

SABB Notes

- ▶ **China is the second-largest source of Saudi imports and the Kingdom's fifth-largest export customer**
- ▶ **Saudi Arabia's 2008 trade surplus with China reached SR 76.1bn on the back of higher oil prices and export volumes**
- ▶ **We believe trade volumes between the two countries have already achieved President Hu's target of SR 150bn by 2010**
- ▶ **Saudi Arabia is increasingly looking East to find growing markets for its oil and petrochemicals**

Saudi-China Trade Relations

A powerful new trading partner

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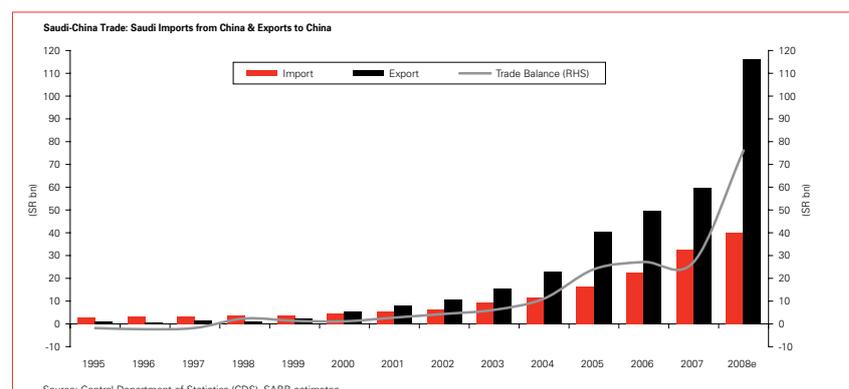
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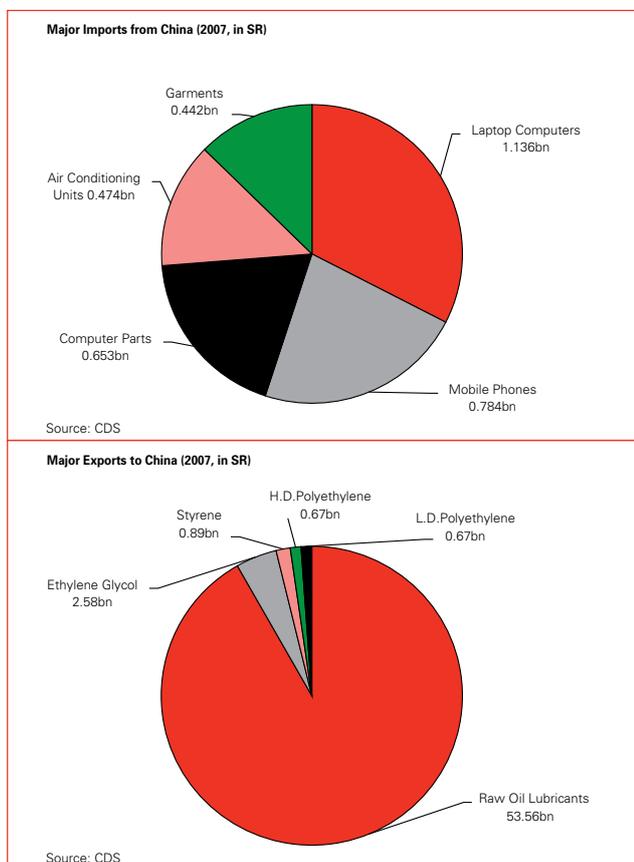
Mutual interests

Diplomatic relations between Saudi Arabia and China were first established in 1990. Yet, without substantial trade or the growth of the Chinese economy, ties between the Kingdom and China would have been far less visible.

In many ways, links between the two have grown so dramatically because of each country's strengths. China is an exporter of goods and Saudi Arabia is a significant importer, while China's growth and thirst for oil imports has been largely supplied by Saudi Arabia. China is second largest source of imports to the Kingdom (2007 data) and is ranked fifth as a destination for Saudi exports. Indeed, Saudi Arabia is China's biggest trading partner in the West Asia and North Africa region.

Both countries' exports and, as a result, overall trade rankings have dramatically improved over the decade. In 1988, China was ranked ninth in exports to the Kingdom, while in the same year Saudi Arabia was ranked twenty-eighth among exporters to China.





Appetites satisfied

For a decade after the establishment of diplomatic ties, trade flows increased. Chinese exports rose by 167% from SR 1.66bn in 1990 to SR 4.44bn in 2000. During the same period Saudi Arabia's exports to China increased by 3,463% from SR 158mn to SR 5.63bn. China's main exports to Saudi Arabia are garments, mechanical and electronic products, air conditioning units and textiles, while its main imports from the Kingdom are crude oil, liquefied petroleum gas and primary plastics.

A substantial boost in Chinese exports occurred after 2000 as Chinese products became much more price-competitive globally. Saudi Arabia's

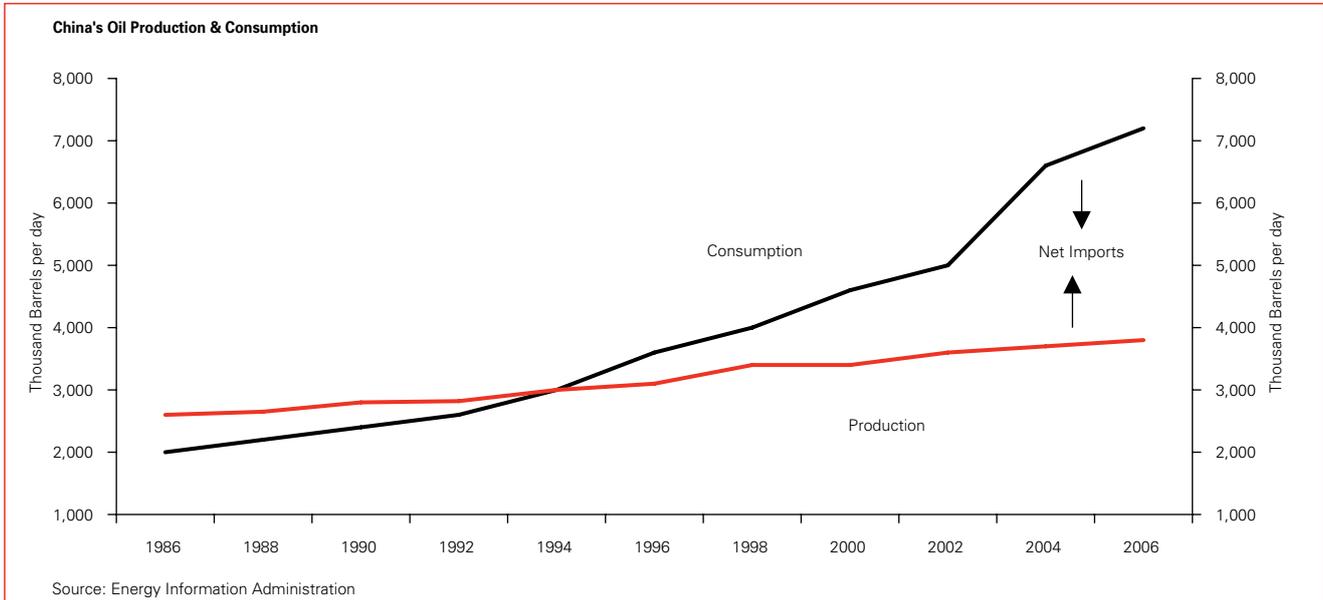
third oil boom (2003-2008) increased the country's appetite for Chinese imports, which satisfied China's desire to acquire market share for its products. Between 2002 and 2004, Saudi imports from China jumped by 160% – a growth rate not matched by any other country during this period in value terms. In percentage terms, only the growth of Argentina's exports to the Kingdom during the same period (353%) surpassed China's.

If we consider the value of Chinese exports over the past eight years, the story is staggering. In 2000, Chinese exports stood at SR 4.48bn, and by 2008 (preliminary data) had risen to SR 40.13bn. In April 2006, Chinese President Hu announced his country's intention that bilateral trade volume between the two countries should reach SR 150bn by 2010. It seems that this was already achieved by 2008, as we estimate that Saudi Arabia's exports reached SR 116.25bn and imports from China reached SR 40.13bn. Also in 2008, the Saudi trade surplus witnessed an increase of 180% due to the rise in oil prices, as well as an increase in oil export volumes as the Kingdom exported to China the equivalent of 720,000 barrels per day.

Fast-growing oil consumption

Saudi exports to China were negligible for the most part of the 1980s (with the exception of 1988). Up until 1994, the Kingdom exported SR 451mn worth of goods to China, but a noticeable increase was observed in 1997 when exports jumped to SR 1.58bn, and again in 1999 when they reached SR 2.35bn.

The reason for these increases was that China had become, since 1993, a net importer of oil. Yet the dramatic leap in Saudi exports occurred

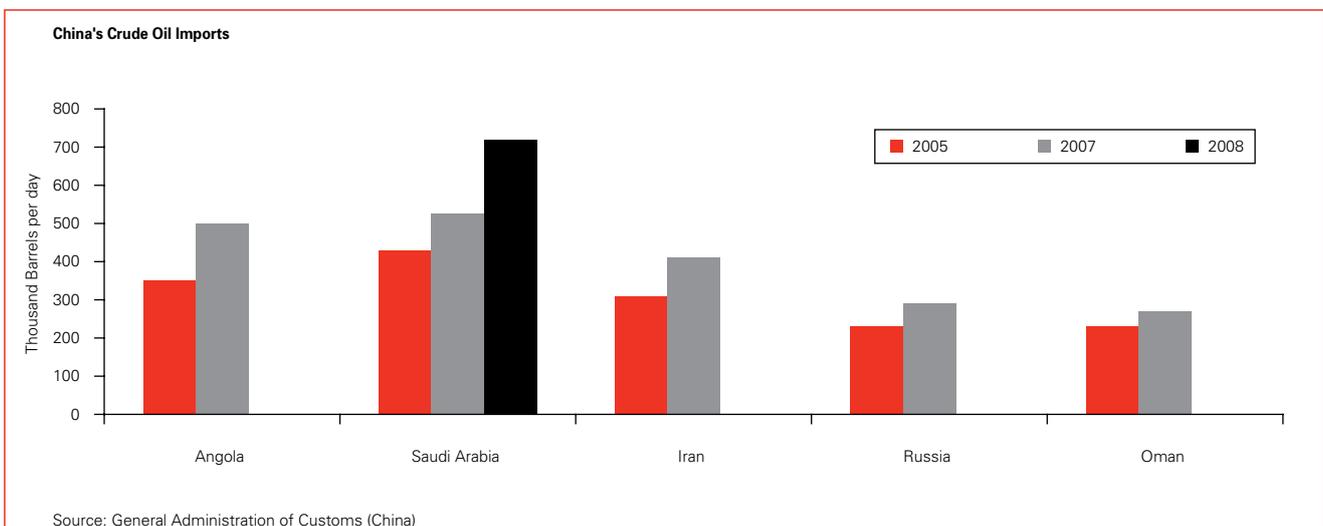


in 2000 when the year-on-year figure rose by 139% to SR 5.63bn. From that year onwards, Saudi exports to China continued to rise on an annual basis. In 2001 exports reached SR 8.15bn and by 2008 exports had achieved SR 116.25bn. Indeed, over the last nine years Saudi exports to China have grown by 963%.

The rise in Saudi Arabia's oil exports was spurred by the growing energy demand in China

that outstripped domestic supply.¹ Between 2000 and 2005 China's oil consumption increased from 4.7mn barrels per day to almost 7mn barrels, 43% of which was derived from imports. It should be of no surprise that since 2000, China has become far less efficient in energy use per incremental dollar of GDP.²

China is the world's second largest net importer of oil behind the US, having surpassed Japan in



¹ Pradhan, Samir, «Gulf-Asia Relations: Towards a New Interregionalism» in Gulf Yearbook, 2007-2008, Dubai: Gulf Research Center, 2008, Section 5, pp: 367-382.

² Lieberthal, K. and Herberg, M., China's Search for Energy Security: Implications for US Policy, National Bureau of Asian Research, Vol. 17, No. 1, April 2006.

2008. Within the energy sector, in contrast to a decade ago, China today is importing massive quantities of oil and, following the modification and augmentation of its refining capacity, is able to absorb increasing amounts of Saudi (heavy) oil. This has catapulted Saudi Arabia into the position of China's leading foreign source of oil, while at the same time making China the Kingdom's leading crude oil customer. At the heart of all developments, however, is China's economic growth – which reached more than 9% per annum between 1978 and 2005.

A lot more refined

Along with Angola, Saudi Arabia has vied to be number one oil exporter to China over the past few years. In 2007, the Kingdom secured that position, supplying the equivalent of 527,000 barrels per day and in 2008 it reached 720,000 barrels per day, in line with Saudi Aramco's agreement in June to increase crude supply to Sinopec to 1.5mn barrels per day by 2015. The current export volume was achieved due to China's acknowledgment that access to Saudi crude was vital for its growth, while for the Kingdom it became evident that its heavier crude could only be refined if either China or Saudi Arabia increased its domestic refining capacity of heavier crude.

The Kingdom's target for increasing value-added refined products for China is based on two major refinery projects. Saudi Aramco has been in long-running talks to take a 25% stake in the 200,000-barrels-per-day Qingdao refinery. The refinery would be operated by Saudi Aramco, but Sinopec will have an ownership interest. The Quanzhou refinery (Fujian province), with a refining capacity of 240,000 barrels per day, will also rely on Saudi crude and be a joint-

venture between Saudi Aramco, ExxonMobil and Sinopec; and an 800,000-tonnes-per-year ethylene cracker and associated chemical units is also planned. In addition, a separate contract was signed by the partners covering 750 petrol stations and a network of terminals in Fujian. Finally, Saudi Arabia has since 2006 been using its experience and knowledge to help China build its own 30mn-barrel strategic reserve.

Investment in KSA

More than 70 Chinese companies are doing business in the Kingdom, of which 62 are construction firms employing close to 16,000 Chinese people. One Chinese construction company won a SR 2.2bn contract, the largest for a Chinese company in the Kingdom, to help expand facilities at King Khalid University. Another venture hinged on intangible factors is the proposed Sino-Saudi Jizan Aluminum plant, which is jointly owned by Chalco (Aluminum Corporation of China Limited). A Chinese contractor also won a contract in 2007 to build a container terminal at Jeddah Islamic Port at a cost of SR 860mn, and the same firm was selected along with a local company to build the industrial port at Ras al-Zour. Chinese cement companies are heavily involved in upgrading and expansion work for Saudi cement companies. And, last but not least, a Saudi-Chinese consortium recently won the SR 6.7bn civil works contract for the Mecca-Medina high-speed railway on behalf of the Saudi Railroad Organisation.³

Data on FDI (Foreign Direct Investments) from either country is not very clear. Chinese government data shows that Saudi Arabia's investments into China over the past five years have not exceeded a total of SR 1.8bn, while

³ The civil works contract is the first stage of a SR 22.5bn plan to build a high-speed railway linking the two holy cities of Mecca and Medina. The project aims to transport hundreds of thousands of pilgrims to Mecca and Medina at speeds reaching 360km per hour.

Chinese FDI in the Kingdom during that period has not exceeded SR 1.7bn. These figures might seem lower than many would imagine, but they don't capture the portfolio investments of Saudi businessmen in China.

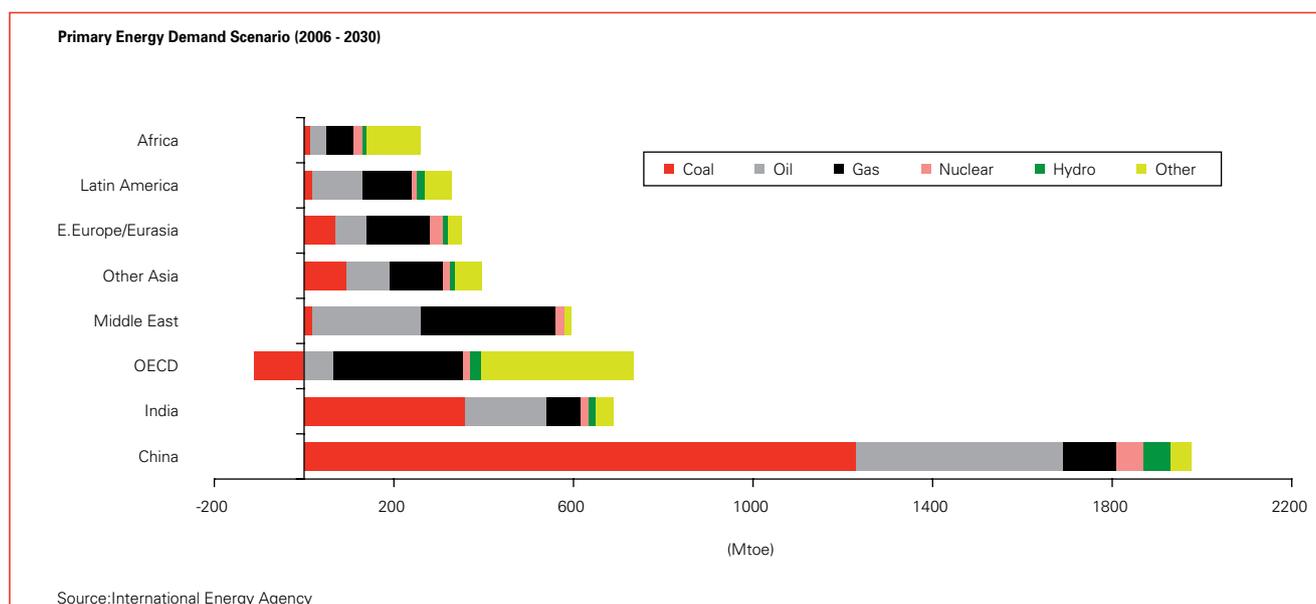
Saudi Arabia has granted Sinopec a SR 1.1bn concession to explore and produce natural gas in a 38,000-kilometre concession area. Sinopec own 80% of a special-purpose company and Saudi Aramco the remaining 20%. Although Sinopec has less experience in natural gas exploration the concession is symbolic of the reciprocal hydrocarbon relationship between the two countries.

Security and friendship

There has been a lot of commentary on China's potential inroads into the military procurement business in Middle East. China's last major arms sale to Saudi Arabia (now-obsolete medium-range ballistic missiles) occurred in the 1980s before the establishment of full diplomatic

relations which is interesting in itself.⁴ In the summer of 2008 China signed a contract to provide Saudi Arabia with one battalion of artillery pieces.⁵ However, this is not a deal that will significantly impact on the Kingdom's strategic procurement policy.

Chinese Hajj pilgrims travelled to Saudi Arabia for many years up until 1979. China resumed pilgrimage activity in the 1990s, when numbers regularly exceeded 6,000, before reaching over 11,000 by 2007. In the late 1990s, Sino-Saudi friendship associations were set up, since when half a dozen trade fairs have been held in Saudi Arabia. In 2003, a non-governmental joint commercial committee was created with a mandate to organise business forums and other activities, as well as advise government officials on ways to facilitate trade. More than 35,000 Saudis travelled to China in 2007. And when emergency aid was needed, Saudi Arabia donated SR 187.5mn in cash and SR 37.5mn worth of relief materials for the earthquake victims of Sichuan province in May 2008.⁶



⁴ Cliff, R. and Byman, D., China's Arms Sales: Motivations and Implications, Santa Monica, CA: Rand Corp, 1999.

⁵ http://www.upi.com/Security_Industry/2008/08/07/China_wins_key_Saudi_artillery_contract/UPI-74931218128855/

⁶ The UK provided SR 7.5 mn in aid to China and Germany SR 3 mn.

What we think: Much has been said about the relationship between Riyadh and Beijing. Many have characterised the relationship as a counterweight or even an alternative to the US-Saudi relationship. There are those who see the Sino-Saudi relations as part of an 'Asian alternative' strategy that would make the Kingdom less dependent on the US. We believe that there is a noticeable shift in trading flows and that this, in itself, is offering economic alternatives to Saudi Arabia. However, we do not feel that the relationship should be seen as a shift in Saudi Arabia's politico-military direction.

More importantly, the relationship with China should be seen as a consequence of China's global economic role and its energy imperatives, making partnerships in the Middle East all the more vital. China does not want its policies to be perceived as motivated by a larger strategy of isolating the US from the region. Political alternatives take time to unfold and, for the moment, Riyadh-Beijing ties are firmly developing in the trade arena.

China needs to nourish its trade ties in the region as it imports close to 50% of its oil from the Gulf. In 2008 Saudi Arabia alone accounted for 20% of China's oil imports. In the short term, as China's economy is slowing down, so will its appetite for oil; but in the medium term, China's dependence on Saudi and GCC oil will continue to rise.

Continuing to look East is the guiding foreign policy principle of Saudi Arabia. China is aware that Saudi Arabia is the seminal global oil producer and that its strength can only increase, as non-Opec oil will not match the capacity of the Gulf producers. Gradually, China is also recognising that the effects on Saudi Arabia of the global economic crisis are minimal. The Kingdom stands as the most unscathed member of the G20.

Both countries hold massive foreign reserves while others are seeing theirs depleting fast, and both also hold large US government paper. Saudi Arabia for its part is clearly aware that China is the second largest economy in the world, with a vast potential demand for energy. With its growth predicated on using hydrocarbons, China needs Saudi Arabian oil (currently 17% of its total oil imports) and Saudi Arabia needs to look East to find growing markets for its oil and petrochemicals over the next decades.

In addition, the Kingdom needs to build its market knowledge in Asia. China offers important economic advantages to Saudi Arabia's downstream expansion into the wider region. And closer to home, China's affordable contractors and low-cost labour force do offer Saudi Arabia an extra cushion for the country's development projects. China's economic policy within the region at large, and particularly in Saudi Arabia, is not hindered by political baggage, unlike the path adopted recently by the EU in its free trade talks with the GCC.

It would be wrong for both Saudi Arabia and China not to develop strong ties. Trade flows between the two countries will increase in the coming years, bringing them closer together. Both countries need to deal with the shifting economic balance of power from the US and the West. For the moment, we don't believe that the roles of the US and China in the region are mutually exclusive. Therefore, we prefer to describe the relationship between Riyadh and Beijing as one of long-term mutual reciprocity. China's role in the Middle East and its ties with Saudi Arabia will grow stronger as a natural result of Beijing's rising status in the global landscape.

Notes

Disclosure appendix

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Dr. John Sfakianakis.

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- 1 - This report is dated as at 10 February 2009
- 2 - All market data included in this report are dated as at close 9 February 2009, unless otherwise indicated in this report.
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