

GCC Outlook 2011

Executive Summary

- Real GDP growth is projected to accelerate to 6 percent in 2011 from an estimated 4.8 percent in 2010 as sustained public infrastructure spending, supported by higher oil prices, helps spur faster non-oil growth. The GCC should also benefit from an easing of bank balance sheet strains, and another increase in hydrocarbons production, including oil.
- With oil prices expected to rise to an average of \$85/b in 2011, GCC public finances will remain reassuringly strong, despite increased spending. Growing export earnings will lead to stronger current account surpluses which will allow for a further build up in external assets, boosting confidence and providing additional revenue streams.
- The recovery in GCC domestic credit growth has been mixed, affected by both muted private sector demand, and bank caution in the face of rising NPLs and provisioning requirements. However, with the provisioning cycle now entering a declining trend and economic growth prospects healthy, credit growth is expected to pick up in 2011.
- Despite pressures from rising food and commodity prices, headline inflation in the GCC remains generally subdued. Differences exist across countries, but rates are not expected to return to pre-crisis highs, with the GCC average projected at just 4 percent for 2011.
- Global exchange rate policies will remain a major issue as the world continues to grapple with large trade imbalances. However, there is unlikely to be any pressure for a change in the GCC's dollar exchange rate pegs. The region's monetary policy will thus continue to be influenced by developments in the USA where policy needs are broadly aligned with those of the GCC.
- The strong economic outlook should support an improvement in GCC equity markets which have generally lagged their emerging market peers. Specific issues will dominate individual markets, both positively and negatively, but all are expected to post gains in 2011.

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Global Environment

The recovery will continue although global growth is likely to slow

The performance of the global economy in 2010 was broadly encouraging, with strong industrial output growth, recovering private consumption growth, and a general improvement in business and consumer sentiment. Emerging markets have done particularly well, with strong domestic demand supported by broadly accommodative monetary policy and an improving external environment. Meanwhile the outlook for 2011 has been bolstered by the recent announcement of further major fiscal loosening in the US. This should provide a powerful impulse for a pickup in consumer spending, and add around 0.5 percentage points to overall US GDP which we now project at 2.7 percent in 2011, the same as in 2010. This will have positive knock-on effects given the importance of the US consumer to the overall health of the global economy.

Nevertheless, growth in 2011 is unlikely to be quite as strong as in 2010. For a start the US inventory cycle has turned, and stocks that were built up in 2010 are likely to be run down in 2011, at least in the first half of the year. In addition US labour and real estate markets remain weak, constraining more rapid consumption growth. Second, the performance of emerging markets is likely to be less stellar as governments begin to tighten policy as their economies threaten to overheat and in response to potentially destabilising inflows of foreign capital which are pressuring consumer prices, asset prices and real effective exchange rates. Third, eurozone growth prospects remain compromised by the necessary fiscal retrenchment ongoing in some member countries, and likely to be initiated by others during the course of 2011. With world trade growth also likely to slow, these factors suggests a soft patch for global growth at least in the first half of the year, though we expect activity to pick up again in the second half and into 2012 and beyond. Overall we expect global growth to dip to 4 percent in 2011 from 4.6 percent in 2010.

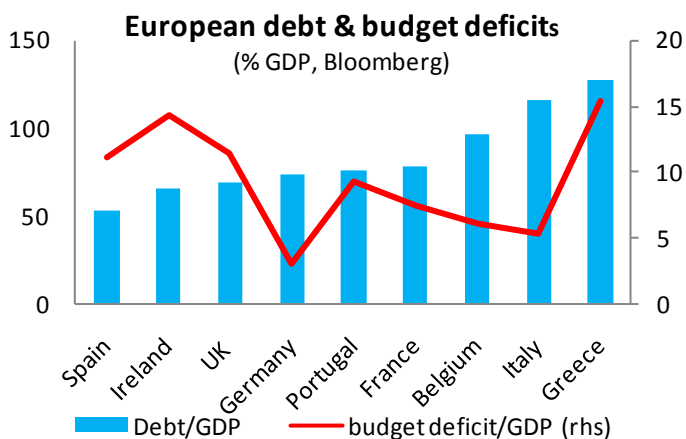
There are numerous risks to the global outlook

Risks remain tilted to the downside, with the external debt positions of a number of peripheral eurozone countries particularly worrisome. At time of writing concerns were mounting that Portugal would soon join Greece and Ireland in seeking a bailout. Any sovereign default/restructuring could trigger a further wave of credit tightening given the exposure that European banks have to the region's sovereign debt, with

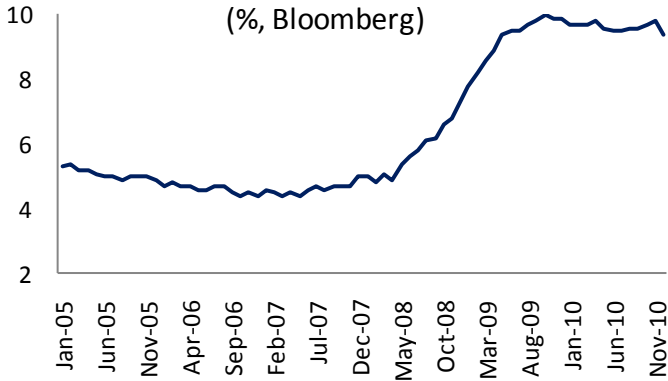
World Economic Outlook			
	2009	2010f	2011f
Real GDP growth (percent, annual)			
World	-0.6	4.3	4.0
US	-2.4	2.7	2.7
Japan	-5.2	2.8	1.5
Euro area	-4.1	1.6	1.4
Emerging Markets	2.5	6.3	6.0
Official policy rate (end period)			
US	0.25	0.25	0.25
Japan	0.1	0.1	0.1
Euro area	1.0	1.0	1.5
(\$/b, period average)			
WTI crude oil price	62.0	79.5	85.0

Source: Samba estimates and forecasts

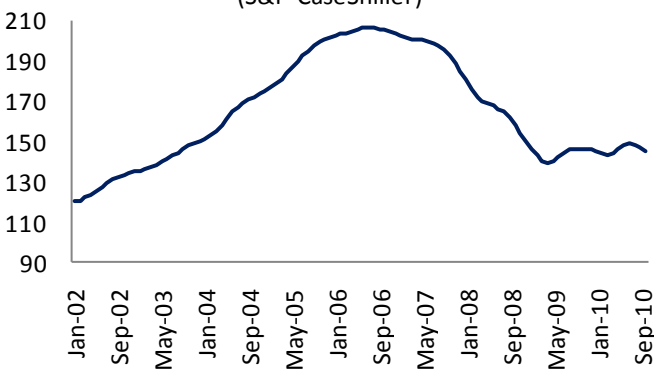
Global risks remain tilted to the downside, with the debt positions of a number of eurozone countries particularly worrisome.



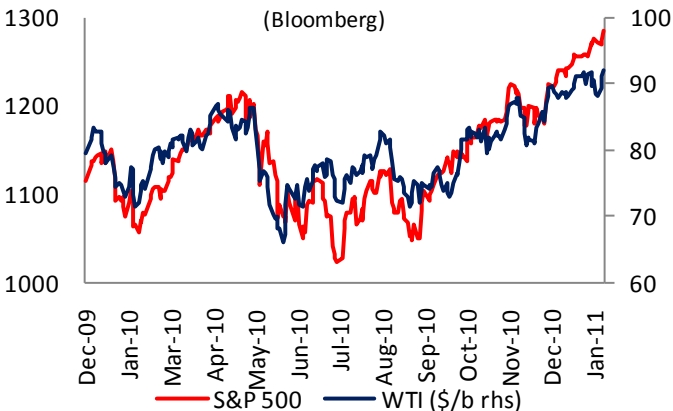
US Unemployment Rate
(%, Bloomberg)



US House Price Index
(S&P-CaseShiller)



Oil Price vs S&P 500
(Bloomberg)



negative consequences both for the eurozone real economy and global credit conditions.

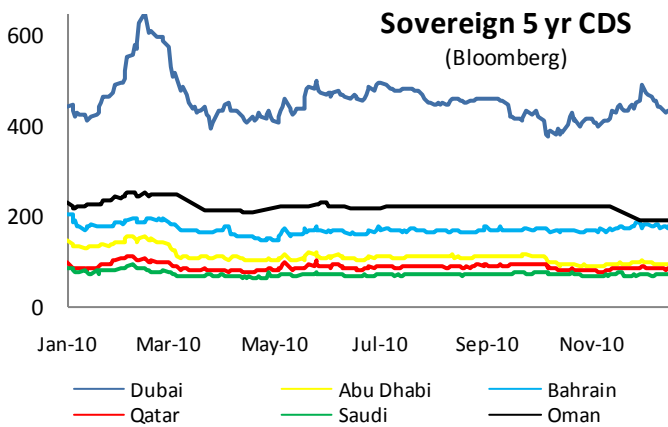
In the US, consumer balance sheets remain weak and vulnerable to any further decline in asset prices, especially real estate. In addition, the current growth stimulus remains largely “artificial”, generated by unprecedented fiscal and monetary laxity which to-date has not generated much in the way of new jobs. High gasoline prices could also nullify some of the impact of the fiscal stimulus, while quantitative easing could put downward pressure on the US dollar, which might mean that consumer prices rise just as growth stalls. There is also a risk that emerging markets may delay policy tightening for too long which might mean an unsustainable run up in asset prices, followed – potentially at least – by a painful bust.

Implications for the GCC

In this general global context there are a number of issues which will have a major bearing on the outlook for the GCC in 2011.

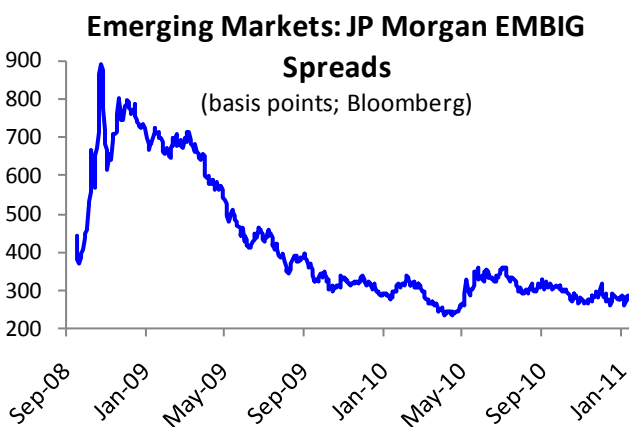
US monetary policy: Persistently high unemployment, weak house prices and low inflation (US core inflation recently dropped to its lowest level on record) suggest that there is little prospect of a rise in US policy interest rates during 2011, despite further fiscal stimulus and relatively healthy economic prospects. Instead the Fed is expected to push ahead with its latest round of quantitative easing which runs through June 2011 and will pump another \$600 billion into financial markets, although this could be scaled down if economic conditions improve. Given the exchange rate pegs to the US dollar, GCC monetary policy will thus remain loose, and their economies susceptible to fluctuations in the dollar exchange rate that may arise from the combination of QE2 and fiscal stimulus 2. Overall we expect that increased liquidity and relatively low interest rates should provide a supportive environment for the GCC’s external financing needs which are particularly large in the UAE (see below). There is a small risk that disruptive speculative capital inflows may surge into the GCC, although this is mitigated by the more restrained credit and private demand environment as the region continues to adjust following its earlier lending boom and real estate slump.

Oil prices: Average WTI oil prices rose 28.2 percent to \$79.5/b in 2010 on the back of a strong rebound in global oil demand and increasing financial investment in oil. With prices in its stated “comfort zone” OPEC was less concerned over maintaining quota discipline, and its oil output rose about 2 percent. This helped boost GCC real GDP growth rates and export earnings but, combined with increasing non-OPEC supply and rising OPEC NGL production, has meant that global stocks



Ratings	Moody's	S&P	Fitch
Saudi	Aa3	AA-	AA-
UAE	Aa2	NR	NR
Abu Dhabi	Aa2	AA	AA
Qatar	Aa2	AA-	NR
Kuwait	Aa2	AA-	AA
Oman	A2	A	NR
Bahrain	A3	A	A

NR: not rated



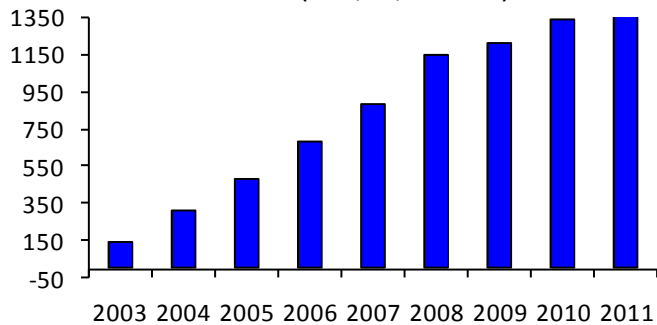
levels and spare capacity remain relatively elevated. Oil demand is expected to expand further in 2011, albeit at a slower pace, and financial investor interest in oil is likely to continue in the face of US quantitative easing and expectations that demand growth will eat into currently high stock levels and spare capacity. Under such conditions average prices are projected to rise to \$85/b in 2011 and there may be room for OPEC production gains although a formal relaxation of quotas seems unlikely. For more details see our *Oil Market Outlook 2011* report, but please note our price forecast has been raised since publication to reflect stronger US growth prospects in the wake of agreement on new fiscal stimulus.

GCC risk perception: Market perceptions of GCC risk have generally remained favourable during 2010 as oil prices have strengthened and global growth and trade recovered. CDS spreads for all GCC sovereigns ended 2010 lower than they started, although only just in the case of Dubai where debt concerns remain and rates remain elevated. In addition, the onset of the Greek debt crisis did have a negative although temporary adverse impact on GCC spreads and the region remains somewhat sensitive to future developments in eurozone sovereign debt markets and, closer to home, developments in Dubai's debt restructurings. However, with oil prices remaining strong markets are likely to remain favourably inclined towards the GCC in 2011.

The GCC's strong sovereign ratings are also expected to be maintained. Moody's has downgraded Bahrain one notch to A3 due to concerns over public finances and performance of the country's large wholesale banking sector, but this has not been matched by other rating agencies. In addition, the general downward migration in GCC corporate ratings during 2009 which was mainly driven by changing assumptions of government support for government related enterprises (GREs) has now ceased, although some individual corporate still face concerns over their credit fundamentals, particularly those exposed to weak real estate sectors. In these instances GCC sovereigns may step in and raise funds to support state enterprises.

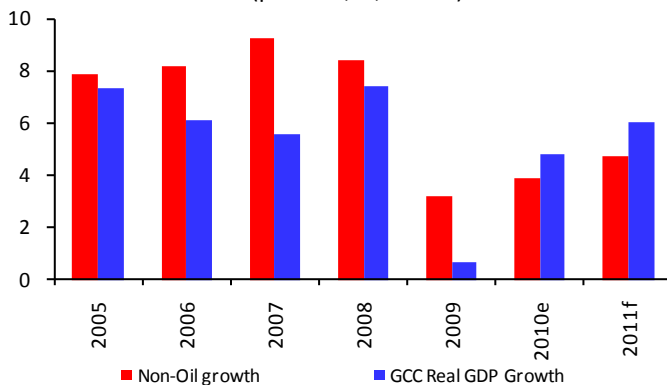
Capital markets: GCC corporations and sovereigns continued to tap international capital markets during 2010 and benefited from the general abundance of liquidity and search for yield. Around \$26 billion in bonds, notes and Sukuk was raised during the year (compared to around \$32 billion in 2009 when GCC sovereigns were active), the bulk during September-November when the prospect of QE2 helped bring down financing costs and investor appetite was strong (prior to the Irish debt crisis). These conditions allowed the Dubai government to successfully return to the bond market following the finalisation of the Dubai

GCC cumulative current account surplus
(\$bn, IIF, Samba)



The GCC has and will continue to benefit from the expected strength in oil prices and its increasing trade links with Asia which remains the main source of global growth

GCC: Real Economic Growth
(percent, IIF, Samba)



World (DW) restructuring agreement, albeit at a price. Although GCC capital raising activity has lagged the surge in issues in emerging markets in general, absent an intensification of the Eurozone debt crisis, market appetite for GCC credits should remain healthy in 2011, although the cost of funds is likely to rise.

This will be an important issue as regional bank lending remains muted while GCC corporates have large short term refinancing needs estimated at around \$46 billion for 2011-12 by Moody's. The majority of this is accounted for by the UAE with Dubai needing to refinance around \$18 billion in 2011. The UAE federal government is also considering issuing sovereign bonds for the first time to fund projected federal budget deficits. Despite favourable conditions, the credit environment for select non-government related corporate issuers in the GCC could remain challenging, particularly those facing large bullet repayments on maturing debt and difficult operating environments such as in Dubai.

Downside risks: Should the eurozone crisis intensify the GCC could suffer as credit availability diminishes and risk aversion increases. Dubai would be particularly hard hit if market conditions precluded it from meeting its large refinancing needs, and the value of its assets sales were depressed. While not our expectation, knock on effects from a crisis in Europe on the global economy would pull down oil prices. However, we believe that this would be mitigated by OPEC action such that average prices would not fall below \$70-75/b which would be manageable for most GCC countries over the short term.

Economic developments and prospects

Performance and prospects: broad themes

Drivers: The GCC has and will continue to benefit from the expected strength in oil prices and its increasing trade links with Asia which remains the main source of global growth. The region also remains structurally strong with large net external assets, modest debt levels (Dubai being the exception), sustained current account surpluses and healthy fiscal balances. GCC populations are young, growing and relatively wealthy. And its governments' are committed to using oil and gas wealth to develop and diversify their economies.

Headwinds: The hangover from the region's earlier credit and real estate booms continues to linger in places. Real estate sectors in the UAE and Qatar remain oversupplied; concerns remain over Dubai's indebtedness and restructuring needs; defaults by two large Saudi conglomerates have dampened

GCC Oil production

mb/d	2008	2009	2010e	2011f
Saudi	9.12	8.09	8.23	8.30
Kuwait	2.57	2.27	2.30	2.31
UAE	2.55	2.26	2.30	2.31
Qatar	0.84	0.77	0.82	0.83
Oman	0.67	0.72	0.77	0.81
Bahrain	0.18	0.18	0.18	0.18
GCC	15.93	14.29	14.60	14.74
<i>% change</i>	3.9	-10.3	2.2	1.0

Source: PFC, Samba

GCC NGL Production

mb/d	2008	2009	2010e	2011f
Saudi	1.43	1.31	1.45	1.71
Kuwait	0.16	0.19	0.20	0.21
UAE	0.53	0.52	0.56	0.63
Qatar	0.61	0.72	0.96	1.11
Oman	0.08	0.09	0.09	0.09
Bahrain	0.01	0.10	0.10	0.10
GCC	2.82	2.93	3.35	3.84
<i>% change</i>	7.6	4.0	14.3	14.8

Source: PFC

confidence, and balance sheet pressures in GCC banking systems have led to a sharp deceleration in domestic credit growth which will likely take time to recover. The region's continued dependence on oil prices also remains a source of vulnerability, and to take advantage of opportunities offered GCC states need to broaden the engines for income and employment creation.

GCC Key Macro Indicators and Forecasts

GCC	2007	2008	2009	2010e	2011f
Real GDP Growth (% change)	5.6	7.4	0.7	4.8	6.0
Nominal GDP (\$ billion)	829	1,027	886	1,016	1,115
CPI (av. % change)	6.7	11.1	2.7	3.2	4.0
Budget Balance (% GDP)	17.7	22.2	-3.2	5.4	6.9
Current Account Balance (% GDP)	24.1	26.2	8.0	11.9	12.5
Oil production (mb/d)	15.33	15.93	14.28	14.61	14.92
Population (million)	36.3	37.6	38.9	39.9	41.0

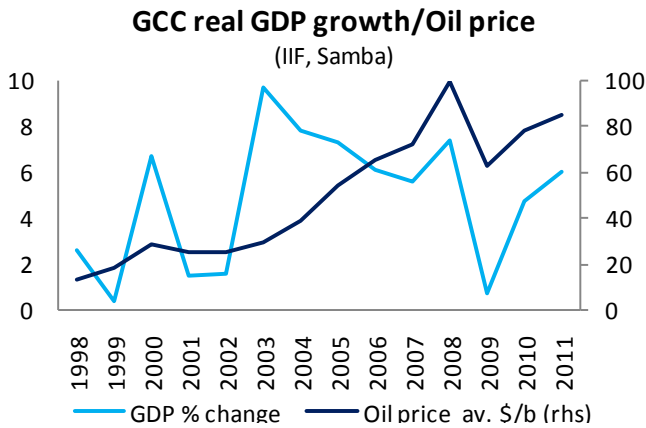
GCC growth rebounds to 4.8 percent in 2010

Real GDP growth in the GCC is estimated to have rebounded to 4.8 percent in 2010 from 0.7 percent in 2009. Sustained expansionary fiscal policies, supported by higher oil prices, helped spur faster growth in non-oil sectors although the recovery in private sector activity remained tentative. Stronger growth was prevented by continued corporate and consumer deleveraging and bank caution in the face of rising NPLs and uncertainty surrounding debt restructurings in Dubai. In addition, real estate sectors continued to struggle in the UAE and Qatar, GCC equity markets generally underperformed, and financing conditions, while improved, remained tighter than pre-crisis.

Growth was thus mainly driven by public spending accompanied by a rebound in the dominant hydrocarbons sectors following the decline in crude oil output in 2009 when OPEC quotas were slashed. Despite these quotas still being in place, crude oil output in the GCC is estimated to have risen by 2.2 percent in 2010, while NGL output has jumped by 14 percent (see tables). Qatar's production of LNG has also surged. This combination of rising hydrocarbons output and stronger prices has led to a rebound in export earnings which have been reflected in higher current account and fiscal surpluses.

A further acceleration is projected in 2011

Although the global economy enters 2011 in a state of some uncertainty, the outlook for the GCC economies remains positive. Strong oil prices will sustain robust public spending and buoy confidence, while an easing of bank balance sheet strains,



The region's real GDP growth is expected to accelerate to 6 percent in 2011 on the back of strong public spending, a revival in the private sector and increased hydrocarbons output.

particularly in Saudi Arabia and Qatar, is expected to lead to a faster recycling of the region's large oil surpluses. Absent another credit crunch precipitated by a deepening of the crisis in the Eurozone, capital flows into the region should also remain healthy. Thus although oil output gains may be constrained by OPEC policies (but not NGLs and LNG), this will be offset by stronger non-oil growth as a revival in private sector credit and investment activity combines with sustained public spending. Overall the region's real GDP growth is expected to accelerate to 6 percent.

Performances across the GCC will vary (see tables at end of report). The start up of new LNG and GTL production facilities in **Qatar** is expected to keep growth at around 16-17 percent in both 2010 and 2011. Meanwhile, increasing export earnings will be used to further the states diversification agenda, including infrastructure developments associated with hosting the 2022 World Cup, and lead to a strong revival in non-oil growth. Growth in **Saudi Arabia** will also be solid rising to 4.2 percent in 2011 from 3.8 percent in 2010. Public investment will continue to drive healthy non-oil growth, although the pace of spending is expected to ease as private confidence and investment hardens. While crude output gains could be constrained by OPEC decisions, rising NGL (up 18 percent) should be enough to keep the oil sector expanding at a modest pace.

Increased spending in the context of the government's \$107 billion new five-year plan will help raise growth in **Kuwait** to 4 percent in 2011 from 2.5 percent in 2010, although bank balance sheet strains may still constrain private sector growth. **Oman** is expected to grow by 5 percent bolstered by increasing oil output (Oman is not a member of OPEC) and infrastructure investment. Improving regional activity and abundant global liquidity should benefit **Bahrain's'** dominant financial sector helping push growth to 3.5 percent in 2011. Prospects in the **UAE** are more muted with strong public investment driven growth in Abu Dhabi being dampened by a slower recovery in debt laden Dubai and weak property prices. As a result real GDP growth in the UAE as a whole is likely to be contained at 3.3 percent in 2011.

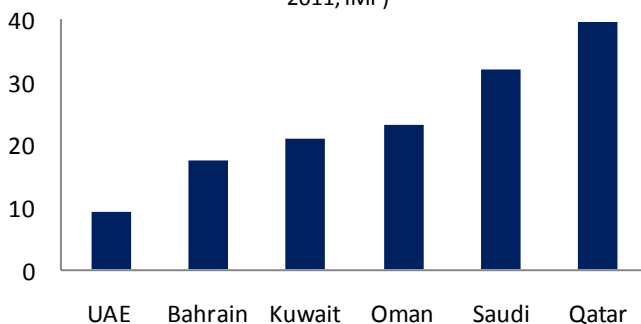
Public Finances

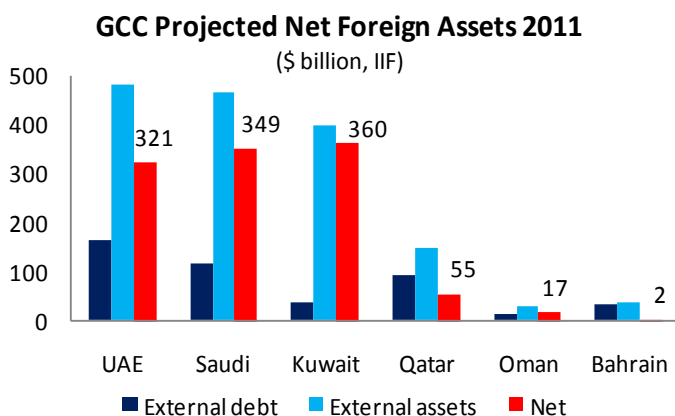
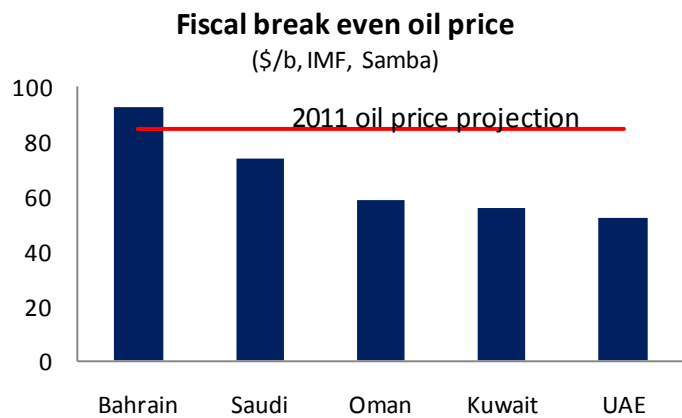
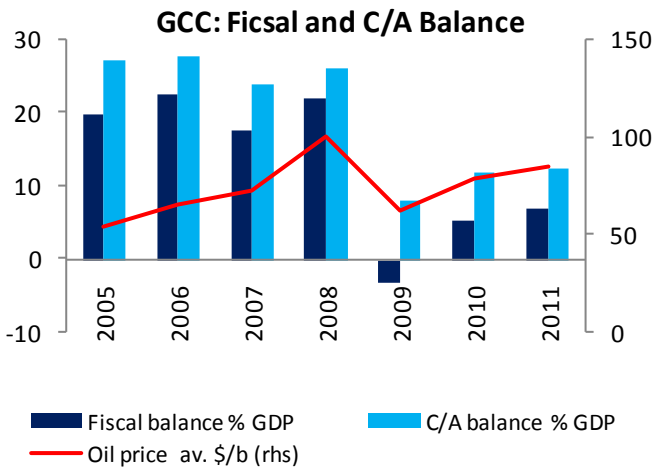
Pace of GCC spending may moderate but will remain strong and supported by healthy oil revenues

After two years of strongly expansionary fiscal policies aimed at mitigating the affects of the global crisis, the rate of increase in spending will likely moderate in 2011 as GCC governments seek to unwind exceptional fiscal stimulus and return spending growth to more sustainable levels. That said, public spending

GCC Fiscal Stimulus

(% change in US\$ government spending from 2008 to 2011, IMF)





will continue to be driven by long-term spending plans and will remain the key driver of growth in 2011. These plans remain affordable in the context of projected oil prices around \$85/b and large external savings, and GCC public finances will remain reassuringly strong. All except Bahrain are expected to post fiscal surpluses despite the large increase in budget break even oil prices that has occurred over the past few years as GCC spending commitments have risen. That said, GCC governments are conscious of their over reliance on oil revenues and the long discussed introduction of value-added tax (VAT) could take place by 2012.

The GCC consolidated fiscal balance is now estimated to have recorded a deficit of 3.2 percent of GDP in 2009, principally reflecting revised data for the consolidated UAE fiscal accounts and the Saudi budget which show deficits of 12.2 and 6.1 percent of GDP respectively. This reflects the large amount of public spending during the year to support banks and state owned enterprises as well as expansionary fiscal policies. In the case of the UAE there are also some presentational issues as the deficit is financed principally from Abu Dhabi's oil company profits, as well as a drawdown in external assets.

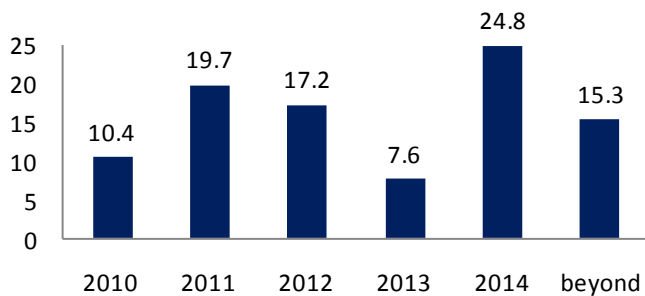
With oil prices up an estimated 28.2 percent in 2010, GCC fiscal balances have since strengthened despite still high spending, although Dubai's finances remain strained. Recent official data suggest that the dominant Saudi fiscal balance returned to a surplus of 6.7 percent in 2010. The UAE is likely to have posted another small deficit, but overall the GCC fiscal balance is estimated to return to a surplus of 5.4 percent of GDP in 2010. This is expected to rise further to nearly 7 percent in 2011 as oil prices strengthen further. A stronger improvement will be precluded by the large multi-year infrastructure and development spending commitments by various GCC states, including Saudi Arabia's \$400 billion five-year (2010-14) public investment program, Kuwait's \$ 107 billion development plan, and Oman's \$78 billion development plan through 2015.

GCC net external position bolstered by current account surpluses

GCC oil export earning rebounded strongly in 2010 driven by higher prices and an increase in production. Exports were further boosted by rising NGL, LNG and petrochemical output and a revival in non-hydrocarbons trade. While imports are also picking up as public sector investment programs are implemented, GCC external balances have improved and will continue to do so in 2011 as oil prices strengthen further. The current account surplus for the GCC as a whole is expected to rise to between \$120-140 billion (around 12 percent of GDP) in 2010-11. Although still considerably lower than the \$200 billion

Large current account surpluses will allow for a further build up in external assets, boosting confidence and providing additional income revenues.

Dubai Inc. estimated debt repayment profile post DW restructuring
(\$bn, IMF, Samba)



The recovery in GCC domestic credit growth has been mixed, affected by both muted private sector demand, and bank caution in the face of still rising NPLs and provisioning requirements

plus surpluses achieved in 2006-08, this will allow for a further build up in external assets boosting confidence and providing additional income revenues.

A large proportion of these external assets will be held by Sovereign Wealth Funds (SWFs) which do not generally provide detailed data on their size. However, estimates from the Institute of International Finance (IIF) suggest that all GCC countries maintain positive net external assets positions (i.e. the value of their external assets exceeds that of their external debt) and that these will strengthen further in 2011 (see chart). For Saudi Arabia, the UAE and Kuwait these positions are substantial at well over \$300 billion each. However, the UAE's external strength masks a sharp disparity between the position of Abu Dhabi which owns the bulk of the external assets and heavily indebted Dubai which has limited savings.

Dubai's 2011-12 external repayment burden remains testing

The October 2010 \$14 billion Dubai World 5-8 year debt restructuring agreement has bought Dubai Inc. time to put its finances in order. However, it still faces a difficult repayment profile estimated at around \$17-18 billion a year during 2011-12. Negotiations concerning debt restructuring at Dubai Holdings are still underway. These will be important to reduce 2011 obligations, with the latest agreement being a deal covering \$2.5 billion of Dubai International Capital's debt.

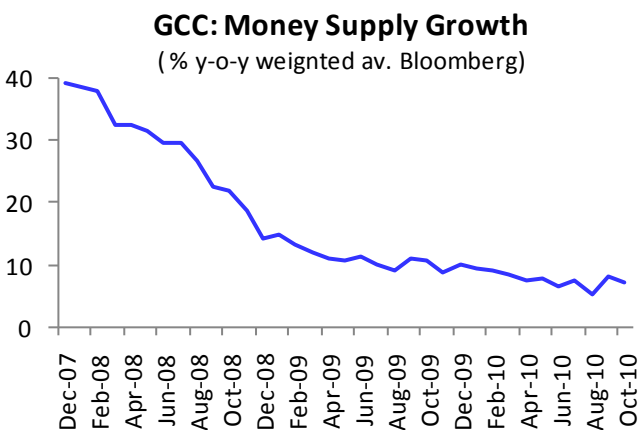
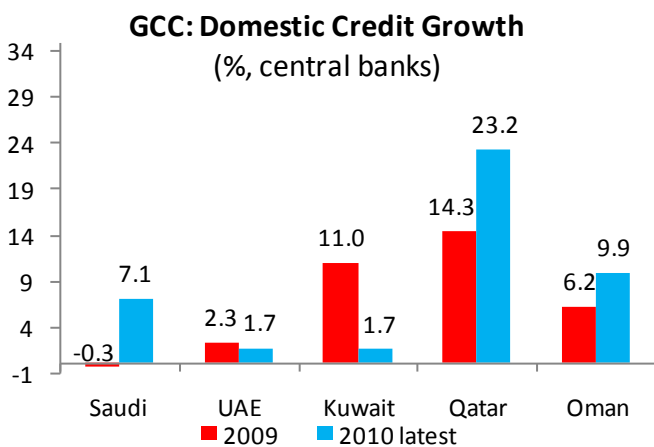
The Dubai government was able to raise a \$1.25 billion bond in 2010 and will be looking to tap the markets further in 2011, both at the sovereign and corporate level. As financially acceptable options arise it will also look to start its asset sales programme needed to meet revised repayments, and has recently agreed to a \$1.5 billion sale of Dubai Ports Australian interests. Any problems meeting repayments would be met poorly by the markets, as would the need for restructuring at another government related entity, and could adversely affect broader GCC market access and costing. We are tentatively optimistic that Dubai will be able to manage in 2011, but progress will need to be carefully monitored and access to external funding remains key.

Domestic credit and monetary policy

Lacklustre private credit growth continued through 2010

The recovery in GCC domestic credit growth has been mixed, affected by both muted private sector demand, and bank caution in the face of still rising NPLs and provisioning requirements. Banks also faced tighter external financing and a

The post boom sluggishness in GCC credit growth is consistent with historical experience but conditions are expected to improve in 2011.



need to repair their balance sheets. This has been particularly apparent in the UAE and Kuwait where domestic credit growth actually slowed for the second year to less than 2 percent in 2010, amid concerns over corporate debt restructurings in Dubai, weak real estate prices and problems in Kuwait's investment companies. Elsewhere credit growth accelerated to 23 percent in Qatar, driven primarily by public sector borrowing although private sector credit remained robust at close to 10 percent. Lending activity also picked up in Oman (10 percent) and in Saudi Arabia (7 percent) albeit off a relatively low base given the 0.3 percent contraction in 2009.

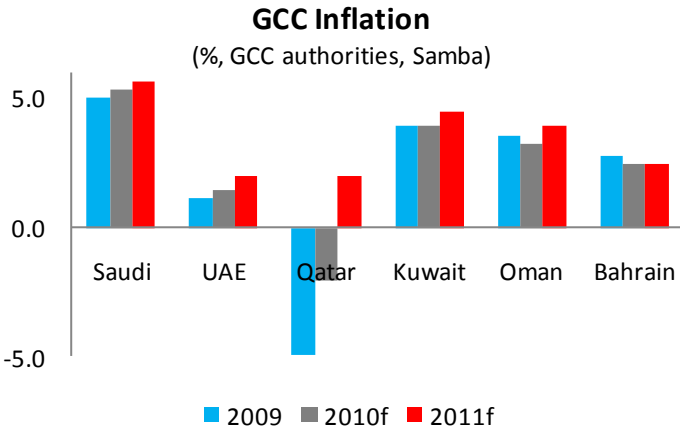
A credit recovery is on the way led by Saudi Arabia and Qatar

The post boom sluggishness in GCC credit growth is consistent with historical experience but conditions are expected to improve in 2011 in line with the acceleration in economic growth, improving consumer and corporate confidence, and an easing of provisioning pressures. Bank deposit growth started to revive in the latter half of 2010 (the slowdown in GCC broad money growth appears to have bottomed out in the third quarter) helping improve banks loan to deposit ratios. GCC banks have also been able to tap capital markets and should be able to do so in 2011, although Dubai banks have remained on the sidelines. For many, balance sheets are looking stronger and banks are expected to look to re-grow their domestic portfolios. This will be particularly evident in Qatar where banks have received strong official support (see Box 2) and will benefit from the pickup in investment activity associated with winning the bid to host the 2022 World Cup.

Lending activity is also expected to revive strongly in Saudi Arabia where banks are also generally in good shape and should see a declining trend in provisioning requirements. The main market will be construction, with banks increasingly happy to extend bridging finance and working capital to contractors benefitting from the public investment surge. Long-term funds will continue to be provided to large industrial projects, particularly if they have public sector involvement. In contrast, UAE and Kuwaiti banks may still have some way to go to repair their balance sheets hit by weak property prices, debt restructurings by government owned entities, and exposure to badly performing investment houses.

Inflation was subdued in 2010

Despite pressures from rising global food and commodity prices last year, headline inflation in the GCC was generally subdued. Differences exist across countries but the regional weighted average rose only modestly to an estimated 3.2 percent in 2010, from 2.8 percent in 2009. Agricultural commodity forecasts



Rising aggregate demand from sustained public spending and a recovery in private sector activity in a low interest rate environment has the potential to generate stronger inflationary pressures in 2011.

Consumer Price Index Weights

	%	Rents	Food
Saudi		18	26
Kuwait		19	36
UAE		39	14
Qatar		31	13
Oman		15	30
Bahrain		26	20

Source: official statistics

suggest that food price pressures are likely to continue this year which, combined with recovering domestic demand is expected to raise GCC inflation modestly to 4 percent in 2011.

GCC economies are heavily dependent on imported goods for final consumption and investment, and this makes domestic prices highly sensitive to external factors, and in particular to inflation in trading partners. In the case of the dominant OECD partners, this has been subdued and is expected to remain so through 2011, helping offset any weakness in the US dollar. However, pressure has come from rising food and commodity prices during 2010, with the former being a key driver of headline rates in the GCC due to its high weighting in consumer price indices (CPIs).

Another key driver has been movements in domestic rental prices which are also heavily weighted in regional CPIs. In the case of Saudi Arabia, shortages of affordable housing continues to push up rents which have combined with pressures from higher food prices to generate average inflation of over 5 percent - the highest in the GCC. In contrast, weak real estate markets in the UAE and Qatar have continued to contain headline inflation rates. In the case of Qatar, this led to a second year of deflation in 2010 although it should be noted that the CPI data is likely to overstate the extent of declining rents as it only captures new contracts. Rents in the UAE (Abu Dhabi) and Qatar should begin to stabilise in 2011 which will put upward pressure on their CPIs.

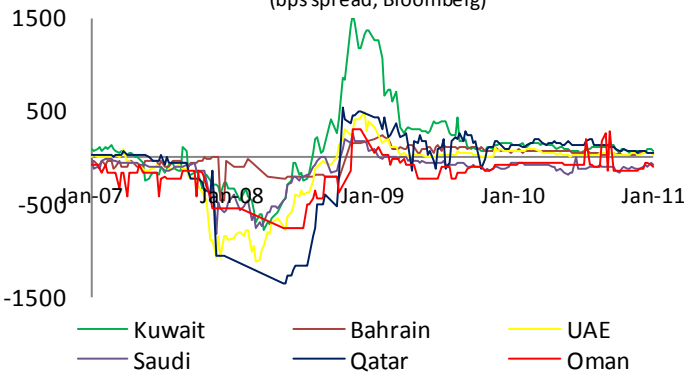
Inflationary risks appear generally contained

Rising aggregate demand from sustained public spending and a recovery in private sector activity in a low interest rate environment has the potential to generate stronger inflationary pressures in 2011. However, this risk is mitigated by the sustained need for deleveraging and balance sheet repair in many businesses, banks and households. While accelerating, credit growth is likely to remain comparatively subdued and, with the exception of Saudi housing, most economies still maintain spare capacity, particularly in real estate which was previously a major inflationary bottle neck. Barring a sustained surge in oil prices back over \$100/b, a return to the boom conditions which helped push inflation to record rates in 2008 currently seems unlikely. The exception could be Qatar where the boost in infrastructure spending associated with hosting of the 2022 World Cup has the potential to generate inflationary pressure and prompt another credit boom unless carefully monitored.

Exchange rate policies will remain a major issue during 2011 as the world continues to grapple with large trade imbalances.

12 month forward exchange rates

(bps spread, Bloomberg)



US\$ Exchange Rate Index

(Bloomberg)



Global exchange rate policies will be a key issue in 2011

Exchange rate policies will remain a major issue during 2011 as the world continues to grapple with large trade imbalances and the effects of sustained quantitative easing in advanced economies, especially the US. Fears have mounted over the spectre of competitive devaluations as all four of the major trading currencies (US dollar, Euro, UK pound and Japanese Yen) face difficult economic challenges and are running out of policy options given the need to rein in unsustainably large fiscal stimulus, and already near zero interest rates. Tensions are likely to remain high over exchange rate policies of large surplus countries, most particularly China, while emerging markets may have to periodically deal with waves of capital fleeing the US into their higher yielding markets.

No pressure is likely to be exerted on GCC to alter exchange rates

How will all this affect the US dollar exchange rate pegs of the GCC states which also continue to run large current account surpluses? We think it unlikely there will be outside political pressure on the GCC to revalue or abandon their pegs as the response of export and import volumes to exchange rates changes in oil exporters is generally understood to be weak¹. With hydrocarbon exports priced in US dollars, earnings are primarily driven by changing prices set in international markets. GCC import volumes meanwhile are primarily driven by changes in public spending.

More immediately, the combination of robust fiscal stimulus in the GCC since the crisis and lower oil prices (over 2008) has already led to a sharp adjustment in the regions current account surplus. Having held at over 25 percent of GDP during 2006-08, the GCC aggregate current account surplus is now projected to remain at less than half this during 2010-11.

Dollar exchange rate pegs will be maintained

Although there may not be any outside political pressure for change, economic arguments may return to the fore if a weaker US dollar and sustained loose monetary policy in the US (which the dollar peg compels the GCC to follow) begins to fuel inflationary pressures as happened in 2007-08. However, we feel this is unlikely. Currently inflationary pressures in the GCC are generally contained (see above). Credit growth remains under

¹ See for example IMF, Consultative Group on Exchange Rate Issues, Hakura and Billmeier, WP/08/216

Forward exchange rates for GCC countries do not currently point to any pressure for a change in the peg.

control, if not weak, and economic growth relatively restrained, such that the US monetary stance is likely to remain broadly aligned with the needs of the GCC. In addition, despite bouts of weakness, the US dollar is not expected to continue to slide against major currencies, and will probably strengthen against the Euro and Yen during 2011.

In the meantime, forward exchange rates for GCC countries do not currently point to any pressure for a change in the peg, and we do not expect a return of speculative capital inflows into the region in anticipation of a possible revaluation as occurred in 2007-08. While inflows have picked up modestly they are not raising problems as in other emerging markets which have felt the need to introduce capital controls to stem upward pressure on their currencies and asset prices. We thus do not expect any major debates about maintaining the GCC exchange rate peg which we continue to view as appropriate (see our *GCC 2010 Outlook*).

Monetary policy will focus on better regulated and supervised credit growth

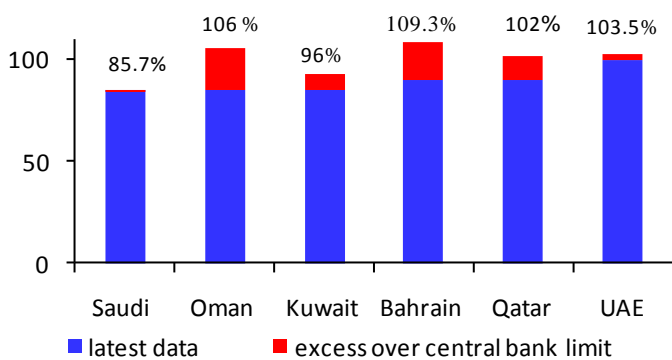
Given the sustained exchange rate peg, GCC monetary authorities will have limited monetary policy options should inflationary pressures rise and/or disruptive capital flows surge. They thus face a difficult balancing act of needing to support a revival in credit growth while mitigating any potential resurgence of inflation. In this context, monetary authorities are expected to place greater emphasis on regulation and supervision to ensure banks are adequately capitalised and provisioned. As bank lending picks up, they are also expected to unwind some of the extraordinary liquidity support measures introduced during the global credit crunch (see Box). They will also need to be ready to mop up excess liquidity if and when domestic demand starts to contribute to inflationary pressures. Development of an active domestic bond market would provide a useful mechanism to manage liquidity as well as being a useful source of funding, and further efforts in this direction are expected.

GCC Monetary Union a long way off

The crisis in the Eurozone has given GCC members further pause for thought with respect to their own moves towards monetary union and a single currency. Time will be taken to review fiscal issues and reassess the prospective regulatory framework. In the meantime, following the ratification of the Monetary Council's charter in early 2010, progress will continue to be made on technical issues such as harmonized banking supervision legislation and data collection.

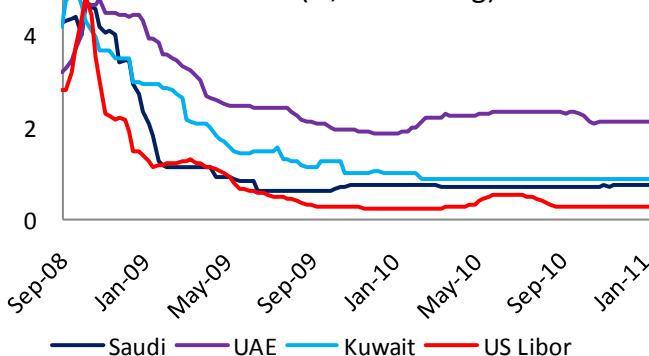
Aggregate bank loan/deposit ratios

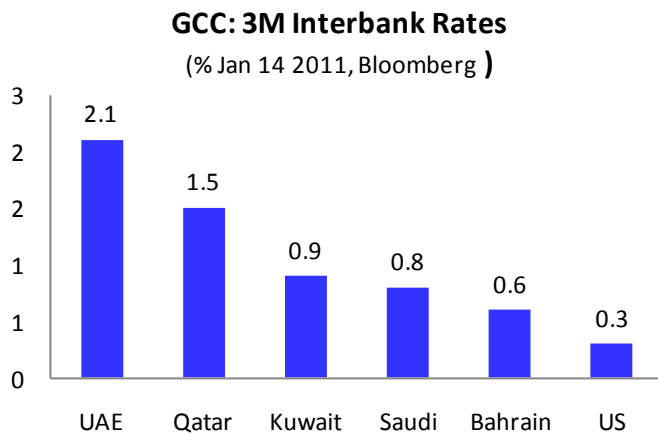
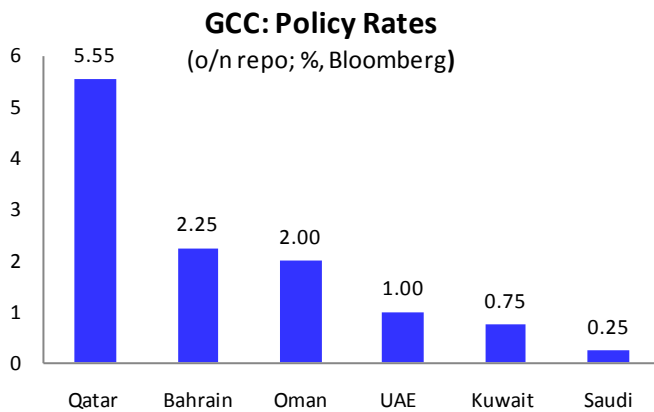
(central banks)



3-month interbank rates

(%, Bloomberg)





Box 2: GCC Liquidity Measures taken by Central Banks and Governments

Saudi Arabia: Interest rates were cut, the reserve requirement lowered to 7 percent from 13 percent, over \$11 billion was injected into banks in various forms, all bank deposits have been guaranteed, and the government extended \$2.7 billion in credit to low income citizens having difficulty accessing loans.

UAE: Interest rates were cut, the central bank provided a \$13.6 billion short term liquidity facility, allowed banks to withdraw up to 100 percent of their central bank reserves, and introduced a dollar swap facility. The government has guaranteed all deposits and interbank lending for three years, and injected \$19 billion in the form of long-term bank deposits, with the option to convert into a loan to boost Tier 2 capital. The Abu Dhabi government has injected new capital worth \$4.4 billion into five of its banks.

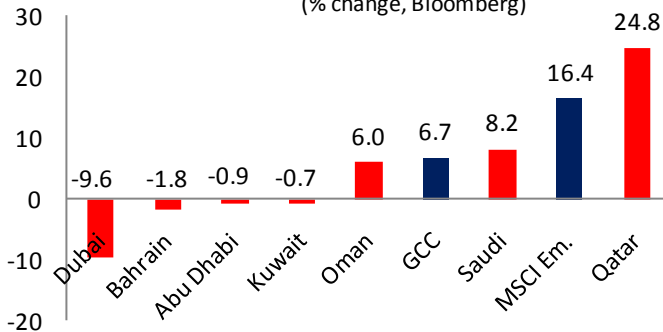
Kuwait: Interest rates were cut, the central bank injected funds into the banking system in the form of short-term deposits, the regulatory loan to deposit ratio was raised from 80 to 85 percent, all bank deposits have been guaranteed, the rights issue in Gulf Bank was underwritten by the government, and the Kuwait Investment Authority has pumped cash into the stock exchange to help stabilize markets. In March 2009 the government approved a \$5.2 billion Financial Stabilization law including a government guarantee of 50 percent of new loans extended by banks to local firms over two years, and a 15-year guarantee against any fall in banks' investment and real estate assets. Other measures allow the KIA to support banks that cannot raise fresh capital.

Qatar: Interest rates were cut, the QIA spent \$5.3 billion on 10-20 percent of the capital of Qatari banks listed on the Doha stock market; \$1.2 billion on buying listed shares within the investment portfolio of local banks to bolster their books after a collapse the stock market, and \$4.1 billion on acquiring the real estate portfolios of nine local banks.

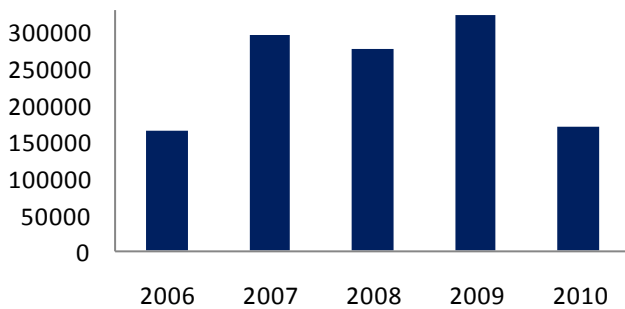
Bahrain: Interest rates were cut, a new dollar swap facility introduced and the deposit guarantee scheme was raised to a maximum of 20,000 dinars (\$53,000) from 15,000 dinars.

Oman: Interest rates were cut, the reserve requirement reduced from 8 to 5 percent, the loan to deposit ratio held at 85 percent rather than cut as planned to 82.5 percent. The central bank lent up to \$2 billion to banks to provide dollar liquidity, and the government created a \$390 million market stabilization fund to invest in local shares.

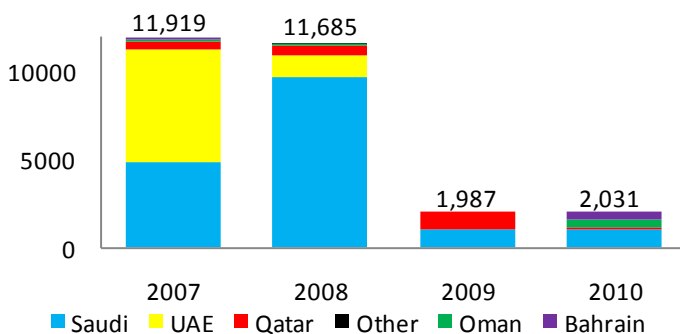
GCC 2010 Stock Market Returns
(% change, Bloomberg)



GCC Stock Market Trading Volumes
(mn shares, GCC stock exchanges)



GCC IPOs
(\$ million, Zawya)



GCC stock markets

Markets underperformed in 2010

GCC stock markets generally underperformed in 2010 compared with the benchmark MSCI emerging markets index which rose 16.4 percent. The exception is Qatar where strong hydrocarbon driven growth, robust fiscal support, and a late boost from the announcement that the emirate had won the bid to host the 2022 World Cup helped drive the Doha exchange up nearly 25 percent. The dominant Saudi market rose 8 percent and Oman's exchange posted 6 percent growth, but in general GCC markets were held up by headwinds from weak real estate sectors, especially in the UAE, rising bank provisions, continued corporate and household deleveraging, and relatively tight credit conditions. In this environment, retail investor confidence has been slow to recover, and this contributed to stock market declines in 2010 for Kuwait, Abu Dhabi, Bahrain and Dubai – the second annual decline in a row for Bahrain and Kuwait.

With retail investors dominating GCC stock markets, their reticence has had a significant impact, reflected in a 48 percent decline in trading volumes and the modest performance of the regional IPO market during 2010. It had been hoped that 2010 would mark a resurgence of IPO issuance in the region, but this was dampened by weak retail investor appetite, and outside Saudi Arabia only three issues took place –one each in Qatar, Oman and Bahrain. The total amount raised (\$2 billion according to Zawya) was only marginally higher than in 2009 and still way below 2006-08 levels. In this environment, we have seen an increasing move towards a book building process aimed at institutional investors rather than floating shares at a fixed price.

The outlook for 2011 is generally more promising

Trading volumes are likely to recover in 2011 as investor appetite revives in response to favourable economic prospects anchored by strong oil prices and large public investment programs. There should also be a revival in GCC bank lending as balance sheets improve and the provisioning cycle enters a declining trend. With financial sector stocks dominating most GCC indices, this should be reflected in improved market performance. However, with the exception of Saudi Arabia, real estate sectors in the region will remain relatively weak acting as a drag on exchanges, especially in the UAE. In addition, while the hangover from Dubai's debt problems is expected to fade, it may still take some time to restore investor confidence in Dubai Inc..

GCC Stock Markets	PE ratios %	Market Cap. \$ billion
GCC	14.4	793.7
Saudi	15.7	360.5
Kuwait	20.0	129.3
Qatar	12.5	128.6
Abu Dhabi	9.9	77.8
Dubai	11.6	52.6
Bahrain	11.7	24.2
Oman	12.8	20.7

Source: Zawya, Jan 2011

As in 2010, we expect that markets in Saudi Arabia and Qatar will outperform the rest of the region, although all are likely to post positive returns in 2011. GCC PE ratios are roughly in line with the MSCI Emerging markets, although the current trailing PE ratio for Kuwait seems a bit rich at 20 percent (according to Zawya), and prospects there will depend heavily on progress with implementing the state's investment program as well as resolution of local investment company problems. In addition, all markets will be sensitive to developments in global equities which are likely to be volatile reflecting uncertainties in the eurozone, and the effects and timing of policy tightening in emerging markets. However, we also expect increased inflows of funds into GCC markets. These would accelerate markedly if the UAE and Qatar were to qualify for MSCI Emerging markets status in the MSCI June 2011 review. Any relaxation of Saudi Arabia's rules to allow direct foreign ownership of shares would also prompt increased inflows.

GCC Key Macro Indicators and Forecasts

	2007	2008	2009	2010e	2011f
Saudi Arabia					
Real GDP Growth (% change)	3.4	4.2	0.6	3.8	4.3
Nominal GDP (\$ billion)	378.8	465.0	376.0	435.5	477.7
CPI (ave. % change)	4.1	9.9	5.1	5.4	5.7
Budget Balance (% GDP)	12.3	33.3	-6.1	6.7	6.0
Current Account Balance (% GDP)	24.9	29.0	6.1	10.6	10.0
Oil production (mb/d)	8.72	9.12	8.08	8.30	8.5
Population (million)	24.2	24.8	26.2	27.1	27.9
UAE					
Real GDP Growth (% change)	7.4	5.2	-1.1	2.2	3.3
Nominal GDP (\$ billion)	198.7	223.0	239.8	260.2	274.2
CPI (ave. % change)	11.1	12.3	1.2	1.5	2.0
Budget Balance (% GDP)	25.0	12.7	-12.2	-2.3	3.1
Current Account Balance (% GDP)	18.6	17.4	4.5	5.5	6.6
Oil production (mb/d)	2.52	2.55	2.25	2.27	2.30
Population (million)	4.5	4.8	4.6	4.6	4.7
Kuwait					
Real GDP Growth (% change)	4.5	5.6	-4.4	2.5	4.0
Nominal GDP (\$ billion)	112.0	148.0	99.0	116.0	125.0
CPI (ave. % change)	5.5	10.6	4.0	4.0	4.5
Budget Balance (% GDP)	40.7	16.0	18.0	16.5	17.5
Current Account Balance (% GDP)	36.8	40.7	29.0	30.0	31.0
Oil production (mb/d)	2.44	2.57	2.26	2.30	2.4
Population (million)	2.9	3.0	3.0	3.0	3.1

Source: IMF, IIF, National Accounts, Samba

GCC Key Macro Indicators and Forecasts

	2007e	2008	2009	2010e	2011f
Qatar					
Real GDP Growth (% change)	26.8	25.4	8.7	16.0	18.7
Nominal GDP (\$ billion)	80.7	110.7	98.3	122.3	149.7
CPI (ave. % change)	13.7	15.2	-4.9	-2.0	2.0
Budget Balance (% GDP)	11.2	10.4	9.4	8.7	9.5
Current Account Balance (% GDP)	32.2	24.5	8.4	17.3	18.8
Oil production (mb/d)	0.81	0.85	0.80	0.82	0.83
Population (million)	1.2	1.5	1.5	1.5	1.6
Oman					
Real GDP Growth (% change)	7.2	12.3	3.7	4.8	5.0
Nominal GDP (\$ billion)	41.6	60.0	53.0	60.0	64.0
CPI (ave. % change)	5.9	12.6	3.6	3.3	4.0
Budget Balance (% GDP)	11.0	13.8	-3.0	5.2	6.3
Current Account Balance (% GDP)	6.2	9.1	-0.6	6.0	8.5
Oil production (mb/d)	0.66	0.66	0.71	0.74	0.76
Population (million)	2.7	2.8	2.8	2.8	2.9
Bahrain					
Real GDP Growth (% change)	8.1	6.3	3.0	4.0	5.0
Nominal GDP (\$ billion)	17.5	20.0	20.0	22.0	24.0
CPI (ave. % change)	3.3	3.5	2.8	2.5	2.5
Budget Balance (% GDP)	1.1	4.9	-8.9	-5.0	-2.0
Current Account Balance (% GDP)	15.7	10.3	2.7	5.2	5.5
Oil production (mb/d)	0.18	0.18	0.18	0.18	0.18
Population (million)	0.8	0.8	0.8	0.8	0.8

Source: IMF, IIF, National Accounts, Samba

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