

Inflation in Saudi Arabia: Drivers, Trends, and Outlook

Highlights

- There are widespread concerns that the world might be about to enter a period of high inflation given the unprecedented fiscal and monetary easing witnessed in the past two years. Some feel that Saudi Arabia will not escape this inflationary spike given its open trade channel and the government's own substantial fiscal expansion.
- To assess the validity of these concerns we focus on the main drivers of Saudi inflation: trading partners' inflation, food prices, and domestic rents.
- Looking at each factor in turn we find that the outlook for trading partners' inflation is essentially benign, with depressed unit labour costs and excess global economic capacity likely to dampen core inflation in OECD countries. The food price outlook is also comfortable with ample stocks weighing on prices of key Saudi staples, such as wheat, rice and sugar.
- Rental price inflation is set to pick up. Rents are an expression of demand for expatriate labour, and this is likely to accelerate in line with firming—albeit uneven—domestic investment growth.
- On balance, we expect inflation to stabilise at around 5 percent over the next three years. This is high by historical standards, but is well within bounds for a rapidly-developing emerging market.
- There are a number of risks to this outlook. Prolonged US dollar weakness would—all other things being equal—make agricultural commodities' funds more attractive to non-USD investors, and thereby push up international food prices. Meanwhile, increasingly unpredictable climactic events will affect the supply of these commodities. A faster-than-expected rebound in domestic investment could see a rapid run-up in rents, given the tightness of the housing market. By the same token, approval of the long-awaited mortgage law could help to ameliorate rental pressures by redirecting investment away from high-end commercial and residential real estate towards low- and mid-level housing.

Office of the Chief Economist
Economics Department
Samba Financial Group
P.O. Box 833, Riyadh 11241
Saudi Arabia

ChiefEconomist@samba.com
+9661-477-4770; Ext. 1820 (Riyadh)
+4420-7659-8200 (London)

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There are concerns that the unprecedented global fiscal and monetary easing will mean a new period of high inflation...

...from which Saudi Arabia will not escape

Introduction

The scale of global monetary and fiscal easing undertaken over the past two years has led many respected observers to suggest that a resurgence of inflation is all but inevitable. Given that the US Federal Reserve's balance sheet alone expanded from \$800 billion to \$2.2 trillion in less than a year, many feel that serious price pressures will emerge, almost regardless of the pace of the recovery in global output.

Such concerns are also evident in Saudi Arabia. Inflation has moderated significantly since the mid-2008 high of 11 percent. But some local commentators fear that sharp increases in prices will be generated by both the government's own substantial fiscal expansion (government spending rose by 10 percent of GDP in 2009), and an increase in global inflation feeding into the country through the import channel.

Are these worries justified? To answer this, we will examine the inflationary spike of 2007-08 in order to gain a better understanding of the main causes of Saudi inflation. We will then consider developments in 2009, when inflationary pressures eased quite rapidly, before moving on to examine the near- and medium-term outlook of the various drivers, both domestic and international.

Some inflation is a good thing. In a period of deflation households tend to postpone consumption on the expectation of further price falls to come. This in turn prompts firms to delay investment decisions, meaning that output will eventually start to shrink and unemployment will rise. Real interest rates also rise, triggering defaults and credit tightening.

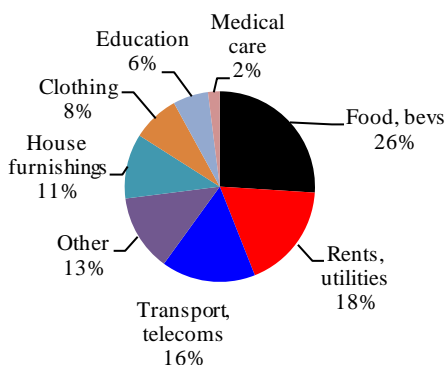
However, excessive inflation is unwelcome. Besides distorting prices, rapidly increasing inflation erodes savings, reduces the future value of earnings (thereby discouraging investment), stimulates capital flight (into foreign assets, precious metals, or unproductive real estate) and complicates economic planning. In its extreme form, inflation can trigger social unrest and political upheaval. Thus, a moderate, stable and predictable rate of price growth, which allows both consumers, producers and savers to feel comfortable, is a universally-recognised goal of monetary policy. What has been Saudi Arabia's experience of inflation?

Inflation in Saudi Arabia

Inflation in the Kingdom is measured in two main ways: through the Cost of Living Index (CLI) and the Wholesale Price Index, both of which are updated and published by the Central Department of Statistics and Information (a department of government that is wholly separate from the central bank, SAMA). There are no regular surveys of labour productivity or inflationary expectations.¹

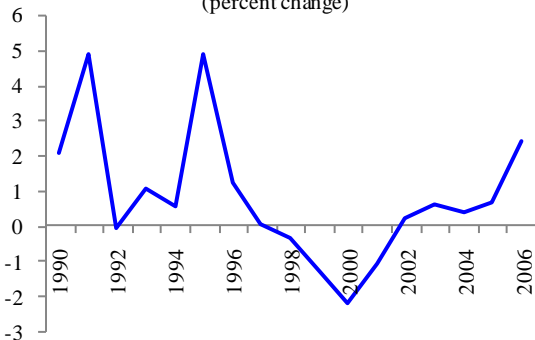
¹ Extensive research in the OECD countries and elsewhere shows that individuals and firms who anticipate an increase in prices may be more likely to demand higher wages from their employers, or raise prices at their own businesses. Accordingly many central banks keep a close eye on consumer inflation expectations.

Cost of Living Index: Weights 2008



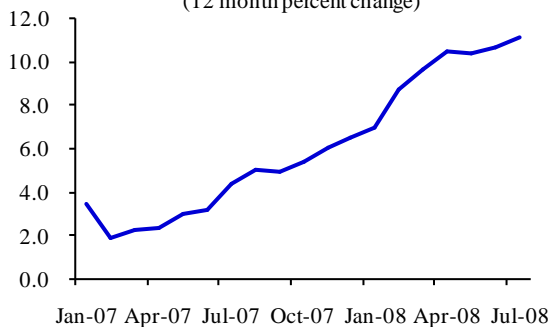
Source: Department of Statistics and Information

Saudi Arabia: Consumer Prices
(percent change)



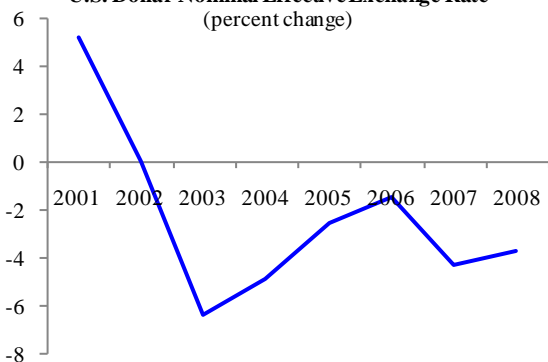
Source: Department of Statistics and Information

Saudi Arabia: Consumer Prices
(12 month percent change)



Source: Dept of Stats & Info.

U.S. Dollar Nominal Effective Exchange Rate
(percent change)



Source: Bloomberg

Saudi Arabia has a history of low and stable inflation

The CLI is composed of hundreds of products, and is based to a 1999 index. Food and rental costs together account for around 44 percent of the total CLI. Around 10 percent of goods and services in the CLI are subsidised by the authorities, chiefly petroleum products and electricity. The prices of these goods are fixed for long periods, and therefore rarely have any impact on changes in the CLI. For these reasons, there is no distinction made between headline and “core” inflation, which excludes food and energy prices.

The central bank, SAMA, is guided by the overarching policy of maintaining price and exchange rate stability. Under a fixed peg, such as that enjoyed by Saudi Arabia, price stability must, in theory, take a back seat to the maintenance of the exchange rate. Nevertheless, for long periods of Saudi history both objectives were comfortably accommodated. Consumer prices rose by an annual average of just 1.3 percent in the 1990s and by just 0.1 percent in the 2000-06 period, while there was only occasional modest pressure on the exchange rate. The gentle trajectory of inflation reflected a number of factors, including generally moderate economic activity, the easy availability of cheap imports, flexible labour markets, and an open capital account. The fixed exchange rate itself helped to lower inflationary expectations.

Serious inflation began to emerge in 2007

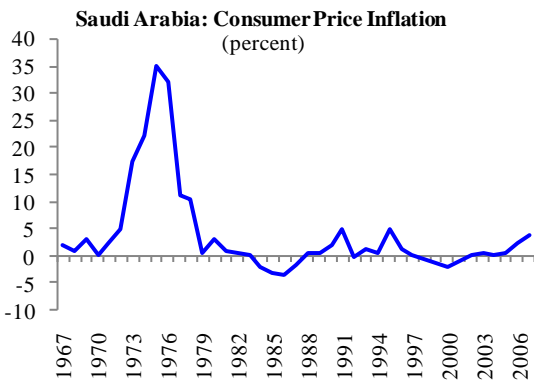
This began to change in 2007. In that year, consumer price inflation gathered pace to an annual average of 4 percent (from 2.4 percent in 2006), ending the year at 6.5 percent. Prices continued to rise rapidly in 2008 with 12-month inflation reaching a peak of 11.1 percent in July.

Observers focused on the exchange rate peg

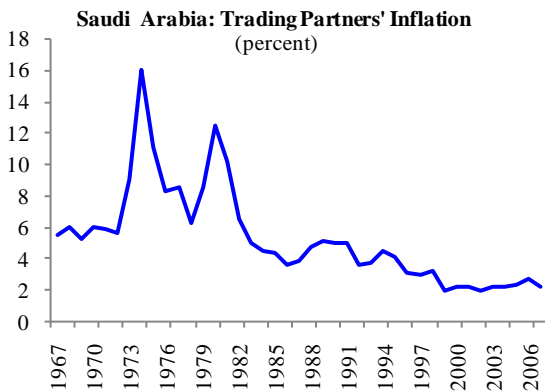
Inflation rose rapidly despite early and forceful monetary tightening undertaken by SAMA, including sharp increases in commercial bank reserve requirements and stepped-up treasury bill issues. The ineffectiveness of these measures led many commentators to focus on the **Saudi riyal’s peg to the US dollar**. Two particular issues were highlighted. First, the peg was generating “imported inflation”, according to observers. The surge in inflation coincided with a sharp weakening of the US dollar against most major currencies, with its nominal value against a trade-weighted basket of currencies (Nominal Effective Exchange Rate) depreciating by 4.3 percent in 2007 and a further 3.7 percent in 2008, after just 1.5 percent in 2006. This put upward pressure on Saudi import prices and hence, according to many, on Saudi retail prices.

Monetary policy constraints were also highlighted

The other explanation focused on monetary policy. The fixed peg constrained SAMA’s policy leeway, placing limits on how much it could adjust interest rates and tame credit growth. If Saudi rates moved too far out of line with US rates, then SAMA would run the risk of attracting unwanted capital inflows,



Source: IMF



Source: IMF

Changes in exchange rate have only limited impact on domestic prices

thereby putting upward pressure on the exchange rate. This constraint was felt to be particularly salient because commercial bank lending was expanding rapidly. By the middle of 2008, bank lending to the private sector was growing at around 35 percent year-on-year—not as high as in some other Gulf states, but rapid enough to suggest that the Saudi economy was overheating. Unfortunately, with the US in rate-cutting mode, there was little that SAMA could do to bring liquidity growth back into line with fundamentals.

IMF attributes most inflationary pressure to trading partners' inflation and food

Was the focus on the exchange rate peg justified? Was the inflationary surge mainly a product of monetary policy constraints and a weakening dollar or was the interplay of various factors more complicated than this? In fact, the evidence suggests that the main causes of inflation in Saudi Arabia, in both the short and long term, are trading partners' inflation and global food prices. The fixed exchange rate also contributes, but largely in an auxiliary manner.

The IMF, which has undertaken fairly extensive research on this topic², finds that absent any adjustment in the exchange rate (impossible under a fixed peg), higher prices of imported goods have a direct and rapid bearing on domestic prices in Saudi Arabia. Food prices—which can be seen both as a related cause of trading partners' inflation and a separate exogenous factor—have also had a pronounced bearing on Saudi prices. Domestic factors, such as the rise in aggregate demand, play only a minor role, according to the IMF. This is largely explained by the limited influence of interest rate changes in the Kingdom (see Box, below).³

Specifically, the IMF research finds that a one percent increase in trading partners' price levels results in a 0.83 percent increase in the price level in Saudi Arabia. The impact of the pass-through effect of changes in the nominal exchange rate is relatively moderate: a one percent increase in the NEER (appreciation) results in a 0.19 percent decline in the Saudi price level.

Exchange rate pass-through is weak, according to the IMF

Why is the exchange rate pass-through so weak? The IMF notes that while changes in the price level of trading partners are usually permanent, changes in exchange rates are not. Thus, exporters, mindful of this and the need to protect their Saudi market share, might be willing to absorb all or part of the exchange rate impact by adjusting their profit mark-ups "price to market". Similarly, Saudi importers might also adjust their profit mark-ups to preserve their market share. As the IMF puts it, "today's market share determines tomorrow's profits" (indeed, this phenomenon has been well documented in other countries)

² See *Determinants of Inflation in GCC*, Magda Kandil and Hanan Morsy, IMF Working Paper, April 2009; and *Understanding the Inflationary Process in the GCC Region: The Case of Saudi Arabia and Kuwait*, Maher Hasan and Hesham Alogeel, IMF Working Paper, August 2008.

³ However, the IMF does find that the impact of trading partners' inflation was intensified by an accommodative monetary policy and the constraints imposed by the fixed peg. Without these, the Fund contends, the impact of higher trading partners' inflation would have abated more quickly than it did.

Imports absorb much of the change in Saudi domestic demand

The IMF attributes little inflationary impact to domestic factors such as government spending and monetary policy. This perhaps overlooks the impact of changes in aggregate domestic demand on non-tradeables such as rental costs, which we will consider later, as well as on asset prices, which is not covered in this paper. Yet the Fund's broad contention makes sense given that increases in domestic demand are usually expressed through the import channel, rather than being channelled into demand for domestically produced consumer goods (which are limited).

Interest rate signals are weak in Saudi Arabia

Interest Rates in Saudi Arabia

The scope of monetary policy is circumscribed by the exchange rate peg and for that reason policy has traditionally tended to be passive. Nevertheless, there is evidence to suggest that even if the authorities were free to adjust interest rates as they saw fit, this would have only a limited bearing on inflationary pressures in the Kingdom.

With many deposits placed on an Islamic basis and the Saudi stock market the only realistic alternative to cash holdings, interest rate transmission signals tend to be weak in Saudi Arabia and the Gulf. This is manifest in deposit activity in 2009: aggregate deposits increased by over 11 percent last year despite a marked decline in nominal deposit rates (from an average 2.89 percent in 2008 to 0.63 percent in 2009)

The counterpart to this is a lack of sensitivity to lending rates. In its efforts to offset the impact of the global financial crisis, SAMA unwound its monetary tightening very rapidly in late 2008 and early 2009. Interest rates were cut (in line with US rates), reserve requirements were slashed, Treasury bill auctions were reduced, and direct liquidity injections were made to the banking system. However, this did not impel the commercial banks to increase lending to the private sector; instead, lending contracted slightly during the course of 2009. In short, even if SAMA had full control of interest rates it is doubtful that this would enable it to exercise decisive influence over the levels of credit or deposits in the economy.

S&P Goldman Sachs Agriculture Price Index



Source: Bloomberg

The 2007-08 Inflationary Spike

Revisiting the 2007-08 period of high inflation, we can see that the factors identified by the IMF did indeed play a significant role. The main driver of the 4 percent gain in the 2007 CLI was a pronounced pickup in the price of food, which increased by 7 percent. This category carries the largest weighting in the Central Department of Statistics' basket with 26 percent. Within this category there were sharp rises in the price of legumes and tubers (30 percent), fresh vegetables (12 percent), fish (12 percent), cereals (7 percent) and meat and poultry (6 percent).

This was not a result of dislocations in the retail market since the wholesale food price also climbed by almost 11 percent during the year. Rather, it was the result of sharp rises of international food prices and associated agricultural inputs. One of the primary indices, the S&P/ Goldman Sachs Agriculture Index increased by 15 percent in 2007, following a more gentle 6 percent increase in 2006. More specifically, prices for wheat, rice, vegetables and cooking oil all rose sharply on global markets in 2007.

The 2007-08 global food price spike was caused by speculation as well as fundamentals

Initially, the UN’s Food and Agriculture Organisation (FAO) attributed the price surge to low levels of world cereal stocks, crop failures in major exporting countries, rapidly growing demand for agricultural commodities and for biofuels, as well as rising oil prices, which raised the cost of food transportation. As the price surge accelerated, several other supporting factors emerged, including government export restrictions and a growing appetite by speculators and index funds for wider commodity portfolio investment. The attractiveness of agricultural indices for non-USD investors was enhanced by the continuing depreciation of the US dollar, since most agricultural indices are priced in the US currency.

Trading partners’ inflation also gathered pace

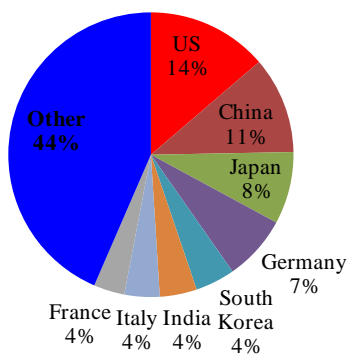
The other exogenous inflationary “push” came from trading partners’ inflation. It is difficult entirely to disentangle this from global food price inflation, since food constitutes a large element of headline inflation in all countries, but clearly it is but one element. In 2007, there was a significant acceleration of inflation in China and Germany, then Saudi Arabia’s second and third largest import markets respectively. German inflation rose to 2.3 percent from 1.8 percent, while inflation in China rose to 4.8 percent from 1.5 percent in 2006. The precise impact of this is difficult to measure from available data, but the prices of a range of consumer goods imports are likely to have been affected, from cars and high-end machinery (Germany) to cheaper manufactured products (China).

These trends hardened in 2008

The Saudi cost of living index rose by 9.9 percent on average in 2008, while the wholesale price index rose by 9 percent. Inflationary pressures were particularly marked in the food and beverages index, which climbed by 14 percent, with large increases for grains (including rice, a key staple in Saudi Arabia) dairy products, and cooking oil. This reflected a continuation of the factors noted in 2007, as well as a 38 percent increase in average global oil prices, which raised the cost of transporting food and other commodities.

There was also a more general pickup in consumer price inflation among the Kingdom’s key trading partners. Indeed, all of Saudi Arabia’s main import

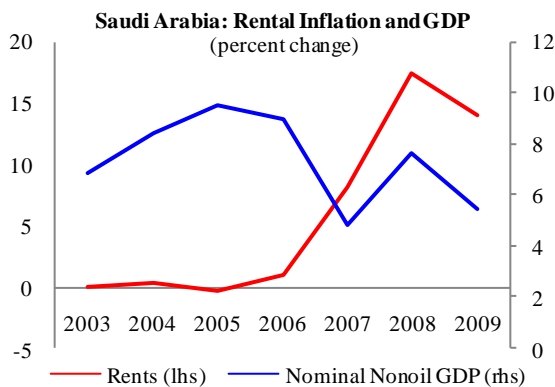
Saudi Arabia: Main Sources of Imports, 2008
(percent of total)



Source: SAMA

Saudi inflation reached on average 9.9 percent in 2008

Rents played an important role.



Source: Department of Statistics and Information

markets saw significant inflation, including the US (3.8 percent from 2.9 percent in 2007), China (5.9 from 4.8), Germany (2.8 from 2.3), Korea (4.7 from 2.5), India (8.3 from 6.4), and France (3.2 from 1.6). This triggered a broader rise in a range of imported products, such as manufactured goods (12.5 percent increase), chemicals (14 percent), and machinery & transport equipment (6.2 percent). Additional upward price pressure was provided by exchange rate weakness. A further bout of US dollar weakness triggered a 3.1 percent depreciation in the riyal's NEER.

Despite the IMF's emphasis on external factors, changes in domestic demand also played a role

So far, therefore, the evidence appears to support the thesis that exogenous shocks have the greatest bearing on Saudi inflation. But although the IMF's research finds that changes in domestic demand have less impact on prices than exogenous factors, one should not underestimate the impact of changes in domestic demand on non-tradeables—specifically **rents**.

Rents, and associated items such as utilities and repairs, account for 18 percent of the Saudi CLI (the second largest category after food) and increased by 10 percent during 2007, gathering pace to 17.5 percent in 2008.⁴ Although a large proportion of Saudi nationals rent, demand from this segment has tended to grow steadily, rather than fluctuate with economic conditions. Instead, it is expatriate demand—be it from skilled professionals or low-paid construction workers—as well as religious tourism that drives changes in rents.

Rents are affected mainly by changes in private investment

By extension, the most influential factor affecting rental demand is changes in firms' investment decisions, and the corresponding impact on demand for expatriate labour. A less direct influence is changes in public sector investment, which will filter through to contracting companies and their demand for expatriate labour. (Changes in religious tourism flows are less distinct and are generally confined to rents in Jeddah and the two holy cities of Mecca and Medina.)

The supply of accommodation, meanwhile, is by its nature slow to respond to changes in demand. Saudi Arabia's current economic boom began in 2003, but this was not initially registered in higher rents as existing excess supply was filled by expatriate workers. However, once excess capacity had been absorbed, in about 2006, rental costs surged. With developers continuing to focus on high-end commercial and residential real estate, there is little slack in the market and increases in demand are now quickly registered by higher rents.

⁴ The rental component of the CLI does not include the rental equivalent of the change in the cost of Owner Occupied Housing, as it does in many other countries. Put another way, it does not include changes in house prices—only rents.

Overall, however, the high inflation experienced in 2007-08 was **largely a product of exogenous shocks**: higher trading partners' inflation, higher food prices, and—as an exacerbating factor—a weakening exchange rate. The increase in domestic spending played a subordinate role since the excess demand was mainly neutralised through higher import spending; however, it did have an impact on inflation through increases in **rents**.

Having established the main drivers of inflation during the inflationary spike, we will now look at how these drivers helped to reduce inflationary pressures over the past eighteen months or so.

Recent Trends in Inflation

Inflation has cooled rapidly

Having peaked at 11.1 percent in July 2008, inflationary pressures began to cool in the second half of 2008 and subsided quite rapidly during 2009. Price growth fell to around 4.5 percent by end-2009 (with a 2009 average of 5.1 percent) and stabilised at around this level in the first two months of 2010. This rate is some way above the long-term historical average, but is well within bounds for a rapidly expanding emerging market such as Saudi Arabia.

What caused this reduction in price pressures? The main dampeners were indeed the exogenous factors that were identified above. With the intensification of the global financial crisis in mid-2008, global economic confidence quickly began to ebb, and the price of most commodities fell sharply. Food prices matched this trend, with the S&P/Goldman Sachs Index falling by 28 percent between September and December 2008.

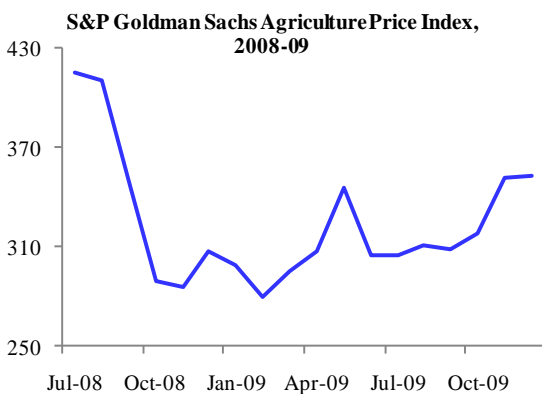
A strengthening dollar dulled the appetite for agricultural commodities

As risk appetite dried up and investors sought the apparent safety of US government debt, so the US dollar strengthened. This had the effect of making commodity indices less attractive to non-dollar investors. This dampened prices and meant lower costs for Saudi importers dealing with dollar-based exchanges, such as the New York or Chicago Boards of Trade. Separately, the stronger dollar also made it cheaper for Saudi traders to source imports directly from non-USD-pegged countries, such as Canada, Brazil or Australia.

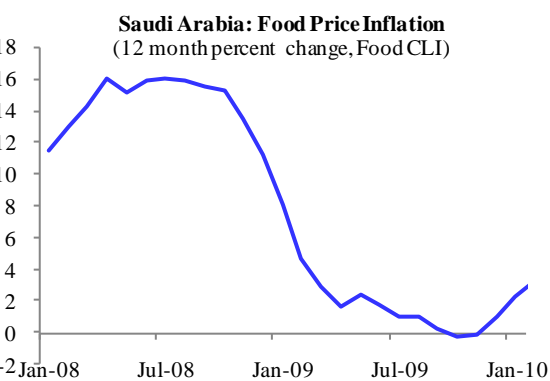
These dynamics are clearly visible in the Saudi CLI, which shows the food and beverages component falling by 2.5 percent in the December 2008-June 2009 period.

Trading partners' inflation also eased rapidly

Simultaneously, inflation among trading partners also began to soften. For example, the average headline inflation rate for the Kingdom's four top sources of imports (US, China, Japan, Germany) fell from 4 percent in the first

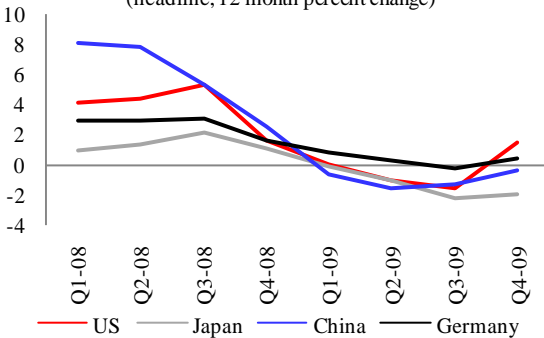


Source: Bloomberg



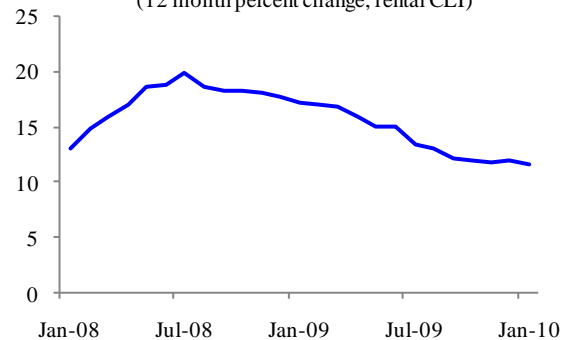
Source: Department of Statistics and Information

Saudi Arabia: Main Trading Partners' Inflation
(headline, 12 month percent change)



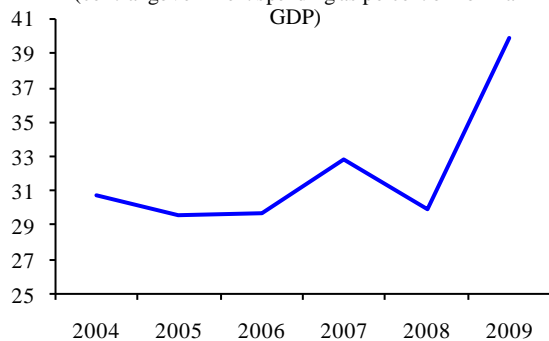
Source: OECD

Saudi Arabia: Rental Price Inflation
(12 month percent change, rental CLI)



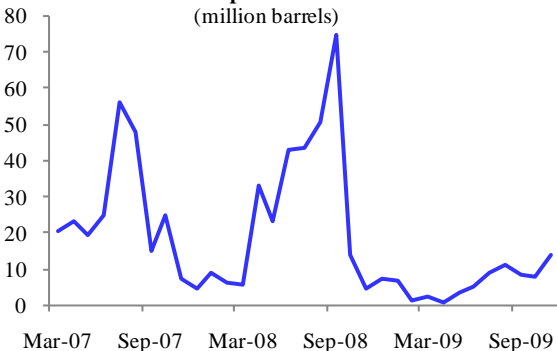
Source: Department of Statistics and Information

Saudi Arabia: Government Spending
(central government spending as percent of nominal GDP)



Source: SAMA

U.S.: Imports of Ethanol
(million barrels)



Source: Bloomberg

quarter of 2008 to zero percent a year later. The rate then moved into negative territory for the rest of 2009. This collapse in trading partners' inflation put downward pressure on the whole spectrum of imported goods in the Saudi CLI, though most of these would not be captured in specific categories of the index.

Rental price inflation remained robust...

If food prices were falling, and trading partners' inflation was turning negative, what has been supporting inflation in the Kingdom? After all, at 4.5 percent, inflation is still well above historical norms. The answer is that the rental component of the CLI continued to rise: average rental inflation was 17.5 percent in 2008, and cooled only slightly to 14 percent in 2009.

...with rental demand supported by government spending

At first glance, the continued strength of the rental component of the CLI is at odds with the general deterioration of private confidence in Saudi Arabia and the broader Gulf. Private investment in the Kingdom ground to a near-standstill in 2009 as credit dried up and projects were pulled. However, unlike many Gulf governments, the Saudi public sector had the resources to fill the breach left by the private sector and support investment. Central government spending increased by a substantial 10 percent of GDP in 2009, and the rollout of new public infrastructure projects helped to feed demand for expatriate workers, and kept upward pressure on rents.

Outlook for Saudi Inflation

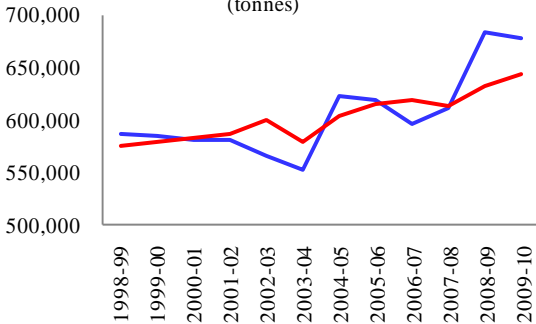
Having established the drivers of Saudi inflation⁵ and their recent dynamics, what is the outlook for inflation in the Kingdom over the next couple of years?

Outlook for food prices is basically benign

Starting with food, the general outlook suggests price stability in 2010. The effects of the "hog cycle," in which supply lags behind demand, are particularly strong in the agricultural sector. High demand for a particular agricultural product at a particular time results in increased plantation, often resulting in a supply glut at the end of the agricultural cycle when those crops are harvested, which in turn drives prices down. High cereals prices in 2007/08 resulted in large plantings in 2008, creating higher yields than required in 2009. As such, world cereal stocks are at far more comfortable levels than they were two years ago, with the stock-to-use ratio at almost 23 percent, up by 4 percentage points from the price spike period.

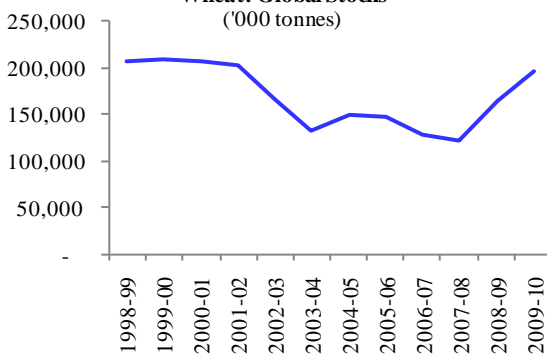
⁵ Some have attributed significant inflationary influence to jewellery, in particular gold. Although the "Local Jewellery" element of the "Other Expenses and Services" category of the CLI has witnessed strong growth over the past year (29% in the year to January 2010), official sources have indicated to us that jewellery accounts for a small proportion of the overall CLI (around 1.6%), and therefore plays only a minor role in overall inflationary trends.

Wheat: Global Supply and Demand
(tonnes)



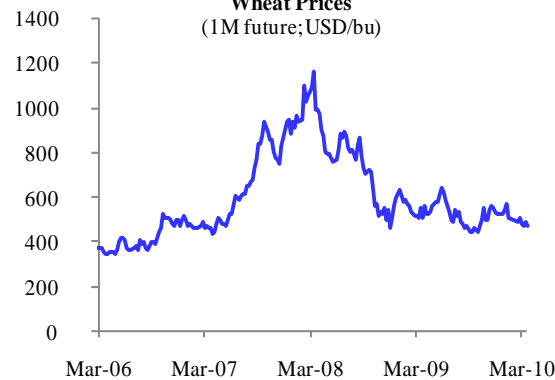
Source: Bloomberg
— Production — Consumption

Wheat: Global Stocks
('000 tonnes)



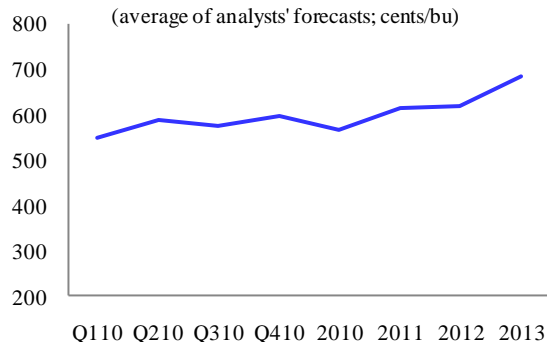
Source: Bloomberg

Wheat Prices
(1M future; USD/bu)



Source: Bloomberg

Wheat: Consensus Global Price Forecast
(average of analysts' forecasts; cents/bu)



Source: Bloomberg

On the demand side, biofuels remain a leading driver for maize and sugar, but growth rates have slowed markedly over the past year or so. In the US—the largest consumer of grains for biofuel production—the use of maize for ethanol has grown by 14 percent during the current winter season, down from 40 percent in the run-up to the price surge.

In combination, these factors suggest that total cereal inventories at the end of the current cycle will be at an 8-year high.

Nevertheless, as the UN's FAO acknowledges, the outlook remains anything but clear-cut. In particular, uncertainty about the path of the US dollar, volatile oil prices, which continue to have a marked bearing on food transportation costs, and a large pool of liquidity stemming from exceptionally low interest rates are all factors that will continue to impinge on prices, often regardless of supply and demand fundamentals.

Wheat stocks are adequate following strong production in 2008-09

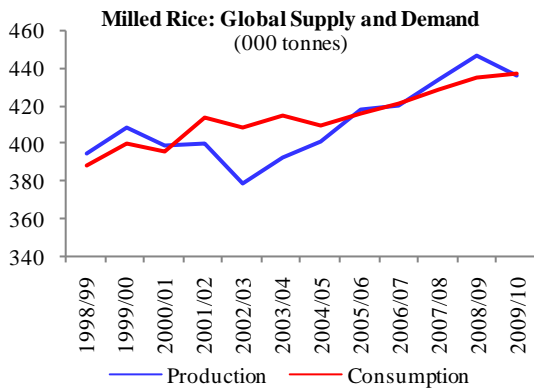
Looking at individual foodstuffs, **wheat** is a major food import for Saudi Arabia, all the more so since the government began phasing out subsidies to domestic producers in order to conserve scarce water supplies. Saudi Arabia became a major buyer of wheat on global markets after starting the phase out programme, to be run over eight years, in September 2008, and its needs will grow as the phase-out programme gathers pace.

Globally, current fundamentals point to large exportable supplies of wheat, driven by the "hog-cycle" dynamics noted above and helped by the further relaxation of export restrictions imposed during the 2007-08 price surge. Production in three of the five largest producers was up in 2008-09 and overall output was up 12 percent for the year.

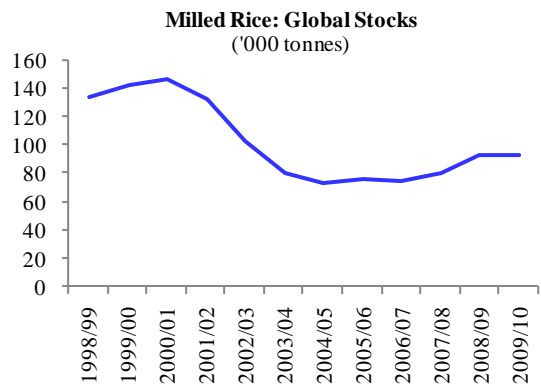
Production is likely to dip in 2009-10, but the UN's Food and Agriculture Organisation (FAO) forecasts imports to fall by around 16 percent on account of increased production in major importing countries such as Iran, Turkey, Syria and Algeria. Based on the FAO's latest forecasts for stocks and utilization, the world wheat stock-to-use ratio is also expected to increase to nearly 28 percent, 2 percentage points higher than in the 2008/09 season and close to the 2003/08 five-year average. To put the recovery into perspective, this ratio dipped to 22 percent in 2007/08, when the global demand supply balance was very tight.

Most analysts expect prices to remain stable in 2010...

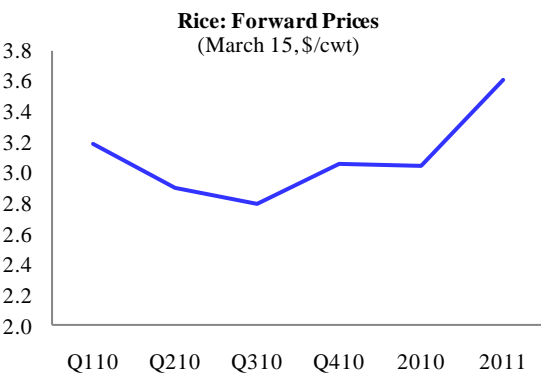
With the world inventory remaining at a comfortable level and continued support in several countries for higher wheat plantings this year, there should be less risk of higher prices in the coming months. In late March, US wheat futures prices were around 10 percent lower than at the beginning of the year, and 20 percent lower than at the same point of 2009. The consensus of analysts polled by Bloomberg also suggested that prices will remain stable in 2010.



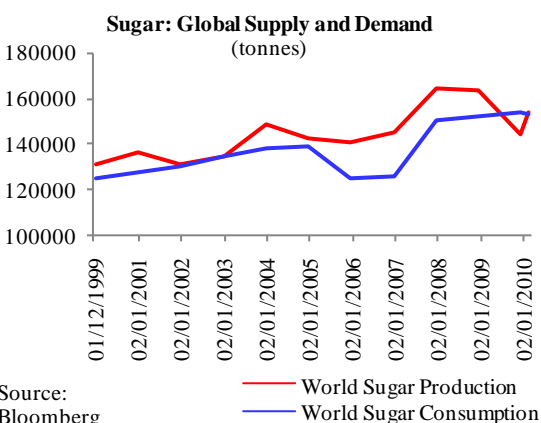
Source: USDA



Source: USDA



Source: USDA



Source: Bloomberg

...though prices will trend up in the medium term

The longer term outlook for wheat is influenced by a number of variables, such as changing consumption patterns, climactic events and the path of the US dollar. However, most analysts identify oil prices, and their influence on transport costs, as the key variable. On average, analysts expect the medium-term price of wheat to rise, gaining around 25 percent between now and 2013.

Rice stocks are also deemed to be comfortable

Rice is a Saudi staple. The prices of all major rice grains fell sharply in the second half of 2008 and remained stable for most of 2009. Production in the second half of last year was negatively impacted by erratic weather (stemming from the El Niño cycle) and a series of natural disasters. These losses restored momentum to world import demand and to international prices in the final quarter of 2009, though they have since retreated again.

Both the FAO and the USDA are forecasting lower production in 2009/10. The USDA thinks that milled rice will total 436 million tonnes this year, around 2.5 percent below the 2008/09 record. This is an upward revision to its previous forecast, reflecting improved production prospects in Indonesia thanks to moderating El Niño effects (Indonesia is the third largest producer behind China and India).

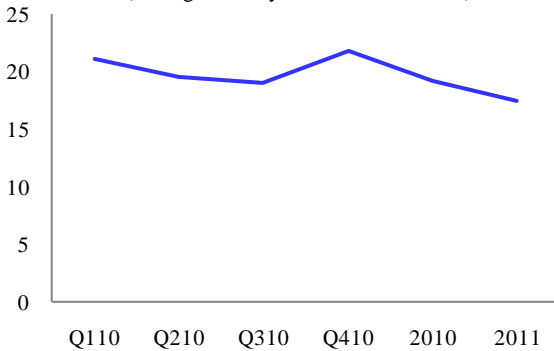
Futures contracts indicate softer prices in 2010, with some uplift in 2011

Both organisations therefore anticipate some drawdown in global stocks, though they deem these be more than adequate. The market seems to share this view, and one-month futures prices in late March were roughly 18 percent lower than at end-2009, and 21 percent lower than a year earlier. Late March forward contract prices indicated that prices will fall by about 4 percent between the first and third quarters of this year, though prices are then expected to rebound to reach more or less the current level by 2011.

The global sugar market is emerging from a period of disruption

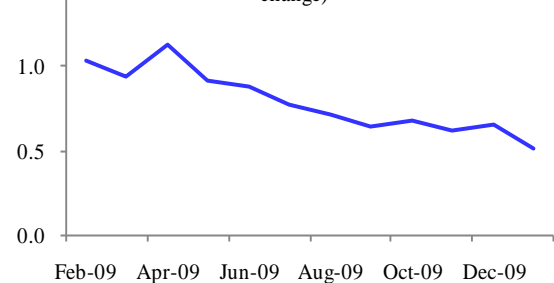
Sugar is another important staple for Saudi Arabia. There have been sharp upward price pressures over the past year or so, sparked by concerns about Brazil's supply and excess import demand from India. Although demand is expected to outstrip supply in 2010, pressures have now eased somewhat, with market participants accepting that global stocks are still more than adequate to meet forecast excess demand. In late February, futures prices were down around 12 percent from early January, though they remained elevated compared to a year earlier. The FAO expects prices to continue tapering down during the course of the year, albeit remaining high by historical norms. Global production levels are expected to rise in 2011 thanks to Brazil's efforts to divert more sugarcane to sugar production. The consensus of analysts' forecasts recorded by Bloomberg in late March suggests global prices in 2011 will be around 17 percent lower than their current level.

Sugar: Consensus Global Price Forecast
(average of analysts' forecasts; cents/lb)



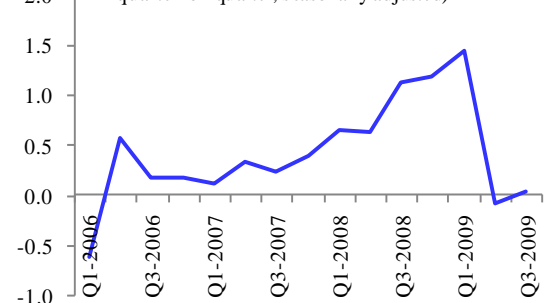
Source: Bloomberg

Saudi Arabia: Trading Partners' Consumer Price Inflation
(core, average for three countries, 12 month percent change)



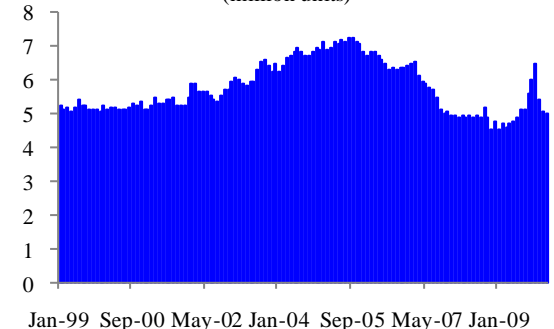
Source: OECD — Germany, US, Japan

Unit Labour Costs
(average for five countries, percent change quarter-on-quarter, seasonally adjusted)



Source: OECD — France, Germany, Italy, Japan, US

U.S.: Existing Homes Inventory
(million units)



Source: Bloomberg

Trading partners' inflation has ticked up

What of **trading partners' inflation**? Average year-on-year inflation among Saudi Arabia's four main trading partners (US, China, Japan and Germany) edged up to 0.88 percent in February, with softer price growth in the US and Germany offset by a sharp uptick in China.

Looked at over the past year, price pressures have clearly increased since mid-2009 but current levels of inflation remain well below historical norms. Moreover, core inflation remains subdued, with the 12-month rate for Germany, Japan and the US easing to just 0.4 percent in February from 0.5 percent in January. Drivers of core inflation in the OECD are still benign: unit labour costs in France, Germany, Italy, Japan and the US increased by a modest 0.05 percent in the third quarter of 2009. In the US, unit labour costs in the fourth quarter fell by 5.9 percent relative to the third quarter on a seasonally adjusted annualised basis.

Beyond this, there is considerable excess capacity in the world economy, particularly in the OECD. A good example is housing in the US. Housing costs (shelter only) account for 33 percent of the US headline CPI. The well-documented excess capacity in the US housing sector suggests that housing will remain a drag on consumer price growth for some time. China, too, appears to have excess capacity in some sectors. The country's latest inflation data point is unsettling, but the authorities are already in the process of scaling back credit growth and certainly have the means and desire to keep inflation subdued.

Most forecasts suggest OECD inflation will remain subdued

These trends suggest that trading partners' inflation will remain moderate for the next year at least. For example, the secretariat of the OECD forecasts that average inflation in its member countries will average just 1.3 percent in 2010, and will even ease a notch to 1.2 percent in 2011. A composite of Bloomberg contributor forecasts suggests that inflation in the Eurozone will average 1.3 percent in 2010, edging up to 1.4 percent by 2011—still well below historical norms.

Rental market is likely to tighten

How might price pressures in Saudi Arabia's **rental market** evolve? We have seen how rents are largely determined by expatriate demand, and hence the growth of investment—most directly from the private sector. We expect private investment to gather pace this year—though hesitantly—after a prolonged period of weakness. Private firms spent much of 2009 hemmed in by credit constraints, a poor export environment and soft domestic demand. In 2010, credit conditions are likely to loosen only gradually as banks stay cautious following the well-publicised corporate debt problems that emerged last year. Nevertheless, the export outlook is likely to improve as global demand for petrochemicals and steel, as well as refined products, begins to pick up. Domestic demand (expressed through retail sales) has been firming

Robust public investment growth will keep upward pressure on rents

for some months, and should continue to do so assuming no sharp downturn in oil prices or correction in the domestic stock market.

But private investment is not the only driver of the nonoil economy: public investment was robust in 2009 and is likely to remain so in 2010 as the government seeks to expand basic infrastructure, such as roads, bridges, railways, power stations, schools, hospitals and universities. This in turn will feed demand for expatriate workers in the construction industry as public contracts are rolled out to private sector contractors.

Supply constraints will unwind only slowly

Additional expatriate demand will not be easy to accommodate given the slow rollout of appropriate housing stock, with developers still largely focusing on high-end (and high-margin) real estate and commercial property, rather than mid- or low-level housing suitable for most expatriates (and Saudis). Boosting the supply of appropriate rental accommodation will clearly take time, and rents are likely to continue rising in the meantime. Indeed, we expect rental inflation to gather pace this year in line with firmer growth of the nonoil economy.

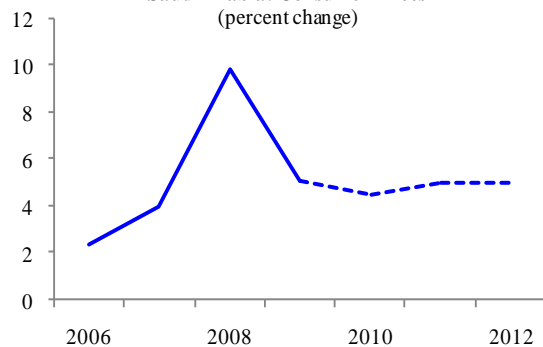
Overall, we expect consumer price inflation of 4.5% this year, edging up to 5% in 2011-12

In sum, we think the rate of inflation will stabilise in 2010. The supply and demand outlook for both wheat and rice are benign, and we think the dislocations in the sugar market will ease as we move through the year. The price of these food items may well edge up, but the rate of growth will be much softer than during the 2007-08 period. There is enough excess capacity in the global economy to suggest that inflation among Saudi Arabia's trading partners will remain weak for the next year at least. Domestic price pressures will continue to come mainly from rents, where we see some pickup in inflation in line with the gradual (and somewhat uneven) recovery of the local economy. Taking all of these strands into consideration we expect consumer price inflation to hold at an average 4.5 percent in 2010, before gathering pace to 5 percent in 2011-12.

There are a number of risks to the outlook, particularly uncertainties about the path of the dollar

There are, inevitably, risks to this outlook. An underlying risk is the **path of the US dollar**. This could affect Saudi Arabia's inflation in a number of ways. First, a weakening of the trade-weighted value of the dollar could lead to some general pickup of Saudi inflation, though as discussed, this is unlikely to be particularly severe given importers' (and exporters') desire to maintain market share. Second, and more seriously, prolonged dollar weakness would—all other things being equal—make agricultural commodities' funds more attractive to non-USD investors, and thereby push up international food prices. The scale of quantitative easing undertaken by the US Federal Reserve is such that dollar weakness remains a real risk, but we still think that

Saudi Arabia: Consumer Prices (percent change)



Source: Samba; Dept of Stats & Info.

A prolonged period of dollar weakness or extreme weather patterns could push food prices higher

Rents could be pushed up by a rapid pick-up in private investment...

...through a new mortgage law would help alleviate rental pressures.

the Eurozone's structural problems are more severe than those of the US, which will support the dollar's relative price against the euro. Beyond this, the dollar remains the world's reserve currency, and this will provide a floor to its value over the long term. Thus, on balance, we see the dollar holding broadly stable over the next year or two.

Food prices will also be influenced by **climactic events** that are nearly impossible to predict. The Intergovernmental Panel on Climate Change has simulated various scenarios for global climactic conditions over the long term, based on inputs such as population growth, economic growth, energy efficiency, urbanisation, etc. This inevitably leads to a wide range of possible outcomes, though the IPCC thinks that the global climate is set to rise by a range of 1.1-4.0 degrees centigrade in the long term, and that heatwaves and other "hot extremes" will increase in frequency. The IPCC also thinks that precipitation will increase, particularly in the northern hemisphere. In the tropics, increased rainfall will be more variable and will often be manifest in more heavy rainfall events.

All of this suggests that the prices of Saudi Arabia's key food imports—wheat, rice and sugar—will be subject to greater volatility over the long-term, and that this will be directly transmitted to domestic prices. One potential offsetting factor is plans to obtain tracts of land in other countries, such as Egypt and Sudan, to guarantee supplies. This approach is not without controversy, however, and negotiations with host governments are likely to be protracted.

Domestic investment could also be firmer than envisaged

Domestically, the main uncertainty revolves around the **pace of private sector investment**. The Saudi economy is clearly in recovery mode, and we expect private sector activity to accelerate gradually during the course of the year. However, the pace of expansion could be much faster than we are anticipating if, for example, credit constraints are loosened more quickly than we expect, or oil prices surge to new highs. With the supply of new affordable real estate still weak, a brisk pickup in nonoil economic activity would be quickly expressed in higher rents.

Rollout of mortgage law would help soften rental price growth

One related positive risk revolves around the **mortgage law**, which is awaiting final approval. A deepening and broadening of the housing finance market would increase demand (rather than just desire) for lower- and mid-level property. Though property ownership is not open to expatriates, a revitalised housing finance market would encourage greater investment in the "buy to let" market, and thereby boost the supply of rental accommodation.

Keith Savard

Director Economic Research
Keith.Savard@samba.com

James Reeve

Senior Economist
James.Reeve@samba.com

Andrew B. Gilmour

Senior Economist
Andrew.Gilmour@samba.com

Raza A. Agha

Research Economist
Raza.Agha@samba.com

Touheed Ahmed

Management Associate
Touheed.Ahmed@samba.com

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Samba Financial Group
P.O. Box 833, Riyadh 11421
Saudi Arabia