' grandsons) of royals as future king.

The royal family has to balance demands from some quarters for political, religious and social liberalization with its own interests and those of the religious establishment. As such, political and societal reforms are likely to proceed more slowly and appear to be less smooth than those in neighbouring states such as Kuwait, Bahrain and Qatar.

Investment Environment:

Driven by the need for job growth and a diversification of the economy, authorities have gradually removed the number of industries previously barred to foreign investors (the "negative list") and have sought to improve the regulatory environment and reform the tax system. However, job creation opportunities are constrained by Saudis' lack of critical skills and the economy's dependence upon expatriate labour; issues that point to the inadequacy of the education system.

The Saudi Arabian General Investment Authority (SAGIA) is undertaking a multi-billion (US) dollar development strategy centered around the building of greenfield economic cities around the country. The cities are designed to attract foreign and domestic investment into the downstream energy, transport and knowledge-based sectors.

King Abdullah bin Abdul-Aziz al Saud is looking to liberalize key sectors of the Saudi economy namely, the oil and gas sector and other strategic industries. However, he will continue to encounter opposition from more conservative elements in government.

The Saudi legal system is viewed as slow-moving and opaque. There is a perception of that the system is biased towards local firms over foreign firms and that strong local connections are vital to obtaining justice.

Political Violence:

The May 2003 Riyadh attacks were followed by several other large-scale terrorist attacks: in Riyadh, in both November 2003 and May 2004, and Yanbu and Khobar in May and June 2004, respectively. Since then, counterterrorism efforts have greatly improved and the ability of domestic terrorist groups such as al-Qaida in the Arabian Peninsula (AQAP) to launch terrorist attacks within the Kingdom has been weakened.

While the authorities have made considerable progress against the terrorist threat, the risk of terrorist attack – particularly against expatriates and oil installations – remains high.

Political

Political Structure
Monarchy

Head of State and Prime Minister
King Abdullah bin Abdel-Aziz al-Saud

Crown Prince and First Deputy Prime Minister
Prince Sultan bin Abdel-Aziz al-Saud

Main Bodies

Consulatative Council (*Majlis al-Shura*): 150 members appointed by the King; advisory function

Council of Ministers: Legislative and executive authority; members are appointed by the King who also heads the Council and can veto its decisions

Major Parties
Illegal

Elections
Phased local council elections which began in February 2005.

Press Freedom Survey :
- 2007 Score: 82 (Not Free)

freedomhouse.org

Control of Corruption Index:
- 2006 Score: +0.18

(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

In the short-term, the Kingdom's outlook remains stable, and policy continuity is expected given that Abdullah has been the de facto leader in recent years. Nevertheless, given the advanced age of the King and the Crown Prince, there is growing concern of increasing political instability over the coming decade which could see a series of aging monarchs, each with different policy views, come to power. The effectiveness of the allegiance commission concept will not be known until it is tested. Militant Islamism is unlikely to lead to the overthrow of the al-Saud regime; rather, we are likely to see the regime muddle through its current challenges over the next several years.

Economic growth and job creation will depend upon the country's ability to develop a skilled workforce and attract expatriates with critical skills. However the educational and social reforms that could enable these developments are likely to be resisted by conservative and religious elements within society.

Saudi Arabia

Economics

EDC

Economic

Credit Agencies

Moody's: A2

S&P: A+

Fitch: A+

Nominal GDP (2006)

US$347.8bn

Population (2006):

25.3 million

Total Trade / GDP (2006):

78%

Currency:

Saudi riyal

Exchange regime:

Conventional peg

Merchandise imports from Canada: 2006

Cdn$539.5mn

Main sources of Foreign Exchange (excl. FDI):

Oil

Largest Merchandise Trading Partner:

United States (20%)

Japan (16%)

Main imports:

Machinery and equipment (43%)

Risks to the Outlook

Continued structural reforms
Strong oil prices

Security concerns
Poor diversification of economy

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Market Spotlight: Major stock market correction, which wiped out about US$350bn in share values (in three months), failed to have strong impact on Saudi Arabia's macroeconomic performance in 2006. Thanks to SAMA prudential regulations, defaults on bank loans have had limited impact. Boosted by buoyant oil prices, rising public and private investment and government spending on mega-projects, 2007 should see another healthy performance. Successive fiscal and external account surpluses have been used to reduce public sector debt and accumulate foreign assets. The 2007 budget is the largest ever. It includes large development projects (new economic cities) to generate employment and build the country future resilience. Petrochemicals, gas exploration and tourism are the sectors targeted under the economic diversification plan. Rating agencies upgraded the Kingdom rating in 2006.

Recent performance: The steady implementation of reforms and the significant increase in government spending, which combined with firm oil prices, have contributed to stronger confidence and private sector activities despite recurring domestic and regional tensions. Moreover, private-sector credit expansion has encouraged not only speculation, but also domestic investment. There has been growing investment in projects in upstream gas, oil refining, power and water. Even though the Kingdom's oil output capacity has been estimated at 10.8mn b/d, oil output has been fluctuating, as the Kingdom has had the stabilizing role of the global oil market. Oil output fell from 8.7mn b/d in January 2007 to 8.6mn b/d in February. The Kingdom has announced for 2007 the largest budget ever, which should focus on infrastructure spending as well as growth boosting and job-creating capital expenditures.

Public spending, as well as ARAMCO's spending plans alone of some US$45bn during 2007-2011, should support respectable growth in 2007 and 2008. In the absence of unforeseen events, projections over the medium term show global oil prices declining progressively. This should lead to a "softer macroeconomic landing" rather than the kind of recession experienced in the previous global oil price downturn. Emphasis in economic policy has been on boosting the pace of growth in the non-oil sector, both to create employment opportunities in its fast rising and young population and to ease the country's reliance on energy export earnings.

Fiscal policy: Even though the 2007 budget is expansionary, it is based on the conservative price of US$42.50 a barrel and an oil output of 8.9mn b/d. While the Kingdom is projecting a budgetary surplus of US$5bn, most informed observers put it at US$30bn after the largest ever surplus of US$70bn recorded in 2006. Contrary to the previous oil windfalls, fiscal surpluses have been used to reduce public sector debt and to accumulate foreign assets. Total foreign assets were standing at about US$225bn at the start of 2007, of which US$165bn were in foreign investments. Government debt stands at 28% of GDP today compared with 119% of GDP in 1999! Subsidies will ensure that the weakness of the dollar and the consequent increase in the local-currency cost for imported goods will contain inflationary pressures. The Saudi Arabian Monetary Agency (SAMA) has increased its benchmark "repo rate" to 5.5%.

External Sector: The Kingdom has recorded unprecedented trade and current account surpluses. Even though external surpluses are expected to be smaller over the next 24 months, the outlook is equally promising. The Kingdom keeps aside US$25bn in foreign exchange reserves and US$32bn in foreign banks. The external debt could be repaid tomorrow.

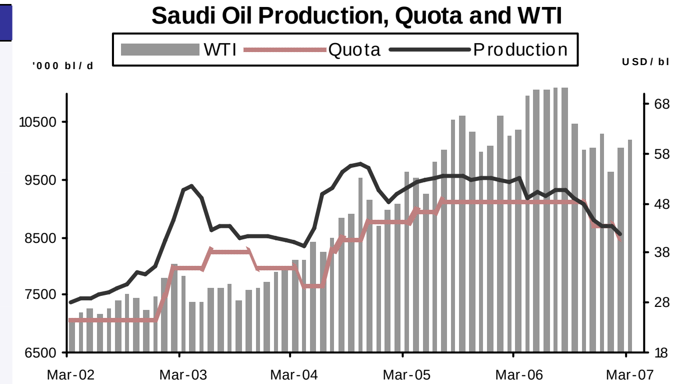
***OUTLOOK**: It is stronger than a few years ago. The **longer-term future** for a country synonymous with oil lies in the growth of its non-oil sector. Current oil windfalls are a unique opportunity to train its citizens and diversify the economy with the help of foreign expertise.*

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	4.0	4.2	4.1	4.5
Inflation (%, year-end)	0.1	2.2	2.5	2.3
Fiscal Balance (% of GDP)	5.6	20.3	12.3	8.9
Exports (US$bn)	106.6	224.1	204.0	200.5
Imports (US$bn)	-36.8	71.0	85.0	97.8
Current Account (US$bn)	25.3	116.8	73.0	52.0
Reserves (month of imports g+s)	3.3	3.1	3.2	3.3
External Debt (US$ bn)	15.4	13.4	13.8	13.6
Debt Service ratio	4.2	2.5!	2.6	2.7
Currency (per US$, year-end)	3.7	3.7	3.7	3.7

Source: EIU, EDC Economics

Saudi Oil Production, Quota and WTI



Source: Bloomberg, EDC Economics