

# Economic Monitor

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## Highlights

(as of May 27, 2011)

- The **global economic** recovery continues although headwinds from high energy prices and natural disasters have slowed the pace of growth, particularly in developed countries. A pick-up in domestic demand and more favorable employment prospects hold out hope that a more durable recovery is on the horizon.
- **Financial markets** performance has been mixed reflecting a number of cross currents. At the moment, market participants seem to be in a more apprehensive mood as concerns about the strength of the global economic recovery, and politicians' ability to handle the nagging problems set before them, have tilted investing in a more risk averse direction.
- **Oil prices** have been volatile, plunging 15 percent in May as markets reappraised geopolitical concerns and global growth conditions. Prices have recovered somewhat since then as forward looking supply concerns continue to trump indications that current supply and demand conditions are well balanced, despite the loss of Libyan production.
- In **Saudi Arabia**, private sector credit has continued to track higher, albeit gradually, as the Kingdom's well-capitalised and liquid banks respond to increasing demand from an expanding private sector. Despite regional political upheaval, Saudi firms have boosted purchases, built up stocks and taken on new staff. However, they have also reported rising input costs, which are likely to feed through into higher inflation as we move through the year.
- While real estate weakness and debt concerns continue to present headwinds, growth in **the UAE** is picking up on the back of increased oil production and higher public spending. In addition, Dubai's traditional core sectors of trade, tourism and logistics are performing well. Real GDP growth is expected to reach 4 percent this year.
- **Qatar's** National Development Plan (2011-16) provides a frank analysis of development prospects and challenges. Hydrocarbons will continue to dominate and underpin national prosperity, but with the completion of major hydrocarbons projects in 2012, the emphasis going forward is on developing the non-hydrocarbons sector.

## Global Markets

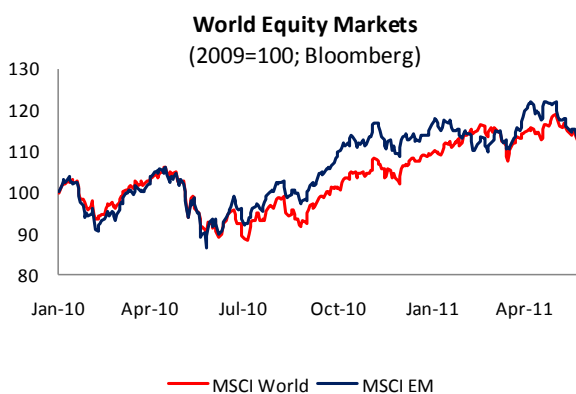
### Global Financial Markets

The global economic recovery continues although headwinds from high energy prices and natural disasters have slowed the pace of growth, particularly in developed countries. A pick-up in domestic demand and more favorable employment prospects hold out hope that a more durable recovery is on the horizon. This will be aided by the continued robustness of emerging market economies despite the cloud of further monetary tightening by central banks. However, uncertainty over the treatment of sovereign debt issues, fiscal consolidation and withdrawal of monetary stimulus could erode investor and consumer confidence to a point that seriously threatens the already tepid recovery.

Since our last *Monitor*, financial markets' performance has been mixed reflecting a number of cross currents that has pulled investors in different directions. At the moment, market participants seem to be in a more apprehensive mood as concerns about the strength of the global economic recovery, and politicians' ability to handle the nagging problems set before them, have tilted investing in a more risk-averse direction. This is reflected in the general downward trend in equity prices since the beginning of May and the gravitation toward higher quality fixed income assets. This pattern could easily reverse as optimists point to the strong balance sheet position of many companies and the seasonal nature of recent market moves.

World Economic Outlook			
	2010	2011f	2012f
<b>Real GDP growth (percent, annual)</b>			
World	5.0	4.1	4.4
US	2.8	2.7	3.0
Japan	3.9	0.5	2.0
Euro area	1.7	2.0	1.6
Emerging Markets	7.3	6.0	6.5
<b>Official policy rate (end period)</b>			
US	0.25	0.25	2.00
Japan	0.10	0.10	0.20
Euro area	1.00	1.50	2.00
<b>(\$/b, period average)</b>			
WTI crude oil price	79.5	95.0	95.0

Source: Samba estimates and forecasts



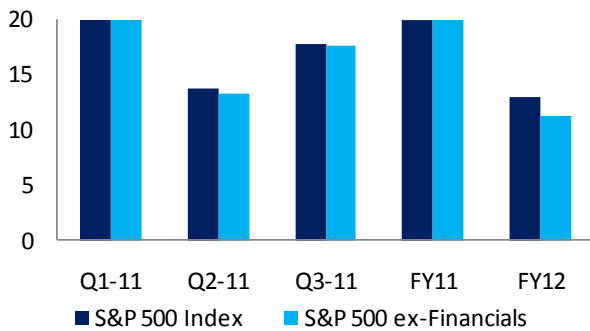
### Equity Markets

#### *Favourable earnings reports overshadowed by more pressing regional and global concerns*

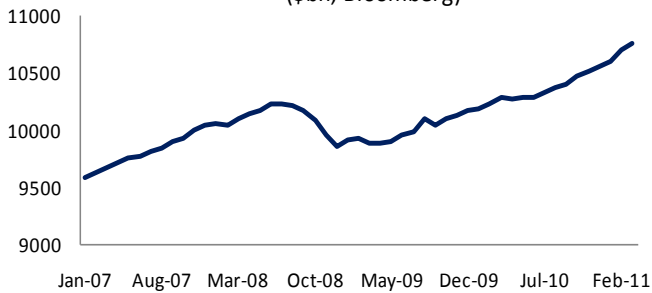
Although earnings reports and guidance on future prospects since our last *Monitor* have surprised analysts on the upside, global equity markets have generally weakened. Equity markets have faltered the most in Europe as politicians seem to be in denial about the ability of Greece to overcome its mounting debt problems under the prescription of measures and assistance currently offered by the European Union, European Central Bank (ECB) and International Monetary Fund (IMF). For U.S. dollar-based investors, the decline in European equity prices has been amplified by the weakening of the euro.

In the United States, equity prices have been somewhat more resilient as companies continue to increase productivity and look favorably on the prospects for domestic consumer demand and exports. S&P 500 earnings could come under some pressure in the near term if oil prices exhibit further weakness. The oil and

**US: Expected Earnings in S&P 500**  
(12 month percent change; Bloomberg)



**US: Personal Consumption Current Expenditures**  
((\$bn; Bloomberg)



**MSCI P/E Ratio**  
(trailing; Bloomberg)



energy sector now accounts for roughly 13 percent of S&P 500 earnings and substantially more of the earnings variability, according to Citigroup. Energy costs, meanwhile, represent only 5 percent of total business sector input costs. In this situation, the profit margin advantage will shift to move value-added processors and other firms who drive profits through unit growth rather than price changes.

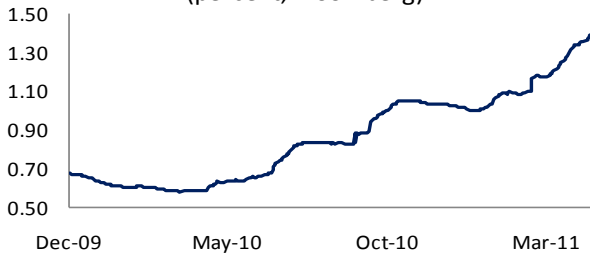
The lack of further fiscal stimulus could also have a bearing on corporate profits during the remainder of the year. Based on data from the U.S. Bureau of Economic Analysis, personal consumption expenditures have risen more than \$520 billion above the previous 2008 peak while wages still remain \$32 billion below their 2008 peak. The direct affects of fiscal stimulus through rising transfer payments of income since the outbreak of the recession, according to one study, account for an estimated 10-15 percent of U.S. corporate profits, or about \$10 per share for the S&P 500.

The decline of equity prices in emerging markets as reflected in the benchmark MSCI EM has been similar to that of European equities. The latest pullback is a reflection of a number of factors, including further monetary tightening in China, weaker global PMIs, and the stronger U.S. dollar. The benchmark index traded within an 11 percent range during the first five months of 2011, representing the tightest performance range of this index for a similar period in time dating back to 1996. In part, this can probably be attributed to the overall stronger fundamentals of these economies as well as to the gradual “maturing” of these markets.

On balance, we are not surprised by the “spring correction” as one has taken place in five out of the past six bull market years. If history is any guide, one should be optimistic that a rally will follow as it has almost uniformly in these circumstances with average full-year gains of more than 25 percent. Emerging market equity performance should also be supported by continued strong economic growth relative to that of mature industrial economies. Moreover, we expect an early peak in inflation and interest rates in many emerging economies along with continued ample liquidity courtesy of an accommodative Federal Reserve.

Attractive valuations are also likely to benefit emerging market equities going forward. The benchmark index currently trades at 11 times 2011 earnings, slightly below the long-term average of 11.5 times earnings. These equities trade at 1.9 times book value which is 4 percent below the long-term average and well below bull market peaks of approximately 3 times book value.

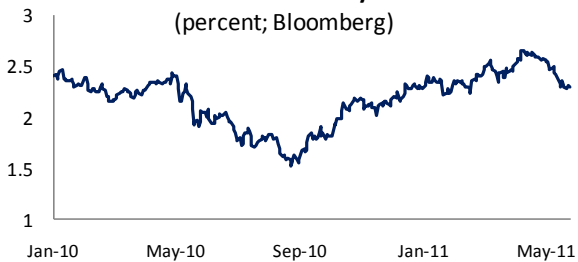
**Europe: 3 month Euribor**  
(percent; Bloomberg)



**US: 10 year Government Bond Yield**  
(percent; Bloomberg)



**US: Breakeven 10-year**  
(percent; Bloomberg)



## Credit Markets

### *European funding markets react to sovereign debt concerns*

Despite the decision of the ECB not to raise its policy interest rate in May, European short-term funding markets still saw further increases in interest rates. Concerns about what additional steps European leaders might take to shore up Greece's debt plight have increased nervousness in financial markets. This has also contributed to stronger competition for deposits driving up deposit rates in a number of euro area countries, most notably in Portugal. Although euro area banks' reliance on wholesale funding has declined since the outset of the financial crisis, it still remains higher than banks in the United Kingdom and United States.

### *U.S. Treasuries shrug off budget and debt ceiling battles as well as winding down of QE2*

Contrary to our protestations in the last Monitor that the nominal yield on the 10-year U.S. Treasury would rise 20-40 basis points in the coming few months, the yield has done just the reverse falling 60 basis points in less than two months. A number of factors appear to have contributed to the significant retrenchment in yields. Data pointing to a weaker economy have increased the attractiveness of Treasuries as investors' concerns have grown about the valuation of equities in a less robust economic environment. Treasuries have also benefited from the recent decline in commodity prices and the prospect that headline inflation could peak and begin to decline in the next quarter or two.

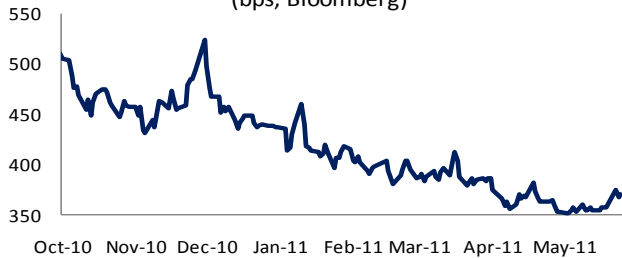
The breakeven rate on both 5-and 10-year Treasuries has declined about 40 basis points since reaching a near-term high in early April. Other sorts of inflation-sensitive gauges have shown a similar response. In addition to the factors mentions above, it also seems likely that the end of QE2 will ease concerns that monetary expansion could put upward pressure on the general price level.

Although Treasury yields could compress further, especially as new issuance is likely to be curtailed until the debt ceiling issue is resolved, we nonetheless expect yields to widen in the not too distant future. With the end of QE2 we are concerned about how the supply of new issuance will be absorbed unless prices for bonds are made more attractive. Excluding intra-governmental holdings, the Federal Reserve absorbed 98 percent of Treasury bond issuance between the end of October 2010 and the end of April 2011. With the U.S. government's credit rating coming under greater scrutiny and the future reining in of the budget deficit still in doubt, it is unclear who will step up their purchases. Overseas investors, who own more than one-half of all outstanding Treasuries held outside of the

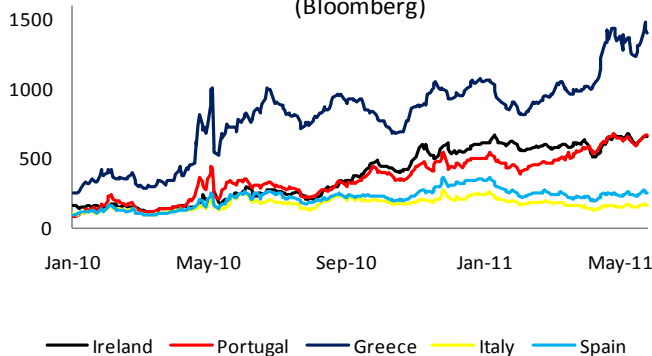
**US: 5-year CDS Investment Grade**  
(bps; Bloomberg)



**Europe: 5-year CDS Crossover**  
(bps; Bloomberg)



**Europe: Peripheral CDS Spreads**  
(Bloomberg)



Federal Reserve, have already scaled back their net purchases in recent months.

***Corporate performance has been mixed in the face of continued strong issuance***

In the United States, the yield on high-grade bonds declined through April and early May, reaching a yearly low. Yields crept up in the second half of May reflecting in part investor nervousness and the gravitation toward Treasuries. The search for “safe” yield is likely to continue to make these assets attractive to pension funds which currently hold an estimated one-quarter of the outstanding stock of high-grade bonds. The correlation between stocks and high-grade credit indices has been particularly strong (R-squared of 90 percent) during the past three months, suggesting that some further weakness in these indices could continue if equities experience a decline during the early summer months.

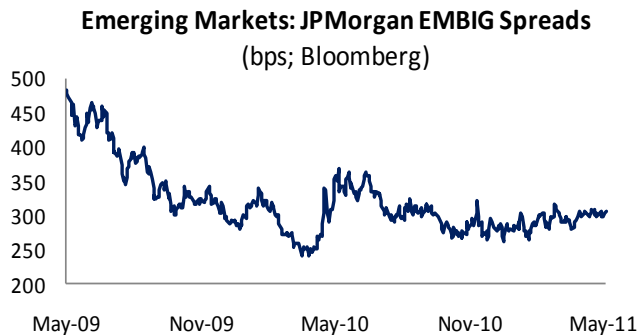
High-yield bonds in the United States have generally underperformed high-grade bonds in the past month. However, the two sets of assets have remained strongly correlated with an R-squared of 88 percent. This is likely signalling more prudence toward riskier assets from investors.

In contrast to the United States, European high-grade credit indices have underperformed the region’s high-yield indices. Moreover, the spread on European high-yield indices continue to trade inside of those on similar U.S. indices. The strong performance of high-yield European corporates so far this year has encouraged new issuance. During the first five months of 2011, European high-yield bond issuance was more than 50 percent above the same period last year, while it was up 30 percent in the United States. Issuance could slow in the coming months as European corporates have a more favorable maturity structure. Investors could become more nervous as well following the news by Standard & Poor’s that it expects the default rate on speculative-grade debt to rise to between 5.5-7.5 percent in 2012 from 3.8 percent at the end of last year.

***Spreads on some European sovereign debt suggest that default looms***

Many euro area sovereign debt markets have been roiled by growing concerns that some form of restructuring of Greek debt could be the only way for the country to resolve its acute financial problems. This would likely lead to a host of negative repercussions throughout Europe, including contagion and reduced market access. The lack of clear guidance from officials has added to recent investor anxiety.

Short-term borrowing costs for a number of euro area sovereigns have increased significantly since our last Monitor. CDS spreads in Greece, Ireland and Portugal are at or near record high levels. In Spain, regional bond spreads are trading



*We would not be surprised to see further spread compression of emerging market fixed-income instruments, although lingering inflation concerns could slow the downward movement*

appreciably higher than those of the sovereign, reflecting the severe weakness in some budgets as well as concerns about their ability to honor debt obligations. As the overall financial situation of peripheral countries has become more tenuous, private non-bank holders of related debt have exited, leaving domestic banks saddled with a higher proportion of their own countries' government debt. A number of prominent analysts and investors now believe that if European officials do not take strenuous action soon, Europe will risk its own version of Lehman Brothers.

***Emerging market bond performance shows no clear trend***

Following a 20-basis reduction in its spread in early April, the benchmark EMBIG index experienced a quick give back of those gains and has been in a trading range of 300-310 basis points since mid-April. So far the index has avoided most of the recent volatility that has plagued other markets. Available data show that money is continuing to move into emerging market bond funds, helping to keep a lid on borrowing costs. According to Barclays Capital, the yield on emerging market dollar-denominated sovereign and corporate debt is averaging about 5.50 percent, down from 6.14 percent a year ago.

With emerging markets continuing to exhibit strong fundamentals, some countries are now judged to be less risky borrowers than several western European countries. Indeed, the credit default swap index for 15 major emerging market countries has declined by a third in the past year to 206 basis points, while the iTraxx SovX index has climbed to slightly above 200 basis points. The transformation of emerging markets in recent years has largely changed its perception among investors as a niche asset class.

We would not be surprised to see further spread compression of emerging market fixed-income instruments, although lingering inflation concerns could slow the downward movement. In aggregate, emerging market central banks have removed less than a third of their "post-Lehman" easing. However, by the middle of next year it seems reasonable to expect that perhaps another 100 basis points of tightening will take place in policy interest rates on average. Additional tightening will also take place through stronger currencies and quantitative measures. This rather slow and deliberate tightening should avoid triggering the onset of a true bear market.

As for the Middle East, bond markets in the region have recovered from losses arising from political unrest, with average yields falling to their lowest level since mid-January. The yield on HSBC-Nasdaq Dubai's Middle Eastern Aggregate bond index has declined approximately 100 basis points since reaching a peak of almost 6 percent in mid-March. However, issuance of new bonds has shrunk about 30 percent from last year, indicating that investors still have some apprehensions about the region.

*An easing in the growth of new orders meanwhile suggests that the global recovery could cool further in the coming months*

## Global Economic Growth and Inflation

Since our last *Monitor* the balance of data suggest that global growth is slowing. One of the broader measures of activity, the JPMorgan Global PMI, indicates the weakest rate of growth of the global economy since the recovery began in August 2009. Although a large portion of this can be linked directly to the Japanese earthquake, the pace of expansion outside of Japan also has slowed. An easing in the growth of new orders meanwhile suggests that the global recovery could cool further in the coming months. Not all of the data has been bad and indeed employment prospects remain favourable along with rising expectations for global inflation to peak before the end of 2011.

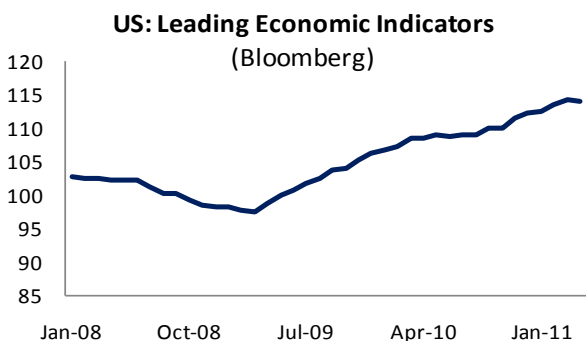
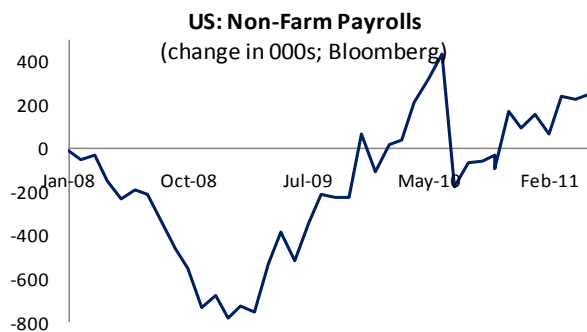
We have made only minor revisions to our forecasts. First, global economic growth in 2011 has been raised to 4.1 percent from 4.0 percent. This reflects our upward revision in euro area growth to 2.0 percent from 1.6 percent previously. This will more than offset our 0.4 percentage point reduction in Japanese real GDP growth to 0.5 percent. Second, we now expect the ECB to raise its policy rate one more time this year to 1.5 percent, instead of remaining on hold for the rest of 2011.

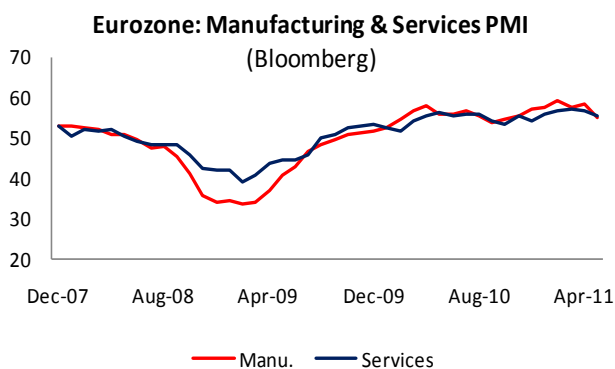
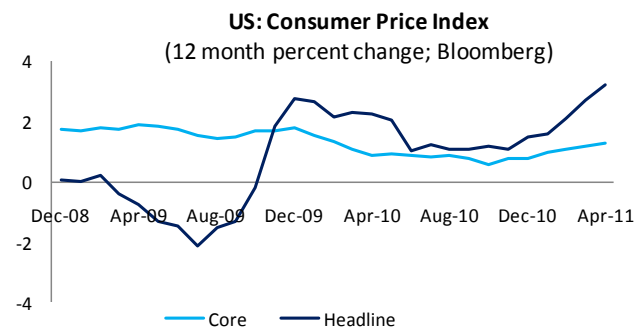
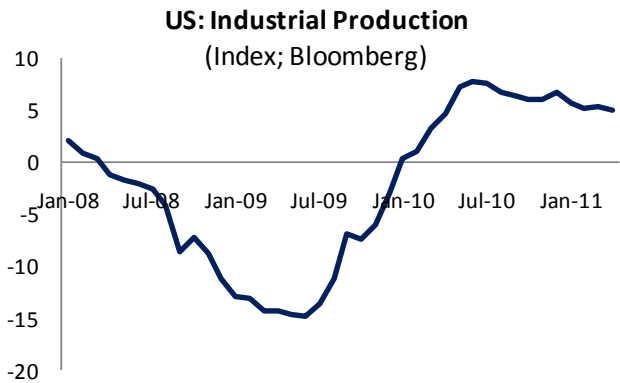
### ***U.S. economic recovery continues but in slow motion***

Economic activity seems stuck in low gear at the moment with first quarter real GDP posting a gain of 1.8 percent (quarter on quarter annualized). Overall growth continues to be restrained by cutbacks in government spending as well as a prolonged slump in the housing market. Fallout from the Japanese earthquake is also negatively impacting output as parts shortages have led to some production cuts in the automotive and electronics industries.

The first decline in ten months in April's leading economic index (LEI) has raised some concerns that the slowdown might continue. The LEI shed 0.3 percent with six of the ten components down in April. Initial jobless claims subtracted 0.3 percentage points which was more than any other component. Despite this setback, the six-month annualized rate of change in the LEI increased 7.2 percent in April and continues to be well above the recession threshold.

Industrial production in April was below the consensus outcome remaining unchanged on a month-on-month basis. The somewhat disappointing outcome resulted from a sharp contraction in activity in the automobile sector (-8.9 percent), which stemmed from supply disruptions related to the earthquake and tsunami in Japan. This situation should be rectified in the not too distant future allowing overall industrial production to show new gains.





Wages and salaries are showing some improvement, reflecting the recent pick-up in nonfarm employment. Payrolls have risen by an average of 233,000 jobs per month over the past three months which has been supportive of consumption. Further improvement will depend in part on how businesses react to recent disappointing data as well as the outlook for exports. Pressure on public sector budgets will continue to dampen prospects for overall hiring.

On balance, private final demand should better last year's performance, reflecting respectable gains in both consumer spending and business fixed investment, some of which stem from one-off government tax benefits. Some aspects of capital spending remain notable bright spots, with demand for industrial equipment, heavy trucks and power generation equipment quite strong. Total business fixed investment could approach 9 percent this year following 5.7 percent in 2010.

With core consumer price inflation remaining well behaved and important parts of the economy still exhibiting weakness, the Federal Open Market Committee (FOMC) is not likely to be in a hurry to remove policy accommodation. Following the completion of QE2 at the end of June, we expect the FOMC to maintain its target for the federal funds rate at between 0-25 basis points until the middle of 2012. On the fiscal side, Congress and the President will continue to battle for at least the next two months over raising the government's debt ceiling and the budget for fiscal year 2012.

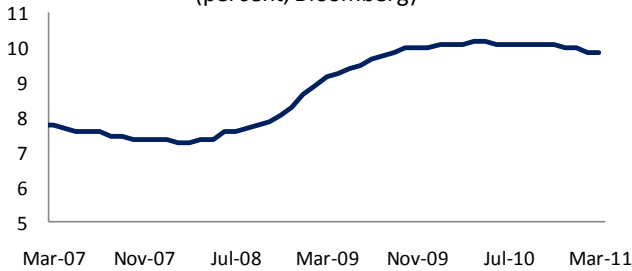
***Eurozone growth surprises to the upside but periphery continues to lag***

Real GDP in the eurozone grew a higher-than-expected 3.3 percent (seasonally adjusted annual rate) in the first quarter. France and Germany were far out front with growth of 3.9 percent and 6.1 percent, respectively. The sharp rise in part reflected a rebound from disappointing fourth quarter results which were influenced by poor weather conditions. Subsequently released data indicates that activity is moderating.

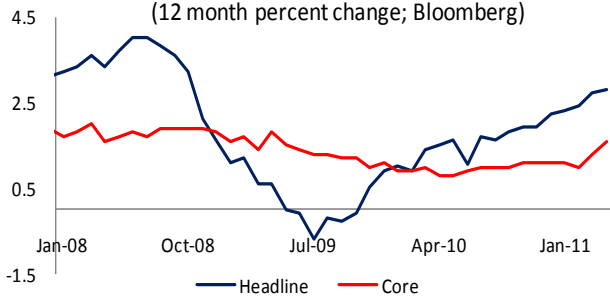
The closely watched composite PMI for activity, a good leading indicator of GDP growth, decreased in May to 55.4 from 57.8 in the previous month. The growth in activity moderated in both manufacturing and services sectors. The slowdown was more pronounced in manufacturing which was likely affected by the Japanese earthquake as firms experienced shortages of intermediate components needed for final products. Despite the deceleration in the latest PMI, it is still consistent with real GDP growth in the current quarter of 0.5 percent (quarter-on-quarter).

While the broader eurozone economy has benefited from a pick-up in investment and strong export performance, it continues to be weighed down in other areas. In particular, domestic demand in the eurozone continues to disappoint. Short-term

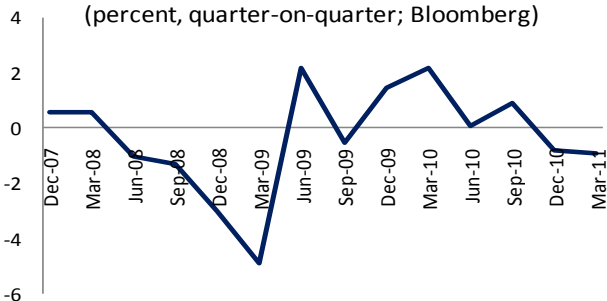
**Eurozone: Unemployment**  
(percent; Bloomberg)



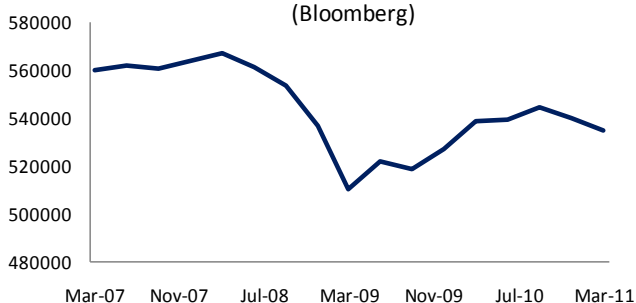
**Eurozone: Consumer Prices**  
(12 month percent change; Bloomberg)



**Japan: Real GDP**  
(percent, quarter-on-quarter; Bloomberg)



**Japan: Real GDP Index**  
(Bloomberg)



consumption indicators have followed a noticeable pattern in recent months with retail trade and automobile sales expanding around the turn of the year, but fading progressively through the quarter. With labor market conditions slow to improve, prospects for more robust consumption in the next few quarters seems rather remote.

Anaemic consumption is not the only problem facing the eurozone economy. The average GDP growth across the core economies continues to exceed that of the peripheral ones. The combination of deleveraging, fiscal retrenchment, and weak labor markets are hurting fixed investment and consumption in the periphery. Austerity fatigue has bred a confrontational political environment with respect to the general population. In addition, fiscally prudent countries are showing signs of resistance to providing further financial support. The alignment of political and economic forces at the moment does not seem conducive to cohesion of the monetary union and to financial stability.

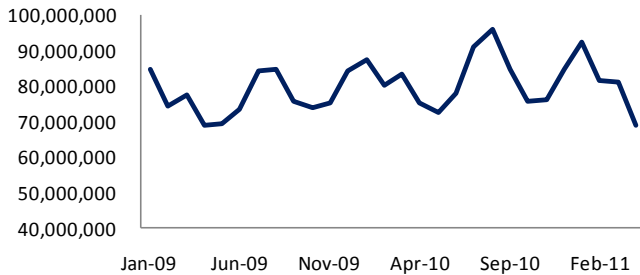
As for monetary policy, it seems likely that the ECB will increase its policy interest rate in July by 25 basis points to 1.5 percent. The consumer price index rose 2.8 percent (year-on-year) in April, which is outside of the central bank's comfort zone. General expectations are for one more hike in the ECB's policy rate this year following the likely move in July.

***Japan's reconstruction moves forward follow sharp contraction in output***

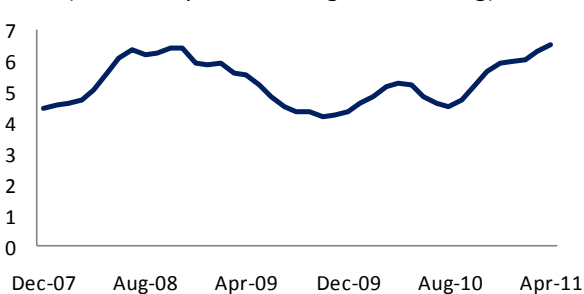
Not surprisingly the return of recession in Japan was confirmed following the release of real GDP data for the first quarter. Output fell 0.9 percent (quarter-on-quarter) while the contraction in the fourth quarter of 2010 was revised from 0.3 percent to 0.8 percent. Declining investment was the largest contributor to the fall in economic activity in the first quarter, led by inventories as supply-chain disruptions forced businesses to run down existing stocks to meet demand. To put the current position of the Japanese economy into perspective, the level of GDP at the end of the first quarter was 5.6 percent below the peak in the first quarter of 2008 and 11 percent below where it potentially could have been had growth continued at its pre-crisis pace.

In the relatively short period of time since the earth quake and tsunami hit the Tohoku area of Japan, impressive progress has been made in getting the economy back on its feet. Thanks to voluntary electricity saving programs, TEPCO and Tohoku EPCO have been able to suspend rolling blackouts. For the time being, the government is trusting on voluntary restraint and has ruled out imposing additional measures—like higher electricity prices—that might further weaken general demand. However, higher electricity prices seem inevitable in order to replace lost

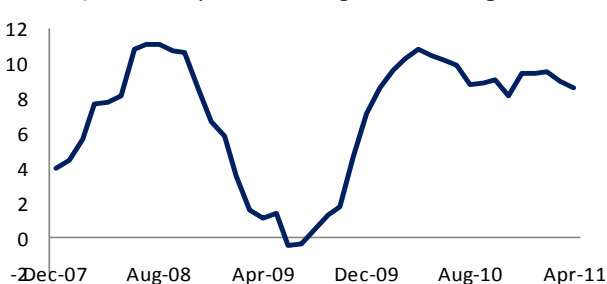
**Japan: Electricity Generated**  
(megawatt hours; Bloomberg)



**Brazil: CPI**  
(12 month percent change; Bloomberg)



**India: Wholesale Prices**  
(12 month percent change; Bloomberg)



generating capacity and to meet the additional costs of relying more on fossil fuels.

More broadly, the reconstruction of production capacity in Tohoku is well underway. According to a survey conducted by the Ministry of Trade and Industry, companies have restored more than 60 percent of production capacity in the disaster-affected areas. Much of the remainder is expected to be restored before the end of this month. Full operation of production facilities, however, is still awaiting repair of some disruptions in the supply chain.

The government and central bank are doing their part to help aid in the reconstruction efforts. The first supplemental budget of 4.0 trillion yen to finance the early phase of reconstruction was announced in early May which is being funded by reducing expenditures in other areas. For its part, the Bank of Japan has introduced a funds-supplying operation that provides financial institutions in disaster areas with longer-term funds against collateral. Loans are being offered at 0.1 percent per annum. The total amount of available loans is capped at 1.0 trillion yen.

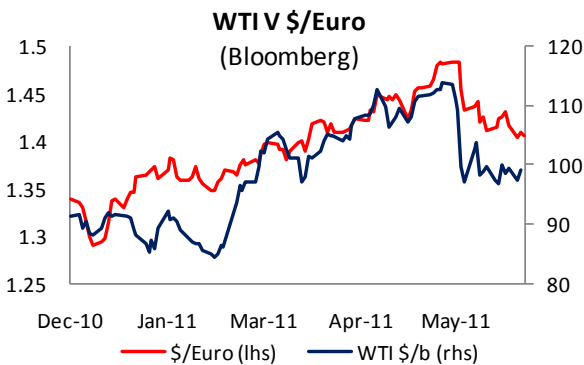
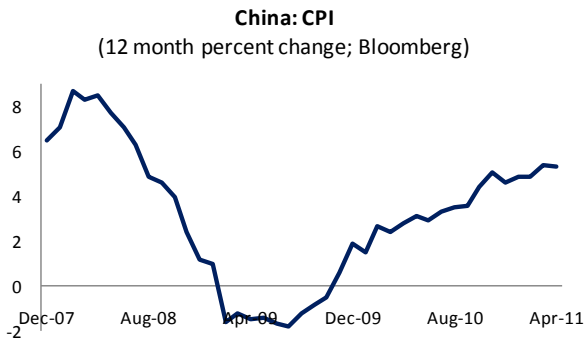
***Emerging market inflation worries continue, but relief is on the horizon***

Emerging economies' growth has outpaced that of major industrial countries for some time bringing along with it concerns about inflation. Emerging market central banks have been using a number of tools to prevent overheating, including higher policy rates and reserve requirements, as well as active exchange rate policies. The success of taming inflation pressures has so far been mixed, but we are hopeful that conditions will improve in the not too distant future especially as food prices react to prospects of more abundant supplies.

To provide some perspective on the inflation situation in emerging markets we take a look at recent conditions in BRIC countries. In Brazil, inflation is still accelerating both at the wholesale and consumer price levels. With wholesale price increases currently at double-digit rates, further pressure on consumer prices seems likely at least for the short term. The central bank is expected to raise interest rates during the next several months.

As for Russia, inflation has picked up over the last several months as food prices jumped in the wake of last summer's drought and fires. The central bank has raised the refinancing rate twice this year. More action could be needed as credit growth has accelerated markedly this year driven by ample bank liquidity afforded by record-high oil prices.

In India, wholesale price inflation—which is the benchmark inflation gauge—breached double digits last year and remains elevated at present. Although much of the rise in inflation can be attributed to the sharp rise in food prices, there is a risk that



Oil Prices	2010	2011	% change
\$/b	average	average y-t-d*	y-t-d
WTI	79.5	98.8	24.3
Brent	79.7	110.3	38.4
OPEC basket	77.4	106.1	37.1

\* May 25  
Bloomberg

inflation could become more entrenched in the economy. The Reserve Bank of India (RBI) has raised its main policy rate by 250 basis points since March 2010. With economic growth continuing at a robust pace, the RBI is likely to continue to tighten policy in the months ahead.

Arguably the most important of the BRIC countries, China, experienced a jump in food prices earlier this year which propelled the overall consumer price inflation rate to more than 5 percent. This development along with a rise in non-food price inflation to 2.7 percent in March (the highest rate in at least a decade) forced the authorities to become more deliberate in their actions. The Chinese central bank has hiked its benchmark lending rate by 100 basis points since last October, and raised reserve requirements by 400 basis points. In addition, the government has directed banks to rein in loan growth. With inflation now showing signs of moderating, we would not expect the authorities to tighten policies to the point of inducing a significant slowdown in economic activity.

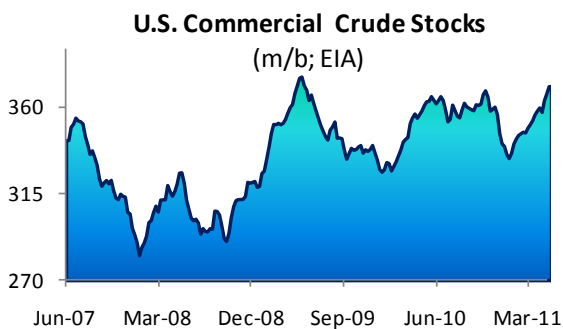
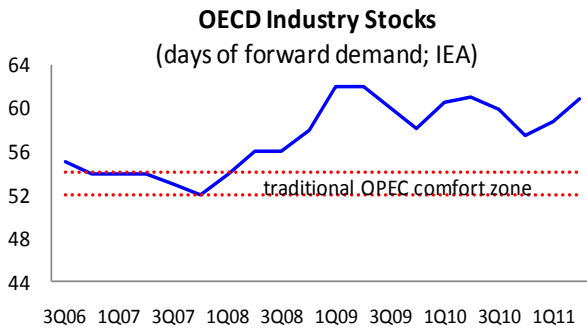
## Oil Markets

### *Markets have been turbulent*

Over the past couple of months oil markets have been volatile as participants digested a deluge of often conflicting data and events, prominent amongst which were: weaker growth indicators; new fears of Greek default; an easing of political tensions in the Gulf; inflationary pressures in emerging markets; warnings by global investment banks that commodities were due a correction; the pending end of US quantitative easing; and movements in the US dollar. With the overwhelming majority of oil trading now accounted for by financial investors their changing perceptions of geopolitical risks and global economic prospects caused prices to drop steeply (prices fell a record \$10/b in a single day).

Futures trading on the Nymex is now reportedly 45 percent higher than in 2008 and triple the level in 2005, and this jump in activity from financial investors is considered by many to be a major factor behind recent escalations in oil prices beyond what fundamentals would suggest. At the same time, the widespread use of high frequency and algorithmic trading played a major part in accentuating the price correction in May as automated stop-loss trading came into play. From a peak of \$114/b in late April, WTI prices are now trading at around \$98-100/b, with Brent at around \$115/b. As of May 24 the average year-to-date price for WTI was \$99/b.

For now, we are holding to our \$95/b WTI average projection for 2011 on the basis of sustained global growth of 4.1 percent. There remains some upside potential given that fundamentals, although well balanced at the moment, could tighten in the



**IEA Global Oil Balance**

(million b/d)	2009	2010	2011f	% chg
<b>World Demand</b>	<b>85.1</b>	<b>87.9</b>	<b>89.2</b>	1.5
OECD	46.1	46.1	46.0	-0.2
North America	23.3	23.9	23.7	-0.9
Europe	14.6	14.5	14.3	-0.8
Asia-Pacific	7.7	7.8	7.9	1.2
Rest of World	39.5	41.8	43.3	3.7
<b>World Supply</b>	<b>85.3</b>	<b>87.4</b>	<b>89.3</b>	2.2
Non-OPEC	51.8	52.9	53.7	1.5
OPEC NGLs	4.9	5.3	5.9	11.6
Call on OPEC	28.4	29.7	29.7	0.0

Source: IEA

second half as this is usually a period of supply disruptions caused by maintenance programs and hurricanes, while also the peak driving season in the US. The combination of market bullishness and upcoming seasonally high global demand could be enough to keep prices over \$100/b.

**Stock levels currently remain comfortable**

Even with the loss of Libyan oil exports and the reported sharp decline in Saudi production levels in March (due to market oversupply according to the oil minister) crude stocks remain ample, and indications are that the physical markets remain well supplied. As of mid-May, US commercial inventories of crude were back close to their 2009 peak of 375m/b. In addition, while total OECD stocks were drawn down substantially last year and are currently around the lower-middle end of their five-year range, in terms of forward demand cover they were back up at 60 days in April. This is well above the 53 days traditionally sought by OPEC. It should also be noted that the five year range, which is often used as a benchmark for market analysis, has been inflated by the abnormal build-up of stocks in 2008-09 when the world tumbled into recession.

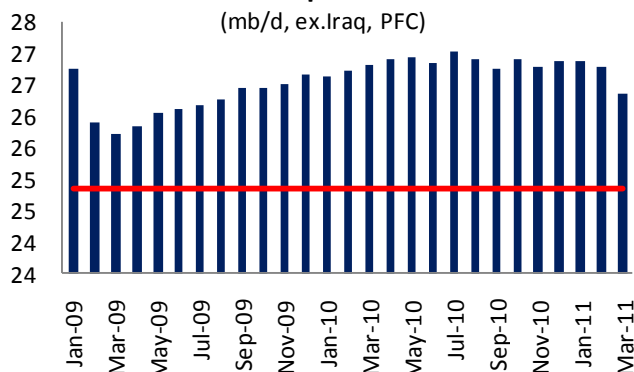
**IEA calls for more OPEC production despite apparent ample supply**

Having recently trimmed its 2011 oil demand growth forecast to 1.5% or 1.3 mb/d, the IEA has gone on to state that current oil prices pose a dire risk to the global economy, and that OPEC should increase supplies to prevent severe market tightening and upward pressure on prices in the second and third quarters. The IEA now projects global demand will average 89.2mb/d this year, reflecting a downward revision to North American demand. This is now projected to contract by 0.8 percent, largely due to high retail gasoline prices.

Whether OPEC will respond at it June meeting is uncertain. The cartel is also concerned over the potential adverse impact of high oil prices on economic growth. However, it currently views the market as being well supplied, despite the loss of Libyan output, and thus additional production risks creating a glut. Non-OPEC production appears to be expanding healthily, and is projected to be up another 800-900,000b/d this year, and OPEC NGL output is also on the rise. This will be the third year in a row that non-OPEC supply experiences a near one million barrel a day increase and, were it not for the MENA oil losses, this would probably be containing price pressures during 2011. However, it is also apparent that markets remain preoccupied with the belief that over the next 12-18 months' supply constraints will rub up against sustained demand growth, and hence continue to price in tighter market conditions than currently prevail.

**OPEC Output V Quota**

(mb/d, ex.Iraq, PFC)



**OPEC meets in June**

OPEC members will have a hard time trying to determine the path of oil market fundamentals given the lingering uncertainty over both demand and supply for the rest of the year. Another factor in their deliberations will be the apparent shift in Saudi Arabia’s position away from its long held \$70-80/b price target to an unspecified figure “below \$100/b”. In this stance, common with other GCC producers, the Kingdom appears to be looking to secure prices high enough to support its expanding domestic spending program, but not so high as to threaten global economic growth. This will be a difficult balancing act. A formal increase in OPEC quotas is a possibility, if only for the psychological effect this could have in cooling the markets, and to acknowledge existing production levels which have been running around 2mb/d above the 24.8mb/d quota since early 2010.

**OPEC spare capacity levels are a concern**

As long as the global economy, and particularly key emerging markets such as China and India, continues to grow then concerns will remain about whether oil supply can keep up. With such imperfect data available to make accurate assessments of supply and demand, and the inherent difficulty in trying to predict the future, the oil market is increasingly driven by longer-term narratives which are necessarily based on a number of unverifiable assumptions. One particularly strong theme in the wake of the loss of Libyan output is that current spare capacity in OPEC will be rapidly eroded by anticipated demand growth which cannot be met by incremental increases in non-OPEC supply. As a result the market will tighten inexorably and prices will continue to be pushed up. This forward looking concern appears to be trumping indications that existing supply and demand fundamentals are well balanced.

Ignoring the demand side (itself subject to numerous downside risks), to what extent and over what time frame this scenario plays out depends significantly on assessments of OPEC’s current and prospective spare capacity. As we noted in our last report, IEA data suggests that, excluding Libya, OPEC spare capacity stands at around 4.4 mb/d, the bulk accounted for by Saudi Arabia (3.1 mb/d). However, many analysts are sceptical that producers can sustainably reach their stated output capacities, such that effective spare capacity may actually be half the current estimates. A bit over 2 mb/d of spare capacity is a slim margin in an environment of incremental annual oil demand growth of 1.3-1.8 mb/d.

**Future OPEC capacity plans subject to numerous obstacles**

Another concern is the fact that while reassuringly large at over 13 mb/d, planned increases in OPEC production capacity are dominated by politically unstable countries (see table). In particular, the potential game changing 9mb/d planned increase

**OPEC Capacity Outlook**

mb/d	Capacity	Planned Capacity	Date
Saudi	12.50	12.50	
Libya	1.50	2.20	2015
Nigeria	2.65	4.00	
Angola	2.15	2.50	2015
UAE	2.80	3.50	2018
Qatar	1.00	1.10	
Kuwait	3.30	4.00	2020
Venezuela	2.70	3.00	
Algeria	1.33	1.40	
Iran	3.80	3.80	
Ecuador	0.51	0.51	
<b>OPEC -11</b>	<b>34.24</b>	<b>38.51</b>	
Iraq	2.70	12.00	2017
<b>Total OPEC</b>	<b>36.94</b>	<b>50.51</b>	

Source: Petroleum Intelligence Weekly

*Long-term oil supply concerns are clearly an issue and, combined with rising costs of production, imply oil prices will increase. But this does not mean prices in the short term will inevitably remain high*

in Iraqi capacity is subject to numerous downside risks, and the authorities have already downgraded their expectations for 2017. In addition, Libya's plans to increase capacity by around 700,000b/d by 2015 are clearly no longer viable.

Taken all together, long-term oil supply concerns are clearly an issue and combined with rising costs of production imply oil prices will increase. But this does not mean prices in the short term will inevitably remain high. There are many risks and financial investors are likely to push prices into bubble territory with ensuing crashes. Countries like Nigeria and Iraq may exceed expectations—even a more plausible 4-5 mb/d increase in Iraqi production will go a long way to meeting anticipated oil demand growth—and non-OPEC supply could continue to expand more than anticipated. Technical innovations and man's ingenuity may change both the demand and supply outlook. Perhaps more significantly, government intervention in oil market trading and the development of long-term energy policies may alter financial investor trading patterns irreversibly.

## Saudi Arabia

Saudi Arabia: Economic					
Indicators	2009	2010	2011f	2012f	2013f
Nominal GDP (\$bn)	369.7	431.5	515.6	524.9	584.3
Real GDP growth (% change)	0.1	3.8	6.1	4.0	4.7
Inflation (average %)	5.1	5.4	5.7	6.4	5.6
Current account (% GDP)	6.2	15.6	16.4	10.3	11.3
Fiscal balance (% GDP)	-6.2	6.7	6.3	6.8	5.4
Net foreign assets (\$bn)	435.6	466.6	548.5	600.2	663.2
Bank deposits (% change)	11.2	4.7	18.8	17.7	19.0
Private sector credit (% ch)	-0.6	5.7	16.3	16.4	15.5

Sources: national authorities, IMF, Samba

*Private credit tracks higher in response to rising demand*

Private sector credit has continued to track higher, albeit gradually, as the Kingdom's well-capitalised and liquid banks respond to increasing demand from an expanding private sector. Despite regional political upheaval, Saudi firms have boosted purchases, built up stocks and taken on new staff. However, they have also reported rising input costs, which are likely to feed through into higher inflation as we move through the year.

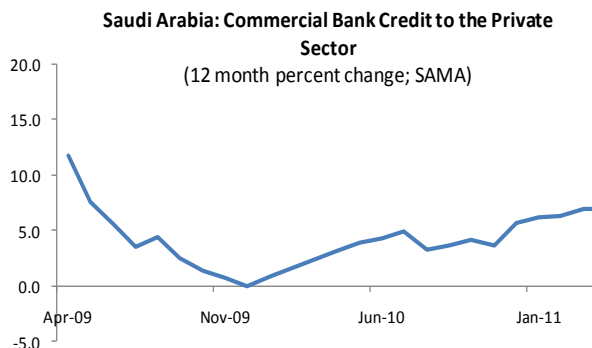
### **Bank lending to the private sector gathers pace**

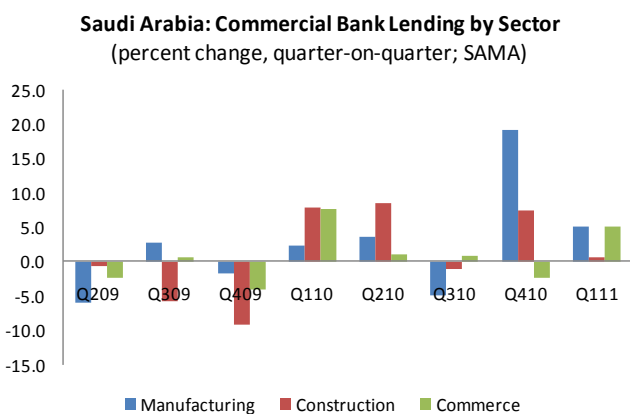
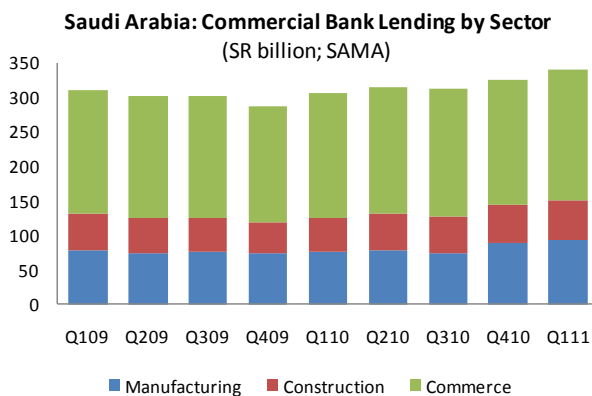
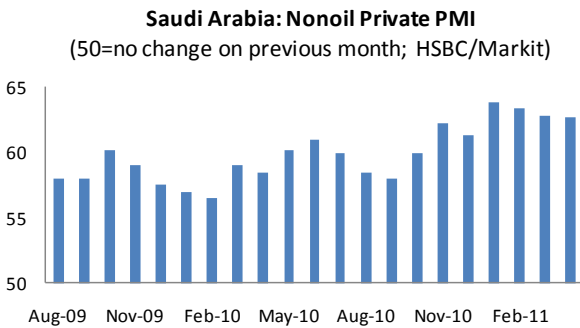
Latest official data show that bank lending to the private sector grew by 6.9 percent in the twelve months to April. This represents a reasonable pickup on the 5.7 percent growth registered in December, particularly given the backdrop of regional political uncertainty. With these concerns now receding and private investment demand hardening, credit growth seems likely to accelerate as we move through the year.

Private sector credit growth surged during the pre-financial crisis years, reaching 21 percent in 2007 and 27 percent in 2008 (lending growth peaked in June 2008 at an annual rate of 35 percent). The drying up of domestic private sector investment and seizing up of global interbank markets saw a rapid retrenchment in the second half of 2008 and overall credit contracted slightly in 2009. Private credit returned to growth in 2010, but with private investment subdued, the rate was a modest 5.7 percent off a low base.

### **Credit fundamentals have changed**

However, supply and demand fundamentals appear to be changing. Helped by resolutely brisk deposit growth—recently boosted by additional salary payments—Saudi banks enjoy ample liquidity, with a sector-wide loan-deposit ratio of just 78. Banks are also well capitalised, and with the provisioning cycle having peaked, institutions are looking to regrow their loan books.





Demand for credit is also much firmer than two years ago. The government's counter-cyclical fiscal stance, which has been reinforced by the additional spending pledges made in February and March (see April *Monitor*) has buttressed private sector confidence. Public sector salaries have been increased, which has supported private consumption, while infrastructure spending has also continued to pick up. This in turn has encouraged the private sector to boost its own investment.

**PMI data point to growing investment demand**

The latest Purchasing Managers' Index (PMI) produced by HSBC shows that private sector investment eased a little in the past few months—unsurprisingly, given the regional political context—but remained firmly in expansionary mode at 62.7 (any number above 50 denotes expansion). According to respondents, new business—especially from the government—prompted firms to build up stocks and take on extra staff. Job creation was the most marked since December 2009, with 14 percent of respondents saying that staff numbers in their firm were higher than a month earlier. By company size, larger firms posted a stronger rate of economic activity than SMEs.

**The manufacturing sector has been a major source of credit demand**

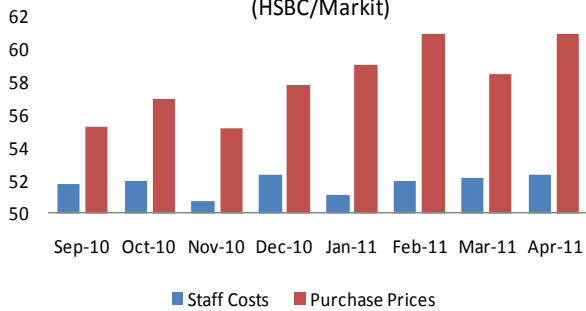
The PMI is not disaggregated by sector of activity, but sectoral demand can be broadly identified by quarterly lending data produced by SAMA. Of the three big sectors—commerce, manufacturing and construction—lending to manufacturing has shown the most vigour over the past twelve months: net lending to the sector grew by SR18 billion in the year to the end of March, with an SR19 billion gain in the past six months reflecting the general health and expansion plans of the Saudi petrochemicals industry, as well as specific import requirements of other large manufacturers such as Maaden.

Flows to the construction sector have been more modest, but have registered something of a rebound. Net flows to the sector were around SR8 billion in the past twelve months, in contrast to the SR4 billion net contraction recorded in the previous year. In general, lending to contractors has not been as strong as might be expected given the level of construction activity in the Kingdom, but this mainly reflects the fact that contractors are for the most part receiving payments up front (or at least in a timely fashion) and have less call for bridging finance from banks.

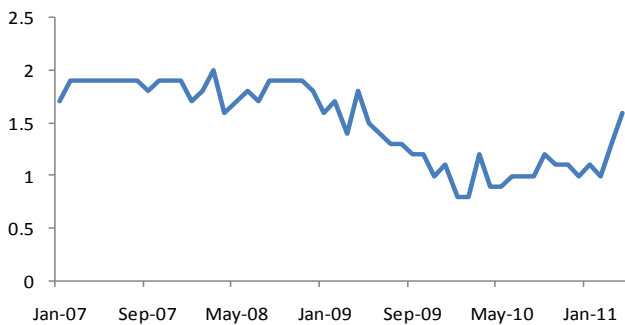
**Commerce is well-placed for a sharp pickup in demand**

Commerce remains the largest sector, with more outstanding credit than the other two combined. The sector covers a wide array of firms, but in general it is more reliant on private than public spending. Consequently, net flows were weaker during the downturn than to the other main sectors, which benefitted

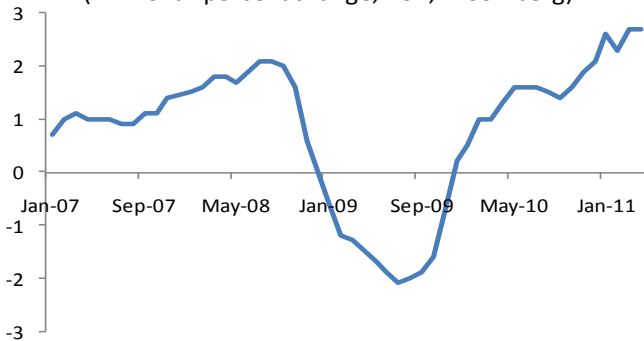
**Saudi Arabia: Nonoil PMI Input Prices**  
(HSBC/Markit)



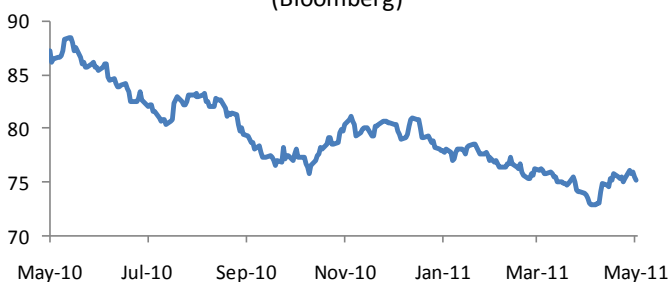
**Eurozone: Core Inflation**  
(12 month percent change, NSA; Bloomberg)



**China: Non-Food Inflation**  
(12 month percent change, NSA; Bloomberg)



**US Dollar Index**  
(Bloomberg)



from the government's counter-cyclical spending on infrastructure. But flows picked up strongly in the first quarter of this year as firms positioned themselves to take advantage of rebounding private consumption (see below).

***Input costs are rising however***

One less encouraging aspect of the PMI survey is input prices. The overall index for input costs rose to 58.2 in April, up from 56.2 in March. Of those surveyed, 17 percent said that overall input prices were higher than the previous month. Purchase prices were the main driver, with 22 percent of respondents reporting that purchase prices had increased on the month (none reported a decline), reflecting in large part the increase in global commodity prices.

***Commodity prices might cool in short-term...***

The outlook for input prices is mixed. Commodity prices have cooled in recent weeks—oil and steel quite considerably—and a softer patch for global growth points to continued commodity weakness in the short term. Nevertheless, the cost of imported inputs for Saudi firms is also influenced by inflation among trading partners, which has been tracking up. This mainly reflects the impact of higher commodity prices, but “core” inflation—that is excluding food and energy prices—is also on the rise, albeit from a low base.

***...but rebound in US dollar might not be sustained***

The path of the US dollar will also influence input prices. In late May the trade-weighted US dollar index was down around 5 percent from the beginning of the year. The outlook for the dollar (and hence the riyal) is far from clear-cut: recently, the euro has come under pressure owing to renewed uncertainties about the outlook for eurozone sovereign debt. Nevertheless, the US's accommodative monetary stance—contrasted with the European Central Bank's tightening—could mean renewed dollar weakness in the medium term. German firms exporting to Saudi Arabia (for example) might choose to absorb this exchange rate loss in order to protect market share if they feel that the dollar is likely to recover, but they are unlikely to do this for long if dollar weakness persists.

***Staff costs likely to pick up***

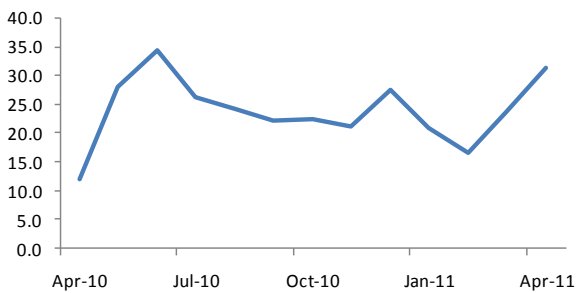
Saudi firms also face rising staff costs. To date, the increase in staff costs has been modest, but the authorities' decision to award public sector employees a bonus of two months' salary is being replicated in much of the private sector, leading to a likely spike in staff costs in the coming months.

Faced with rising input costs, it is no surprise that firms have attempted to protect margins by raising output prices. The output prices PMI has risen quite sharply in 2011, reaching 54.4

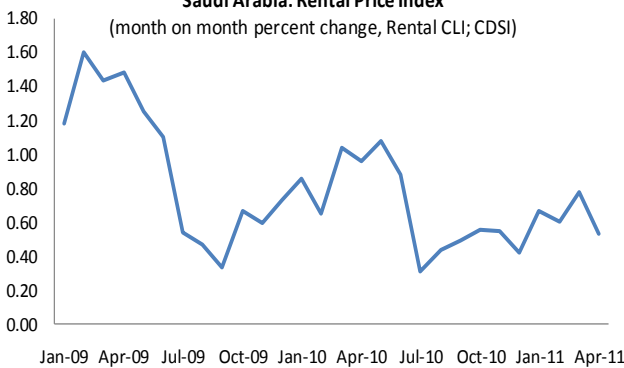
**Saudi Arabia: Cost of Living Index**  
(12 month percent change; CDSI)



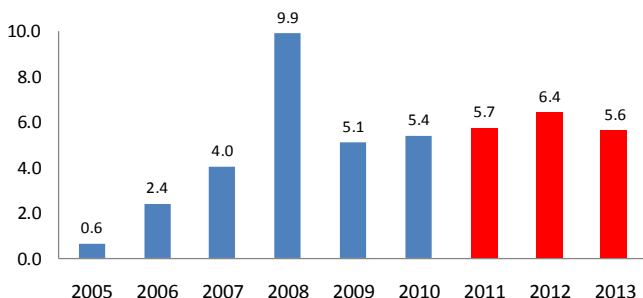
**Saudi Arabia: Points of Sale Transactions**  
(volume, 12 month percent change; SAMA)



**Saudi Arabia: Rental Price Index**  
(month on month percent change, Rental CLI; CDSI)



**Saudi Arabia: Consumer Price Inflation**  
(average percent change; CDSI, Samba)



in April, from 52.2 in December. Eleven percent of respondents said their firm had raised output prices in April, compared with just 1 percent reporting lower prices.

**Rising input costs will feed into CPI data**

The rising trend in output prices is now beginning to feed through into the consumer price index. This is not obvious from the headline year-on-year data: the overall index edged up only slightly to 4.8 percent in April, from 4.7 percent in March, and is still some way down on the 5.4 percent registered at end-year 2010. Nevertheless, on a month-on-month basis the trend is determinedly upward. The index grew by 0.4 percent in April, following gains of 0.3 percent and 0.2 percent in March and February, respectively.

Much of the increase was food-related, and as noted above, commodity prices might now be stabilising (or even reversing) suggesting a weaker impulse from food in the third quarter (commodity price changes take time to show up in local prices). But inflation is also being generated by hardening demand: the volume of points of sale transactions (a proxy for retail sales) grew by 31 percent in the twelve months to April, with firmer growth expected in the second half of the year as salary increases and other benefits continue to feed through. Much of this spending will be directed towards imports, but there will also be upward pressure on the price of domestic nontradeables.

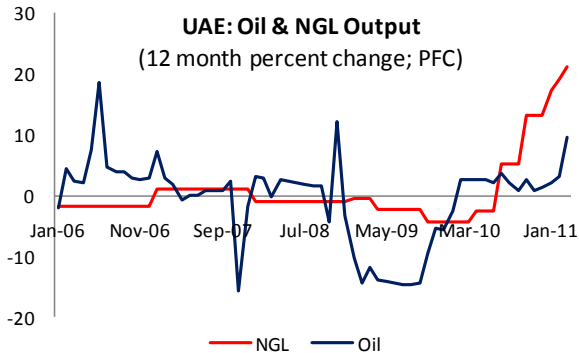
**The outlook for rental inflation is difficult to gauge**

As well as higher prices in the shops, inflation is being fed by rental costs. These have been driven up (on a month-on-month basis) by stronger demand for expatriate labour and a still-slow expansion of the domestic housing stock.

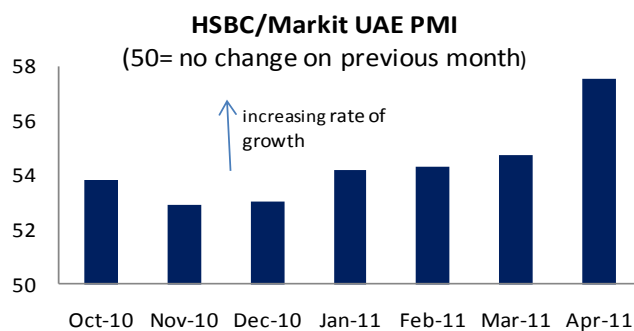
The outlook for rents has been clouded somewhat by the authorities' pledge to enhance housing supply, since many Saudi nationals might decide not to enter the rental market in the expectation of being able to afford to buy a house in a year or two. Nevertheless, this dynamic—if it materialises—seems unlikely to fully offset the demand for additional expatriate labour (after all, the nonoil economy is expected to grow by around 5.5 percent in real terms this year). Consequently monthly rental inflation seems likely to continue ticking up in the months ahead.

Taken together, these various price pressures suggest to us that Saudi inflation will continue to gather pace for the rest of the year and into 2012. Base effects mean that year-on-year inflation will probably crest in the first half of 2012 before edging down again as more housing comes on line and US monetary policy tightens. Risk to this projection is generated mainly by the uncertain outlook for commodities and the dollar.

## United Arab Emirates



While still weak real estate sectors and debt problems in Dubai are providing stiff headwinds, real GDP growth is now projected to rise to 4 percent this year.



GCC: Key Macro Indicators	2009	2010e	2011f	2012f
Nominal GDP (\$bn)	223.0	239.8	264.3	283.7
Real GDP growth (% change)	-3.0	3.0	4.0	3.6
Hydrocarbon	-8.6	2.2	5.8	1.5
Non-hydrocarbon	0.6	3.3	3.4	4.2
Inflation (average %)	1.2	0.9	3.5	4.5
Current account (% GDP)	4.5	6.9	12.2	13.3
Fiscal balance (% GDP)	-12.2	-1.4	6.9	6.1
External debt (% GDP)	74.0	70.1	68.1	77.6
M2 (y-on-y %)	9.8	5.6	11.6*	
Private sector credit (y-on-y %)	4.6	0.7	11.9**	

\*March; \*\*Jan

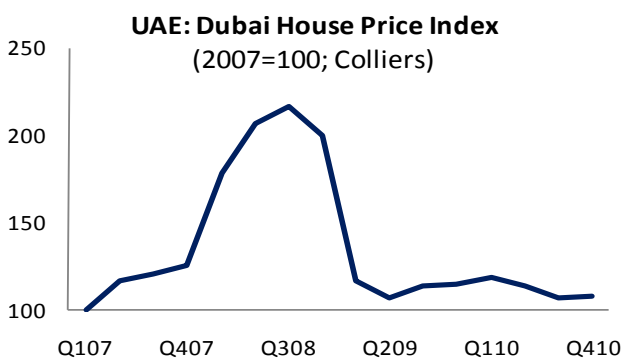
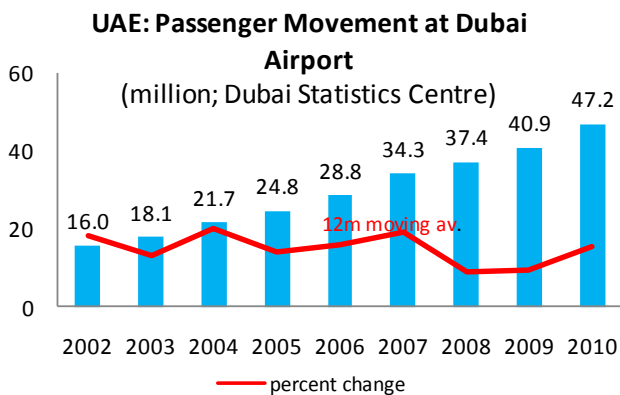
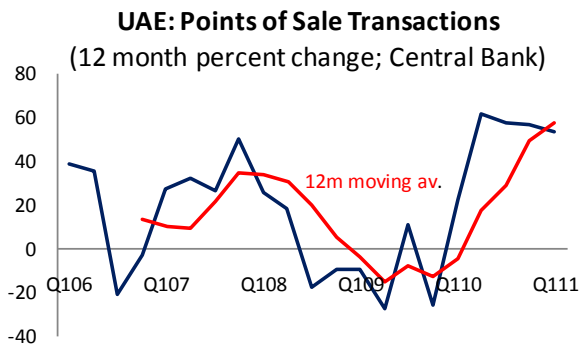
Sources: national authorities, IMF, Samba

### The economy picks up steam

Along with the rest of the GCC the UAE has been buffeted by the outbreak of unrest in the broader Middle East and North African (MENA) region. However, there have been no disturbances in the emirates, where local populations are small and well provided for, although the latest data suggest that unemployment among UAE nationals is around 14 percent. Instead the UAE has begun to be viewed somewhat as a safe haven during these uncertain times, particularly as its growth prospects have been enhanced as a result of the associated surge in oil prices and increase in production to help offset the loss of Libyan crude. The regional unrest has also prompted the Federal government to raise spending, including an additional \$1.6 billion for water and electricity networks in the northern emirates where unemployment amongst nationals is highest. Improving growth prospects in Asia have also helped support a strong revival in trade, logistics, and tourism. While still weak real estate sectors and debt problems in Dubai are providing stiff headwinds, real GDP growth is now projected to rise to 4 percent this year, moderating to 3.6 percent in 2012

### Oil and NGL output increases

Following the loss of Libyan crude, the UAE has begun to pump more oil to compensate. There has been no formal OPEC agreement on higher output but, led by Saudi Arabia, the cartel is acting to stabilise oil markets. Available data from PFC show that UAE crude production was up almost 10 percent year-on-year in March at just over 2.5 mb/d compared with a formal quota of 2.2 mb/d. Production of NGLs is also rising and exceeded 600,000 b/d for the first time in March, an increase of 21 percent year on year. These volume increases will have a direct and positive impact on real GDP growth, but will also



generate additional revenues—mainly for Abu Dhabi, which appears prepared to use them to stimulate growth.

**Outside of real estate the non-hydrocarbons sector is performing well**

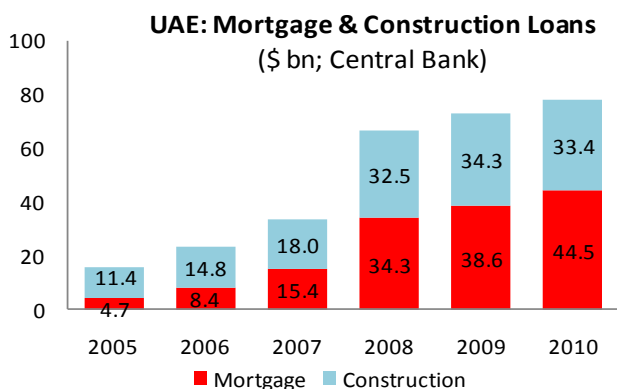
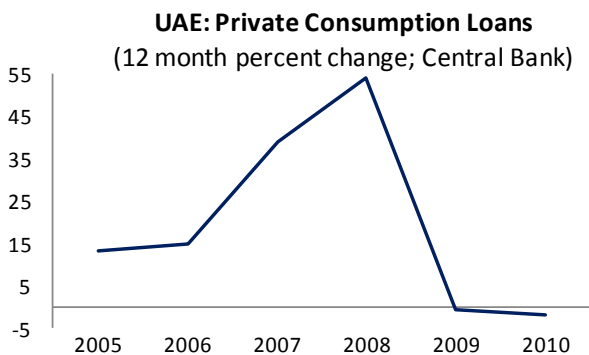
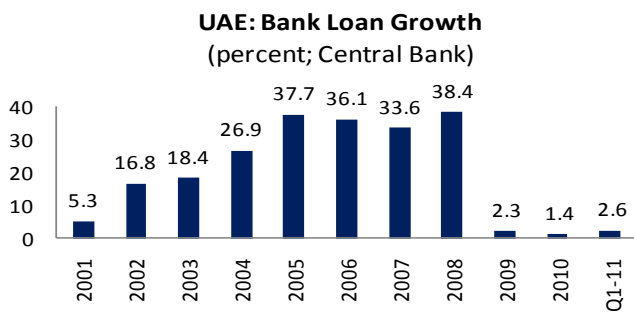
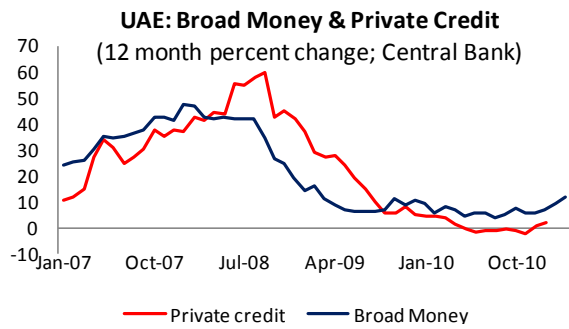
In the UAE’s more diversified economy the non-hydrocarbons sector accounts for over 75 percent of GDP in constant prices, and there is mounting evidence that outside of real estate this sector is performing well. Construction and related activities are benefiting from public infrastructure spending, mainly in Abu Dhabi, from both the government and its related enterprises (Mubadala reportedly plans to invest over \$16 billion this year). Over \$8.2 billion in projects has been awarded in the four months to April according to data compiled by MEED, an increase of 32 percent year-on-year, and another \$105 billion worth remain in the pipeline.

Meanwhile, Dubai is benefiting from its position as a regional hub and its strong links with Asia which have helped spur a revival in trade, tourism and logistics. Passenger traffic through Dubai airport was up 6 percent in the first quarter year-on-year, following a 15.3 percent increase for 2010 as a whole. However, while Dubai may have benefited from some diversion of tourists away from North Africa and Bahrain, regional unrest appears to have adversely affected cargo business, which saw a 3 percent decline over the same period, following robust growth of 17.7 percent in 2010.

A number of other indicators of non-oil activity are positive: hotel occupancy rates have risen to around 85 percent, points of sale transactions—a proxy for consumption—have rebounded, and year-on-year the volume of exports (including re-exports) and imports grew by 26.5 percent and 39 percent respectively in January. A good overall indicator of the health of the non-oil private sector is the relatively new HSBC/Markit Purchasing Managers’ Index (PMI) for the UAE which presents the results of surveys of business executives covering a number of areas (output, new orders, employment, prices, costs). The most recent survey data confirm a strong start to 2011, with the seasonally adjusted headline PMI reaching a record in April (see Chart).

**The real estate sector remains weak**

While some available indicators point to stability and in places modest increases in UAE real estate prices, the overall position is still weak. On an annual basis, data from Colliers point to another 6 percent drop in Dubai prices in 2010. Looking ahead, there has been some welcome pick-up in activity, and the expanding economy should pull in more expatriates. There could even be some increase in demand prompted by the political unrest elsewhere in the region. However, the fact remains that the market is oversupplied and is likely to remain so as more



unfinished projects are completed. As noted in the recent IMF Article IV report, the surplus of residential properties reportedly exceeds 30 percent, while additional supply equivalent to 15 percent of the current stock is expected in the next two years. Under such conditions prices are unlikely to retrace their highs for some time, and this will remain a major drag on the economy given the large exposure of banks, corporates and individuals to the sector.

**Expansionary fiscal stance likely to prevail**

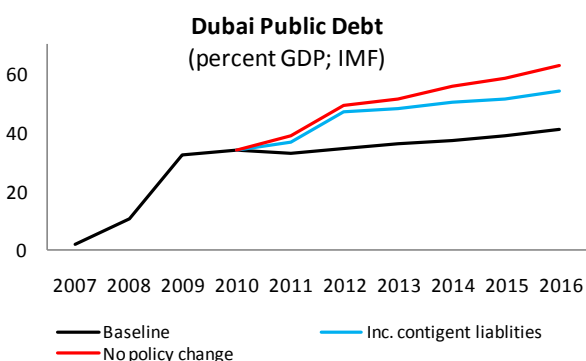
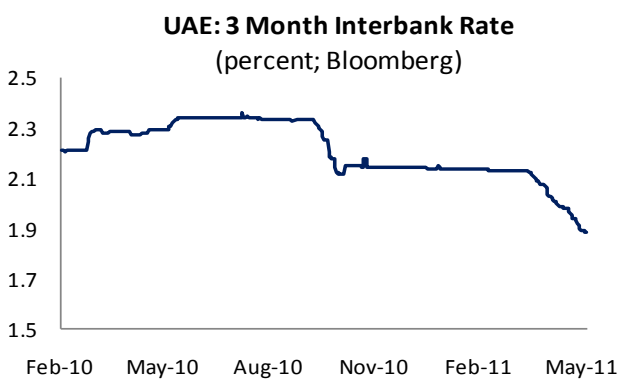
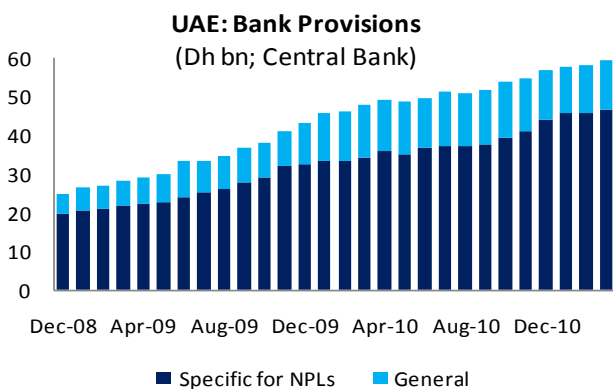
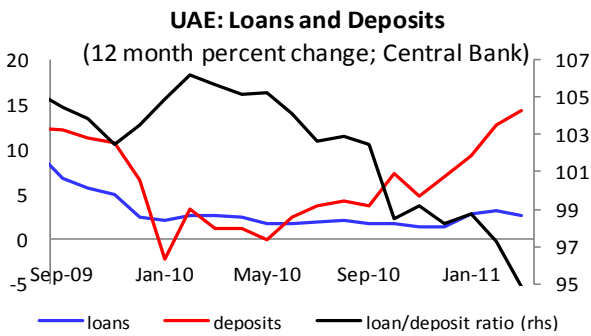
Abu Dhabi’s budget intentions have not been publicly announced, but it appears clear that any thoughts of consolidation have been ditched in the wake of MENA unrest. We thus expect expansionary fiscal policies will prevail, offsetting the small consolidation apparent in Dubai’s 2011 budget. As well as increased investment in infrastructure, spending will also rise on salaries, pensions and subsidies. The current high oil prices, and hence revenues, backed by Abu Dhabi’s large external savings, provide plenty of room for spending increases and we expect that the UAE’s consolidated fiscal balance will remain healthily in surplus. However, the steady increase in spending over recent years has increased the UAE’s dependency on, and vulnerability to, oil prices, evident in the fact that the budget break-even oil price is now estimated to be around \$75/b.

**Inflation will remain low**

Inflation in the UAE as a whole is estimated to have held below 1 percent in 2010, but has since picked up to 1.2 percent in March this year. The weakness in rents has been the main factor containing the overall CPI, as elsewhere inflationary pressures are rising. Food prices in particular are on the increase. However, given the government’s recent promise to keep the price of basic consumption items low, we expect that the impact on inflation this year will be mitigated. Nonetheless, rising inflation in trading partners, some weakness in the US dollar, and higher commodity prices are likely to push inflation closer to 4 percent this year.

**Private sector credit showing signs of revival**

Loan growth remained weak during 2010, slipping to 1.4 percent from 2.3 percent in 2009. It was notable that lending for construction declined for the first time (-2.6 percent), while there were further declines in personal consumption loans and lending for trade. However, mortgage lending continued to pick up (15.2 percent) and the declining trend in private sector credit growth appears to have bottomed out. Year-on-year credit to the private sector turned positive at the end of 2009 (0.7 percent), and was up further at 1.9 percent in January. In addition, overall loan growth revived somewhat through the first quarter (2.6 percent). With economic activity on the rise we expect that private sector credit growth will improve steadily



through 2011, aided by lower interest rates, strong deposit growth and a revival in domestic demand. Bank liquidity has improved and capital ratios remain strong (20.7 percent in March) providing supportive conditions. Overall we expect that loan growth will approach 5 percent this year.

**Bank liquidity improves**

Bank deposits have built rapidly in recent months, growing by 14.3 percent year-on-year in the first quarter, on top of 6.8 percent growth in 2010. The boost to deposits would appear to suggest improved confidence in the economy and also perhaps some diversion of funds to the UAE in the wake of regional unrest. Combined with weak loan growth, this jump in deposits has pushed the aggregate bank loans-to-deposit ratio down to around 95 percent in March this year. The improved liquidity conditions are also reflected in a drop in interbank rates. Three month rates have dipped 25 basis points since March and were holding at around 1.9 percent in late May.

**But banks are still under strain**

While government support over the past couple of years has helped boost bank capital adequacy ratios, banks are continuing to feel the strain from the large scale restructuring of government related entity (GRE) loans which have moved on from Dubai World (finally completed in March) to units of Dubai Holdings. Under these, banks have generally had to accept extensions of maturity and taken haircuts in net present value terms, if not principal, given lower interest rates. Combined with large exposure to the weak real estate market, this has strained bank balance sheets and led to rising provisions.

Bank provisions rose to \$15.5 billion at end-2010, up 31 percent on 2009, and continued to rise through the first quarter reaching \$16.2 billion in March. The strain has proven too much for one bank, Dubai Bank (itself part of Dubai Holdings), which had to be rescued by the Dubai government in May. It should be noted that Abu Dhabi banks are better positioned, being less exposed to troubled GRE's, and IMF stress tests on overall UAE banking data indicate resilience to shocks. However, the Fund notes that the aggregate data can mask risks in individual banks from concentrated exposure to particular borrowers or sectors.

**Debt concerns continue to pose risks**

The large debt overhang amongst UAE GREs and private companies continues to dampen economic prospects, particularly in Dubai. The IMF estimates that the UAE faces \$59 billion in debt repayments during 2011-12, of which \$31 billion is owed by Dubai. To date there have been limited asset sales by Dubai, revenues from which could be used to repay this debt, while not more than \$10 billion is thought to be available in the Dubai Financial Support Fund (DFSF), much of which is earmarked for Nakheel to fund operations and settle liabilities.

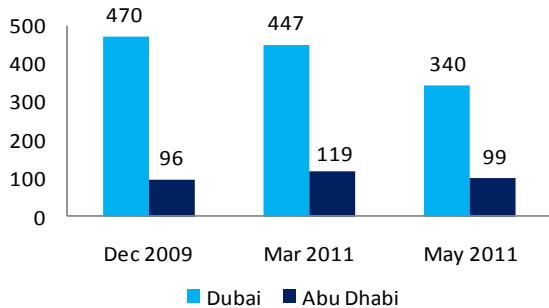
**UAE Gross Public & Publicly-Held Debt**

(\$ billion)

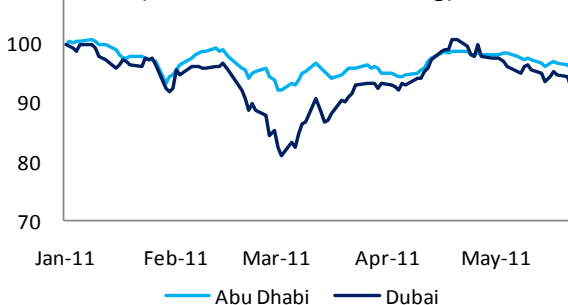
Maturing in	2011	2012	beyond	Total
<b>Dubai</b>	<b>16.0</b>	<b>15.2</b>	<b>81.7</b>	<b>113.0</b>
Government	5.6	1.6	28.9	36.0
GREs	10.4	13.6	52.9	76.9
<b>Abu Dhabi</b>	<b>17.1</b>	<b>10.6</b>	<b>76.4</b>	<b>104.0</b>
Government	0.4	1.3	9.9	11.6
GREs	16.6	9.3	66.4	92.4
<b>Other Emirates</b>	<b>0.9</b>	<b>0.3</b>	<b>4.0</b>	<b>5.2</b>
<b>Federal government</b>				<b>19.1</b>
<b>Total UAE</b>	<b>33.1</b>	<b>25.8</b>	<b>158.1</b>	<b>236.1</b>

Source: IMF 2011 Article IV Report

**UAE: 5 Year Sovereign CDS Spreads**  
(Bps; Bloomberg)



**UAE: Stock Indices**  
(end-2010=100, Bloomberg)



Improving market conditions will boost earnings from better-performing GREs that can be used to finance weaker GREs.

The current oil price windfall also improves the prospect of potential support from Abu Dhabi, although it too faces around \$28 billion in repayments over 2011-12, and there are signs that some of its own real-estate-intensive GREs are experiencing financial difficulties.

It thus seems likely that a large chunk of Dubai’s debt will be up for refinancing and thus susceptible to market sentiment and roll-over risk. Market sentiment has improved of late—Dubai’s CDS rates have actually declined since unrest broke out in the MENA region, although they remain high—but remains brittle and both sovereign and GRE borrowing costs are likely to be elevated. Dubai’s direct sovereign debt has risen steeply since 2007 and now stands at around 34 percent of GDP according to IMF estimates. However, the IMF also notes that the data underestimate total public sector debt by omitting quasi-sovereign contingent liabilities, and suggests that an additional \$11 billion of contingent risk can be foreseen for the government of Dubai by end-2016. This would raise the debt to GDP ratio to 47.4 percent, and the IMF’s debt sustainability analysis indicates that Dubai’s debt may become unsustainable in the absence of policy change. What effect such analysis will have on the markets is unclear, but the \$1.3 billion sukuk issuance by Nakheel planned for June will provide some indication of the level of support for Dubai.

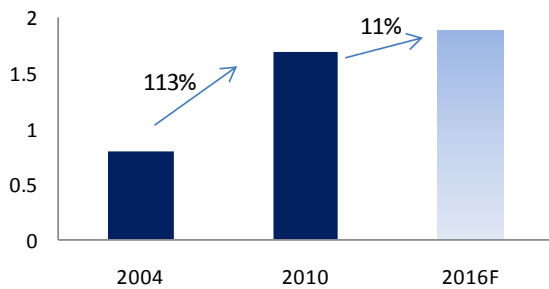
**UAE as a whole remains a net external creditor**

While Dubai’s debt problems are a clear concern, the UAE as a whole remains a large net external creditor, mostly reflecting the strength of Abu Dhabi’s finances. The IIF estimates that the UAE’s net external assets amounted to around \$300 billion at end-2010 based on a conservative estimate of the value of ADIA’s assets (\$305 billion). This provides considerable reassurance when looking at the rising debt levels in Abu Dhabi, particularly in the context of rising oil revenues as well. However, as the DW debt restructuring has shown, it does not translate into cover for Dubai.

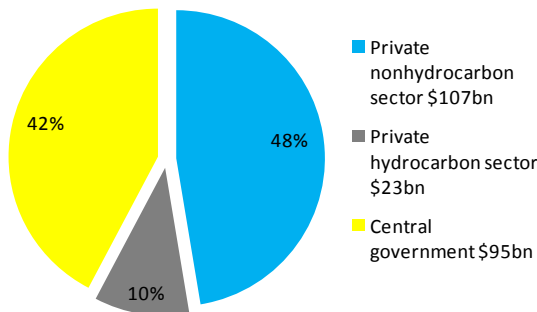
**UAE stock markets yet to find solid ground**

Both Abu Dhabi and Dubai’s stock markets have been battered by the effects of regional unrest as well as recent uncertainty in global markets, much of it stemming from concerns over the Eurozone. As of late May the Abu Dhabi market was still off around 3 percent and the Dubai market 5 percent, despite both staging mini rallies through most of April. First quarter corporate and bank results were mixed, which is likely to have prompted some sell off, while news of more restructuring and the Dubai Bank failure will have dented investor confidence. Weak real estate prices are also acting as a drag. However, given the positive growth prospects, both markets may now be

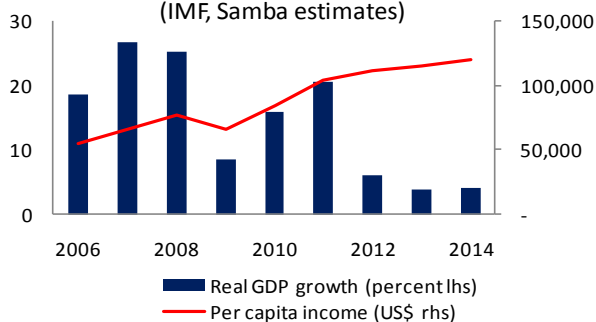
**Qatar: Population**  
(million; QSA, NDS)



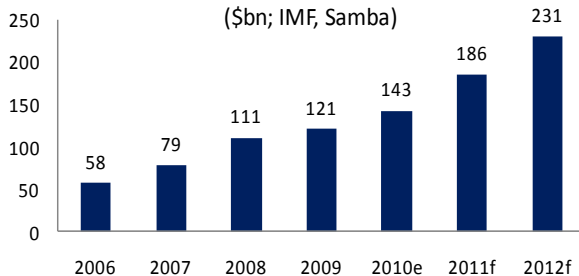
**Qatar: NDS Projected Investment 2011-16**  
(total=\$226bn)



**Qatar: Real GDP & Per Capita Income**  
(IMF, Samba estimates)



**Qatar: Cumulative Current Account Surplus**  
(\$bn; IMF, Samba)



underpriced with trailing PE ratios of just over 10, compared with a GCC average of 13.7 according to Zawya.

## Qatar

For our latest analysis please refer to the recently published report *Qatar: National Development Strategy Review & Economic Update* available on the Samba website, highlights of which follow below.

- Qatar's National Development Strategy (NDS) covering 2011-16 provides a frank analysis of the country's development prospects and challenges. Hydrocarbons will continue to dominate and underpin national prosperity but, with the completion of the last of the major hydrocarbons projects in 2012, the emphasis of the NDS is on developing the non-hydrocarbons sector.
- We project that real GDP growth will exceed 20 percent this year before slipping to 6 percent next and – in line with the NDS – hold at around 4-5 percent a year post-2012 as the non-hydrocarbon sector takes over as the engine of growth. This will be supported by the massive \$226 billion planned investment program, including \$95 billion from the central government.
- It seems clear that revenues from hydrocarbon exports will make Qatar a wealthy country, ensuring sustained fiscal and current account surpluses and a further build-up in external assets even under adverse oil and gas price assumptions.
- Managing such wealth, promoting economic diversification and completing large scale infrastructure investments in time for the 2022 World Cup will present challenges. But the NDS provides reassurance that policy makers are prepared, and will take steps to mitigate potential inflationary pressures and to avoid wasteful spending.
- Recent data confirm the continued increase in hydrocarbon output and point to improving conditions in the non-hydrocarbon sector which should receive a further boost from the expansionary budget announced for 2011/12. Private credit growth is reviving, helped by recent interest rate cuts, and the stock market returned to positive territory in May. Inflation is on the rise, but remains muted overall (1.7 percent in March), due to sustained weakness in rents. That said, reports suggest that the real estate sector has begun to stabilise.

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