samba سامبا

Report Series

January 2010

Saudi Arabia:
Baseline Forecast 2010-12

Executive Summary

- We anticipate only a modest recovery in global economic activity in 2010. As the impact of fiscal and monetary stimuli begins to fade so the weight of indebtedness and unemployment on the private sector will become more apparent. We do not expect a "double dip" recession, but the pace of recovery in the second half of 2010 will likely be weaker than many expect. Economic activity will pick up in 2011-12, but growth will remain below its long-term potential.

- Oil prices will broadly follow this trend, though there will be additional support from financial markets given likely US dollar weakness. We therefore anticipate an average for WTI of $75/barrel in 2010, climbing to $95/b by 2012. Nevertheless, the path of oil prices is far from clear-cut: OPEC production discipline may need to be tightened to offset the impact of still-brittle demand and additional non-OPEC output.

- Saudi Arabia's economy should rebound by around 3.7 percent in real terms in 2010 following near stagnation in 2009. Oil production is expected to increase only slightly this year, but investment in the sector should remain robust. With public investment staying firm and private consumption ticking up, the nonoil sector is also expected to expand. However, financing constraints mean that private investment is likely to remain soft. Only towards the back end of 2010 do we see credit strictures loosening sufficiently to allow private investment growth to gain traction. With nonoil export markets improving, overall GDP should pick up to over 4 percent in 2011-12.

- The fiscal and external positions are expected to remain comfortable. Much of the public investment surge is being undertaken by state-owned firms rather than the central government directly, and we therefore think the central government will record manageable deficits of less than 3 percent of GDP in 2010-12. The general government position is a matter of conjecture since no accounts are released. The current account is set to record reasonable surpluses thanks to firming oil prices, subdued private sector activity and lower import costs.

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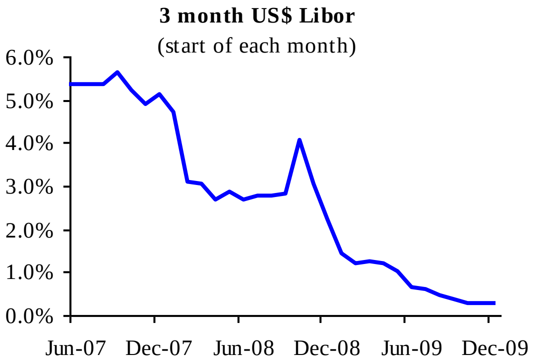


Overview

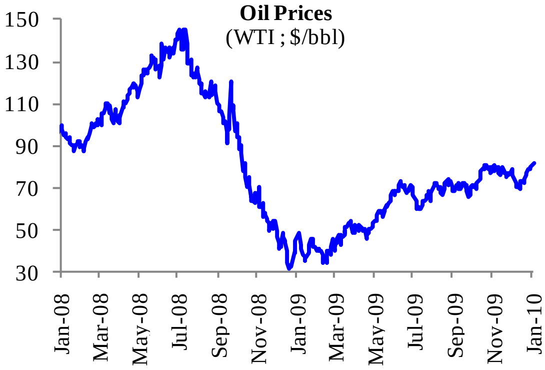
The following analysis presents our Baseline Forecast for the Saudi economy in 2010-12. In essence, our view is that economic activity in the Kingdom should accelerate over the next three years after the near stagnation witnessed in 2009. Public investment will remain the main driver of growth in the short term, but private activity is beginning to pick up and should become more apparent by 2011 as credit constraints unwind.

Underpinning these assumptions is our expectation of a slow recovery from global recession. We estimate that the global economy contracted by around 1.1 percent in 2009, with deleveraging and tighter credit conditions weighing heavily on households and firms in the OECD countries. The outlook for 2010, particularly in many emerging markets, is more encouraging and as a result we see global growth firming to 3.1 percent.

However, much of the current growth impetus is coming from the massive fiscal and monetary stimuli undertaken over the past year or so. By mid-2010 much of this momentum will have begun to peter out, especially as many of the fiscal measures were “one-off” in nature. We do not believe that the substitution effect from the private sector will be enough to offset this, given the overhang of corporate and household debt, credit scarcity and persistently high levels of unemployment. There will be support from emerging markets, where these problems are much less acute, but we see overall global growth staying below its long term potential in 2010. Only as we move through the second half of 2011 and into 2012, with unemployment trending down and debt ratios more comfortable, do we see firmer growth of around 3.5 percent (still below long term potential) with the promise of a more vigorous rate of activity in 2013.

As with many emerging markets, Saudi Arabia has been buffeted by the global financial crisis and subsequent recession. The authorities moved early to increase liquidity in the local banking system, but corporate credit remains tight. Most foreign banks remain reluctant to participate in syndicated deals, while local institutions do not have the resources for the scale of lending that many Saudi industrial projects require. Meanwhile, many export-oriented corporate projects are still suffering from depressed global demand and/or feedstock scarcity.

With private investment constricted, the public sector has stepped up investment in order to keep infrastructure expansion targets on track and to underpin confidence. The public sector is undertaking this spending surge in an environment of comparatively weak oil revenue (certainly when judged against 2008). Oil production contracted by around 12 percent in 2009, and oil prices are some 45 percent off their mid-2008 peak.



Nevertheless, nominal prices remain high by historical standards, and have been supported by financial markets, which continue to view oil as a good hedge against US dollar weakness. Meanwhile OPEC output restraint appears just sufficient to allow prices to continue firming over the next eighteen months, albeit with the usual volatility.

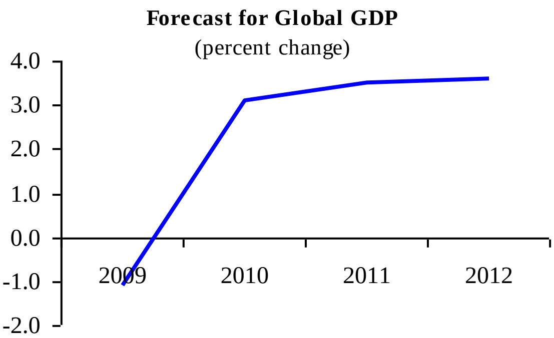
Thus, we anticipate an average price for the benchmark WTI of $75/barrel in 2010, up from $62/b in 2009. We see WTI averaging about $85/b in 2011 as the global economic recovery becomes more robust. A further increase to an average $95/b is envisaged for 2012.

The changes to our oil price assumptions mean that the fiscal and current account positions are likely to hold up reasonably well, with the fiscal deficit set to remain below 3 percent of GDP (and narrowing) and the current account in line to record decent surpluses. In any event, thanks to years of high oil prices and careful husbanding of resources, the authorities have ample financial assets to bridge any gaps that might emerge; these resources include sizeable deposits with the central bank, huge domestic borrowing capacity, large official net foreign asset holdings, and the absence of any sovereign external debt.[1]

Baseline Forecast

Global economy is over the worst…

We believe that the global economy is now through its trough and activity is expected to gather pace over the next six months. The relative health of emerging markets, allied to the stabilisation of OECD credit markets and an associated rebound in trade, should allow a moderate bounce-back in economic activity in 2010.



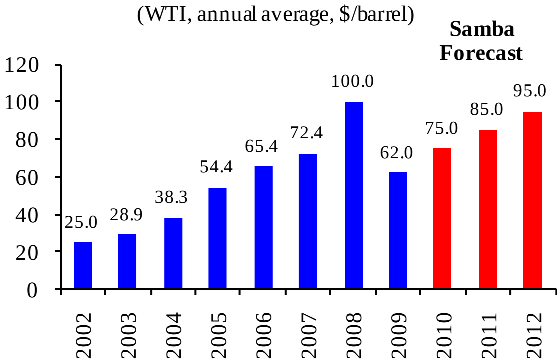
…but recovery likely to be weak and fraught with uncertainty

However, much of the impetus for the recent upturn in activity in the OECD has been driven by the massive monetary and fiscal stimuli undertaken in 2008-09. Once these measures have run their course then activity might begin to slow again as we move into the second half of 2010. Household and corporate debt is still onerous and global deleveraging still has some way to run. High levels of unemployment are also likely to persist, weighing on consumption and investment activity. Therefore the recovery from recession will be weaker than comparable previous episodes, with global growth reaching only 3.6 percent by 2012.

[1] Nevertheless, Saudi Arabia does have external debt, some of which has been taken out by public sector firms. Total external debt stood at $79.5 billion at end-2008 (17 percent of GDP), and comprised Saudi banks' foreign liabilities and the liabilities of Saudi nonfinancial firms (e.g. Sabic, Saudi Aramco, Ma'aden, Saudi Electric). Source: BIS, World Bank, OECD, and IMF external debt database; IMF Article IV Consultation paper, June 29 2009.

Global Forecast	2009	2010	2011	2012
Real GDP growth (percent, annual)				
World	-1.1	3.1	3.5	3.6
US	-2.6	1.9	2.0	2.0
Japan	-5.7	1.5	1.2	1.3
Euro area	-4.1	1.0	1.3	1.5
Emerging Markets	1.5	5.0	5.5	5.5
GCC	0.0	3.2	4.6	4.8
Official policy rate (end period)				
US	0.3	0.3	1.3	2.5
Japan	0.1	0.1	0.5	0.7
Euro area	1.0	1.0	2.5	3.5
Crude oil (WTI, $/b, average)	62	75	85	95

Oil Prices
(WTI, annual average, $/barrel)



Oil prices should track upwards…

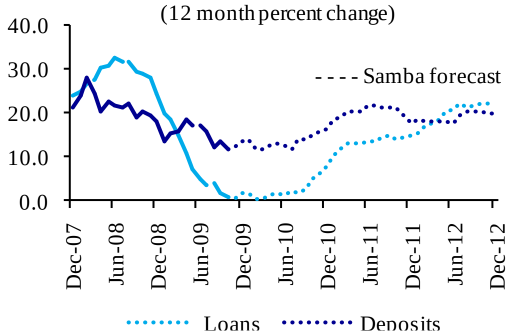
Oil prices have moved into a range of $70/b-$80/b since our July forecast, when they were trading at around $60-$65/b. At the current level of around $80/b (WTI) prices are 55 percent of their 2008 peak, but well above the nominal historical average.

The oil demand outlook remains fragile, however: OECD industrial stock levels are still equivalent to 60 days of forward cover, according to the IEA, well above the 52-54 days that OPEC seeks to maintain. OPEC's spare capacity has also risen to over 6 million b/d, while the organisation's compliance with its own quotas has slipped to around 60 percent in recent months from 80 percent in March 2009.

…but here too the path will be uncertain

Overall, we think that the supply overhang will linger into 2010 meaning that OPEC will have to remain vigilant about restraining output growth. Assuming it is, we anticipate a **$75/b** average price for 2010, up from an average of **$62/b** in 2009. Prices should continue to trend up in 2011, reaching an average **$85/b**, and climbing to **$95/b** in 2012. Hedging activity will continue to blur market fundamentals and is likely to exacerbate volatility.

Outlook for Commerical Banks' Deposits and Loans
(12 month percent change)



The main implications for Saudi macroeconomic performance are as follows:

- Economic growth should accelerate from the weak base recorded in 2009, reaching around 4.5 percent by 2012.
- Private investment growth in Saudi Arabia has suffered from a global credit squeeze, and is likely to remain constrained. The banking system is liquid, but greater risk sensitivity has kept spreads on corporate financing wide. Banks are likely to remain cautious about new lending and will seek to ensure that their existing portfolios do not come under strain. Project finance might perform better, but banks are only likely to commit significant long term funds where the project sponsor is strong.

- Against this, we expect public spending to remain vigorous as the government continues to pick up the slack left by private investors. Thus, investment in hydrocarbons, utilities, transport and education infrastructure (among other areas) should remain robust. And with the authorities eager to limit the social impact of weaker growth, current spending should remain firm.

Box: the 2009 Fiscal Performance and 2010 Budget

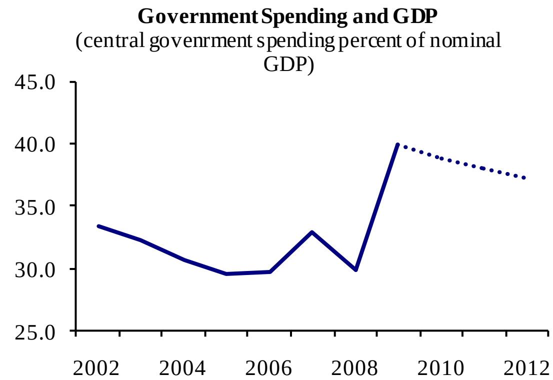
In late December the authorities released their 2010 budget, along with various 2009 data. The **2009 accounts** show a deficit of SR45 billion, or **3.3 percent of GDP**—the first deficit since 2001. Spending and revenue were lower than we had expected, though both were comfortably larger than the 2009 budget had forecast. At SR550 billion, spending was only 5.8 percent higher than the 2008 outturn (against a ten-year average of 11 percent). At first sight this is odd, given the surge in capital spending witnessed in 2009. The apparent anomaly is explained by the fact that a) unit costs have fallen, and b) much of the investment push is being undertaken by state-owned enterprises (SOEs) rather than the central government. (The broader general government position is a matter of conjecture since details of this account are not released.)

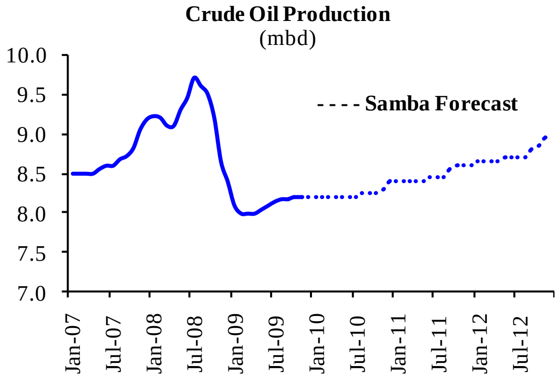
There is no breakdown of oil and nonoil revenue, but based on the government's top-line revenue figure of SR505 billion, we estimate that oil revenue was just under SR430 billion, representing a 56 percent decline on 2008. This is a steeper decline that than indicated by the changes in oil prices and production and suggests that the state hydrocarbons producer, Saudi Aramco, kept a larger share of oil export earnings for its own capital expenditure.

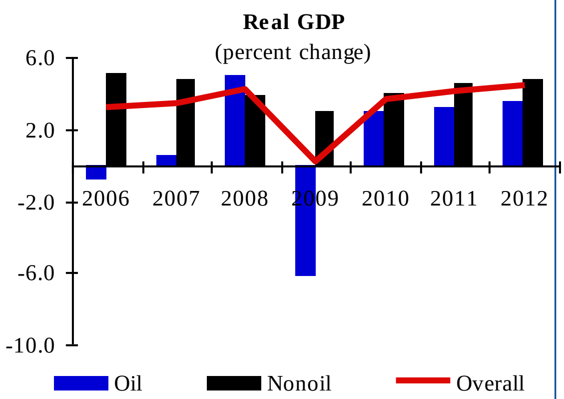
Gross domestic **debt** witnessed a small decline in 2009 (to SR225 billion), which indicates that the deficit has been funded by a drawdown in domestic savings rather than fresh debt issues. This reflects the authorities' concern to encourage domestic banks to increase private sector lending rather than invest in government securities. Public sector domestic savings remain ample and we estimate that the government's net debt position at end-2009 was negative SR818 billion or -60 percent of GDP.

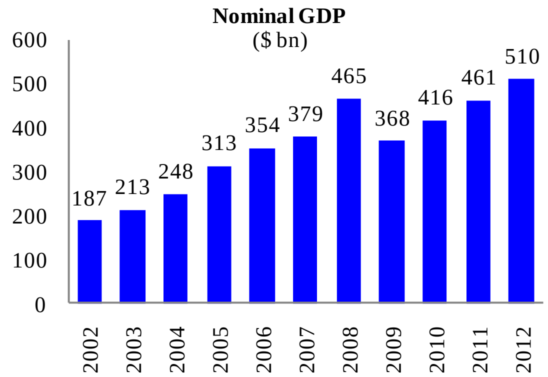
The **2010 budget** shows that the government has maintained its expansionary stance. The budget projects a deficit of SR70 billion (larger than in the 2009 budget), based on revenue of SR470 billion and spending of SR540 billion. The oil price assumption is not revealed in the budget, but we estimate this at around $57/barrel (Arab Light). This assumes that Saudi Aramco withholds the same proportion of oil revenue in 2010 as it did in 2009. Although Aramco's immediate oil capacity expansion plans have been completed, the drive to secure more domestic gas supplies is likely to be stepped up and we think this is a reasonable assumption.

Traditionally, both spending and revenue have been significantly higher than budgeted, and we think this will be the case in 2010. We therefore see spending increasing by around 10 percent compared to the 2009 actual as capital spending growth is maintained and import costs rise in line with nonoil commodity prices. Revenue looks set to record an 11 percent increase compared to 2009, with oil prices and production both rising, and nonoil revenue recovering as trade picks up. Thus, we see a deficit of around the same nominal level as in 2009, though its relative size will fall to **2.8 percent of GDP**.









Following weak growth in 2009, the economy is likely to expand by 3.7 percent in 2010

- Recent data from the authorities show that the economy expanded by just **0.15 percent** in 2009. This is better than the contraction that we were anticipating, and appears to reflect a reasonable showing from the nonoil economy, where robust levels of public investment helped to offset withering private investment and keep the nonoil sector growing by 3 percent. The oil sector, meanwhile, contracted by just over 6 percent according to our estimates. In nominal terms, GDP fell by around 20 percent, pulled down by the 38 percent collapse in the value of oil output.

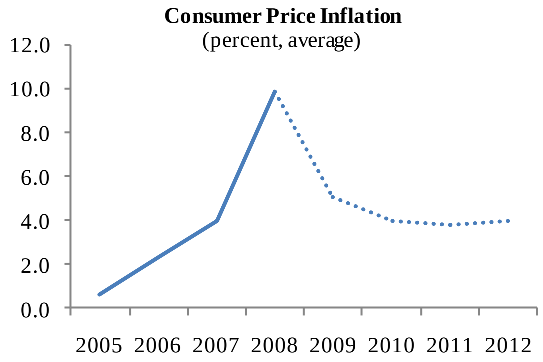
- As noted above, we expect oil prices to track upwards in 2010 and this should allow Saudi oil output to edge up slightly. Public investment is expected to hold firm and private consumption should also tick up. Private investment should stablilise, but will remain weak. These trends point to nominal GDP growth of around 13 percent, pushing overall nominal GDP up to $416 billion. In real terms the economy is expected to grow by around **3.7 percent**, around 0.5 percentage points higher than the 2005-2009 five-year average.

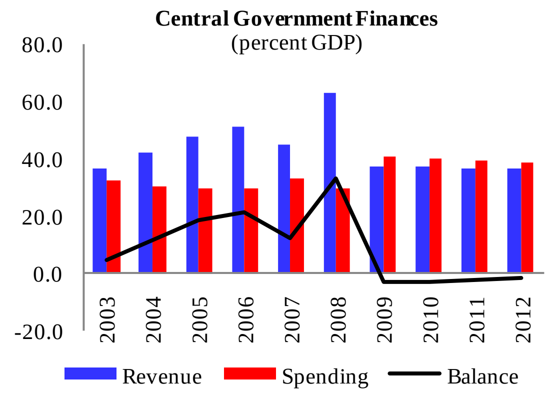
Stronger growth is anticipated for 2011-12, but output will remain below long-term potential

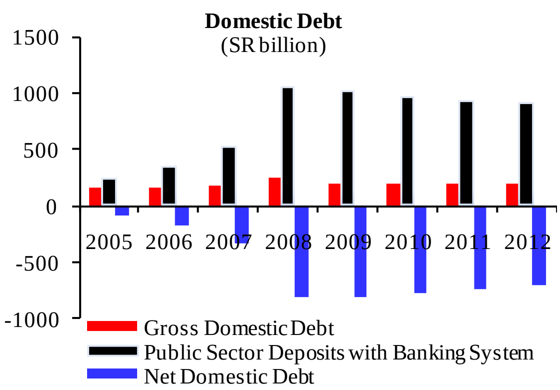
- Our forecast for 2011 is based on a further increase in oil prices and the beginning of a revival of private investment, which should allow public investment to cool off a little. Private consumption growth will be supported by the stronger oil price environment, and nonoil export growth is expected to benefit from firmer global demand. Therefore, we expect real GDP growth of **4.1 percent** in 2011. This trend should be consolidated in 2012 as further gains in oil revenue, greater credit availability, and an improving export environment bolster private confidence and investment, boosting growth to **4.4 percent**. By end-2012 the economy should be worth around $510 billion in nominal terms.

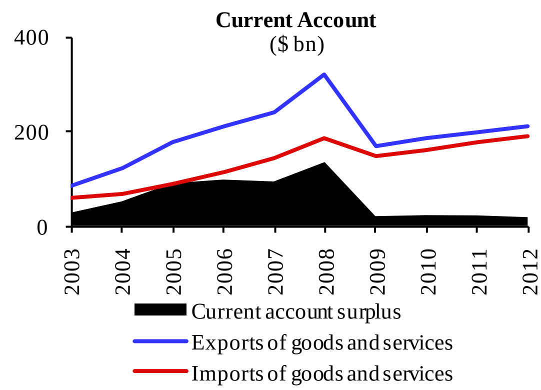
- Inflationary pressures will remain stable and manageable over the 2010-12 period, though they will be high by historical standards. Price pressures in the Kingdom tend to be driven by inflation among trading partners rather than domestic liquidity conditions (reflecting the weakness of interest rate signals). Consequently, Saudi inflation will largely reflect developments in the global economy. An enormous amount of liquidity has been pumped into the global economy over the past 18 months, and that presents an inflationary risk. However, we feel that there is still considerable excess capacity and with wage demands likely to remain muted, global inflationary pressures should remain subdued until the back end of the forecast period. Population growth will continue to generate some domestic price pressures, but inflation is likely to stabilise at around **4 percent**.

- The fiscal outlook is manageable, with deficits equivalent to less than 3 percent of GDP in prospect. Spending growth is expected to accelerate









in 2010 in line with rising costs (see Box), but should ease off in 2011-12 as costs stabilise and the private sector replaces the public sector as the engine of economic growth. Revenue will be impacted by both Saudi Aramco's investment plans (which are expected to remain ambitious given the need to bring more natural gas on line) and domestic fuel consumption, which is accelerating.

- The general government position is not revealed, but the overall public sector could well be in larger deficit than the central government. It is notable that latest data show an SR174 billion drawdown in public sector savings in the first 11 months of 2009. Given that this is much larger than the central government deficit, we assume that SOEs are running down their savings in order to finance investment. Nevertheless, outstanding public sector deposits were still worth SR878 billion in November (63 percent of GDP) and we have no concerns about the public sector's fiscal outlook.

Current account outlook appears comfortable

- We had expected the current account to slip into a quite sizeable deficit in 2009, given the public sector spending surge and the slump in oil export earnings. But government data show that although export earnings declined by some 46 percent, import spending actually fell by around 20 percent. This underscores the loss of private sector investment appetite, but also reflects the fact that Saudi importers built up large stocks of raw materials during the boom period which were run down in 2009. Softer global commodities' prices also had an impact.

- There is no disaggregation of the invisibles account, but net outflows may have been slightly smaller than in 2008, reflecting in part stronger yields on foreign assets. Together, these trends produced a current account surplus of **5.6 percent of GDP**.

- The current account position should stabilise in 2010, as export earnings recover by 10 percent and import spending picks up by around 9 percent in line with recovering private consumption and higher costs. Invisibles outflows are expected to gather pace, driven by stronger remittances outflows. Therefore the overall current account should post a surplus equivalent to **5.4 percent** of GDP.

- The surplus is expected to ease to around **5 percent** of GDP in 2011, with spending on services and remittances outflows offsetting gains in the visible trade account. A further easing to **3.6 percent** of GDP is anticipated for 2012.

- The projected evolution of the current account indicates that the net foreign asset position (official and commercial bank) will strengthen to around $478 billion or 94 percent of GDP by end-2012, from $415 billion at end-2009.

Saudi Arabia: Baseline Macroeconomic Forecast

	2008	2009	2010	2011	2012
Nominal GDP ($ bn)	465.0	368.2	415.9	461.0	509.7
GDP per capita ($ '000)	18743.2	14493.4	15985.5	17306.7	18686.4
Real GDP (% change)	4.2	0.2	3.7	4.1	4.4
Hydrocarbon GDP	5.0	-6.2	3.0	3.2	3.5
Non-hydrocarbon GDP	3.8	3.0	4.0	4.5	4.8
Nominal GDP (% change)	22.8	-20.8	12.9	10.9	10.6
Hydrocarbon GDP	34.9	-37.7	19.4	13.7	12.8
Non-hydrocarbon GDP	7.7	5.5	7.0	8.0	8.2
Commercial bank deposits (SR bn)	846.1	953.1	1108.0	1304.9	1562.9
% change	17.9	12.7	16.2	17.8	19.8
Commercial bank loans (SR bn)	766.6	780.3	839.5	965.2	1179.2
% change	24.6	1.8	7.6	15.0	22.2
3 month deposit rate (end year, percent)	2.9	0.5	0.6	1.6	2.6
CPI inflation (% change, average)	9.9	4.4	4.0	3.8	4.0
Hydrocarbon exports ($ bn)	281.4	150.7	162.6	173.3	182.6
% change	36.9	-46.4	7.9	6.6	5.4
Current account balance ($ bn)	135.7	20.5	22.5	22.4	18.4
(% GDP)	29.2	5.6	5.4	4.9	3.6
External debt ($ bn) [1]	79.5	84.9	86.6	90.9	95.5
(% GDP)	17.1	23.1	20.8	19.7	18.7
(% current account receipts)	23.1	41.4	38.9	38.1	37.5
Fiscal revenue (SR bn)	1100.0	505.0	561.7	616.8	674.2
(% change)	71.1	-54.1	11.2	9.8	9.3
Fiscal spending (SR bn)	520.0	550.0	605.3	656.8	710.3
(% change)	11.5	5.8	10.1	8.5	8.1
Fiscal balance (SR bn)	580.0	-45.0	-43.6	-40.1	-36.1
(% GDP)	33.3	-3.3	-2.8	-2.3	-1.9
Public sector gross domestic debt (SR bn)	241.9	-	-	-	-
(% GDP)	13.9	-	-	-	-
PSD* with banking system (SR bn)	1056.0	-	-	-	-
(% GDP)	60.6	-	-	-	-
Public sector net domestic debt (SR bn)	-814.1	-817.5	-777.7	-737.7	-701.6
(% GDP)	-46.7	-59.3	-49.9	-42.7	-36.8
Memoranda:					
Oil price (WTI; $/barrel)	100.0	62.0	75.0	85.0	95.0
Crude oil production (m b/d)	9.2	8.1	8.2	8.5	8.7
Natural gas production (m boe/d)	1.3	1.4	1.5	1.7	2.7
Net Foreign Assets ($ bn)	463.5	415.0	437.5	459.9	478.3
(% GDP)	99.7	112.7	105.2	99.8	93.8

[1] Foreign liabilities of Saudi banks and non-financial enterprises.

Sources: SAMA; Ministry of Finance and National Economy; Samba.; *PSD: Public Sector Deposits

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