

Saudi Arabia:

Mid-Year Economic Review and Forecast, 2011-13

Executive Summary

- The **global economic recovery** has slowed in recent months, owing in part to the impact of the Japanese earthquake and tsunami, which disrupted global manufacturing supply lines, though higher global commodity prices have also weighed on consumption. The impact of these factors is dissipating (commodity prices have moved lower) and we expect firmer global growth in the second half of the year. However, structural problems will continue to drag, most notably the severe debt overhang in the eurozone and an extremely weak US housing market. In general, Emerging Markets will continue to outperform the OECD, but the pace of growth in EMs will also cool in line with ongoing monetary tightening.
- **Oil prices** have been volatile recently, with markets unsettled by the outage of Libyan crude and OPEC's failure to agree an increase in quotas. This has led the International Energy Agency to release some of its stockpiles of crude to the market in an effort to keep prices from overheating and doing serious damage to the global economic recovery. Saudi Arabia has not objected to this policy, and it too has increased output. As a result, prices have come off their recent highs. Nevertheless, with financial investors continuing to fret about the medium- to long-term outlook for supply, prices are expected to remain high by historical standards. We think that WTI will average around \$95/barrel in 2011 and 2012 before edging up to \$100/b in 2013.
- **Saudi Arabia's economic recovery** is gathering pace thanks in part to fresh fiscal measures, which are expected to see overall government spending grow by around a third this year. Many of the new measures, such as salary adjustments, are feeding directly into private consumption and we see the nonoil economy growing by around 5.5 percent this year. With hydrocarbons output also rising sharply, overall growth should reach 6.5 percent in 2011, the highest rate since 2003. Growth is expected to ease to around 4 percent in 2012 as oil output is reined back, but the nonoil economy should remain buoyant. The main challenge lies with inflation, which is being generated both by rising import prices and domestic rents. Nevertheless, increased subsidies are helping to ameliorate retail price pressures and rental inflation should start to ease in the medium term as new housing comes on line.

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Saudi Arabia

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Global Economic Forecast			
	2011	2012	2013
Real GDP growth (percent, annual)			
World	4.0	4.3	4.6
US	2.3	2.7	3.0
Japan	-0.2	2.7	1.9
Euro area	1.8	1.6	2.0
Emerging Markets	6.0	6.5	6.5
Official policy rate (end period)			
US	0.25	0.75	2.00
Japan	-0.2	2.7	1.9
Euro area	1.5	2.3	3.3
(\$/b, period average)			
WTI crude oil price	95	95	100

Source: Samba estimates and forecasts

Global Economic Outlook

Overview: a recovery with heavy structural drags

Having recovered reasonably well from the financial crisis and subsequent recession, the global economy has slowed quite markedly in the past few months. This slowdown is partly attributable to the Japanese earthquake and tsunami, which disrupted global supply lines (and hit Japanese output), and partly to the impact of higher commodity prices, which have pushed up global inflation. However, other structural and cyclical factors are also at play, such as weak housing markets (US), severe debt overhangs (eurozone periphery and US), monetary tightening (emerging markets) and generally sluggish employment growth (US and parts of eurozone).

Some of these malign influences have begun to dissipate: global commodity prices have fallen back somewhat, and Japanese output has begun to recover. Other issues are more intractable, and these will continue to act as a drag on the pace of growth. Still, on balance we expect global growth to pick up again in the second half of 2011 and into 2012, albeit at a fairly muted pace.

Inflationary pressures should begin to moderate in line with softer commodity prices and monetary tightening. The growing influence of financial markets suggests that oil prices will remain volatile, but we think that the average price of WTI will remain more or less where it is now, at around \$95/barrel in 2011-12. Some uplift to \$100/b is likely in 2013 as the pace of global growth picks up.

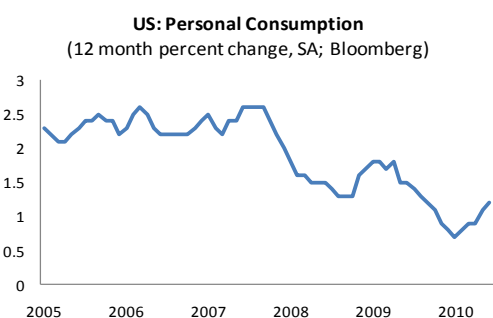
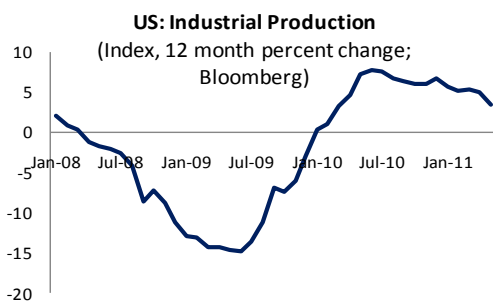
The US: waiting for a sustained pickup in consumption

In the US, activity has been affected by the Japanese earthquake and tsunami which disrupted supply lines for various industries, particularly the automotive sector. Growth has also been dented by higher gasoline prices, which act as an “inflation tax” on overall consumption. The impact of these factors should recede as Japanese supply lines are restored and global oil prices continue to ease back from recent highs (though prices at the pump might prove “sticky”).

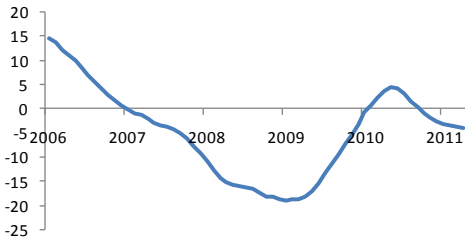
Employment growth remains stubbornly slow, but net jobs are now being consistently added, rather than shed, and hours worked are also increasing. If employment growth continues (albeit hesitantly) and imported inflation begins to ease then real incomes should rise in the second half and give a boost to overall consumption. Exports should also be helped if, as we expect, the US dollar weakens.

Overall, we see US growth easing back to **2.3 percent** this year, well below historical averages. Growth should gather pace to **2.7 percent** in 2012 as employment growth gains traction and consumption becomes more robust.

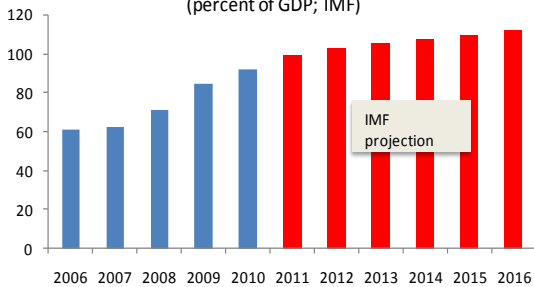
However, there remain serious **structural drags** on the economy. House prices are a key element of overall wealth perceptions—and hence consumption—while housing construction is a major employer.



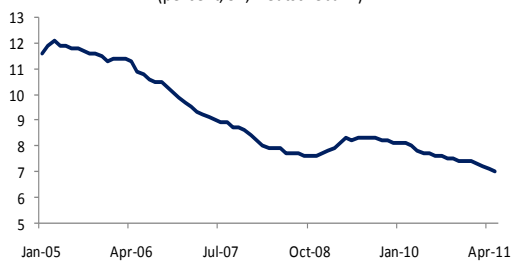
US: Case Shiller Housing Index
(12 month percent change, SA; Bloomberg)



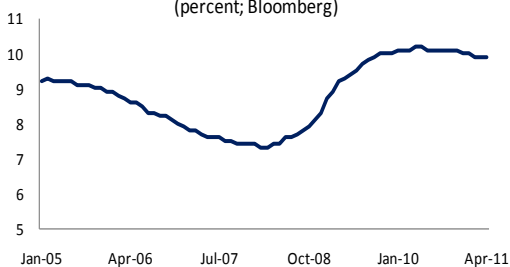
US: General Government Debt
(percent of GDP; IMF)



Germany: Unemployment
(percent, SA; Deutschebank)



Eurozone: Unemployment
(percent; Bloomberg)



Unfortunately, the Case-Shiller index for 20 US cities hit a fresh low in April, and prices have now clearly moved into “double dip” territory (home values have now fallen more from peak to trough than they did in the Great Depression). A recent uptick in housing starts is encouraging, but the large overhang of supply in some states suggests that prices will remain weak for years to come.

Just as ominous is the financial position of both the federal and state governments. Some states are in a dire fiscal position, which will become more apparent when the current fiscal year ends and a good deal of federal assistance is withdrawn. The **federal debt** position is itself problematic. We expect the US Congress to agree to raise the US debt ceiling limit, but appetite to tackle long-term structural fiscal burdens—such as Medicare or defence spending—is still weak. Failure to address these issues is unlikely to impair short-term growth prospects, but will certainly put upward pressure on interest rates in the medium- to long-term.

Eurozone: doing better than expected, but fiscal retrenchment yet to bite

In terms of growth, the eurozone has done better than many expected. Growth in the first quarter of 2011 was 0.8 percent (compared to 0.5 percent in the US), some way higher than consensus forecasts. The performance has much to do with **Germany**, where export growth has been particularly strong (German exporters have taken full advantage of burgeoning demand for high-end manufactured products in emerging markets). German unemployment has been falling and is now at a record low of 7 percent, a trend that should lend support to consumption growth. It is difficult to overstate the importance of Germany to the eurozone economy: German consumption accounts for 15 percent of eurozone GDP, or about the same amount as the entire GDP of Greece, Portugal, Ireland and Spain combined. If the German consumer continues to spend, then this should offer some support to the zone’s generally lacklustre growth outlook.

The German performance (and to a lesser extent activity in other “core” states, such as France and the Benelux) contrasts sharply with that of the “**peripheral**” countries, where economic output is either stagnant or contracting. The prospect of further sharp fiscal retrenchment in order to rein in ballooning fiscal and debt positions, combined with generally poor competitiveness, suggests that growth rates in the periphery will remain depressed for the medium term.

The most pressing structural weakness remains **Greece**, where debt-to-GDP is at an unsustainable level (particularly when the outlook for GDP growth is so poor). Markets see a Greek default on its obligations as a strong probability. We believe that the eurozone authorities should be able to find a path to a “managed” or “soft” default, likely involving the extension of maturities for private bond holders—a scenario that, having been heavily flagged, is likely to be manageable, though not pain-free (see Box 1). Nevertheless, the path is fraught with potential pot-holes, with any mis-handling potentially leading to contagion and a severe and prolonged

tightening of credit conditions across the zone. Moreover, the medium- to long-term outlook suggests that Greece’s debt position is untenable and that a comprehensive restructuring is probably unavoidable. Assuming that the Greece situation is not severely mis-handled, then we expect eurozone growth to reach around **1.8 percent** this year. However, growth is expected to fall back to around **1.6 percent** in 2012 as fiscal retrenchment really hits home.

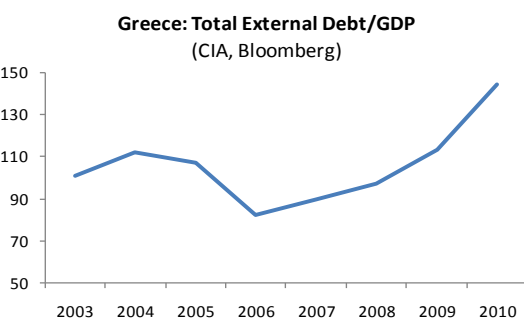
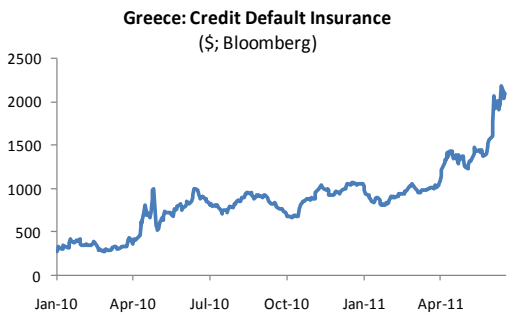
Box 1: What if Greece defaults?

Judged from credit default spreads, markets currently think that there is a 70-80 percent chance that Greece will default on at least some of its obligations. This default could take the form of an “orderly” restructuring of maturities, or an abrupt failure to meet payments of interest and/or principal. Either way, many believe that because a Greek default has already been priced in, it has less chance in isolation of causing widespread financial damage in the eurozone—unlike the bankruptcy of Lehman Brothers, which very few saw coming. This view is buttressed by the fact that a large portion of Greek debt is now held by either Greek banks, the ECB or other eurozone governments. As a result, the face value of other foreign holdings (the part that directly threatens the rest of the financial system) may now be less than €80bn (\$115bn), or 0.2% of global GDP. Banks in Germany and France have the largest direct exposure, but this still accounts for only around 1-2% of GDP in these countries.

But this is not the whole story, and there are good reasons to think that a Greek default might have serious ramifications for the global financial system. First, it is not just the holders of Greek debt that would be affected by a default. US (and UK) banks and other institutions have exposure as providers of credit default insurance, or as holders of bonds issued by European banks. Even an “orderly” restructuring of maturities could trigger payment of credit default insurance. This in turn would likely mean a spike in interbank interest rates, and a possible contraction of credit to the private sector on both sides of the Atlantic.

While a Greek default itself would mean varying amounts of pain depending on whether it was “soft” or “hard”, the bigger danger lies in the risk of **contagion**. The debt and fiscal positions of Portugal, Ireland, Spain and Italy vary, but with markets rattled, their financing costs in private markets would undoubtedly soar to unsustainable levels—quite probably leading to their default. Were this to happen, then a region-wide seizing up of financial markets—and possibly intra-regional trade—would be likely. The global economic recovery would also be in peril since European demand for raw materials and manufactured products (mainly from emerging markets) and services (mainly from North America) would be hard hit. Saudi Arabia would be affected by weaker demand for oil and petrochemicals, though it would probably find that eurozone imports were much cheaper given the likely decline in the euro’s value.

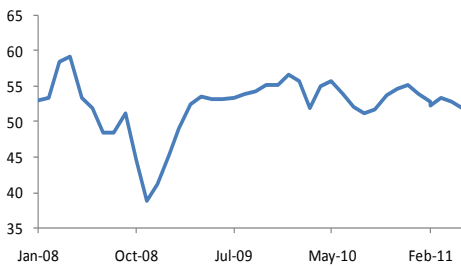
A contagion of this type would take some time to work its way through the system. But even with stability restored, questions about the viability of the eurozone project would clearly be top of the agenda. The countries with the largest debt overhangs are those with the most rigid structural problems.



Resolving these, and making these economies more competitive is the main long-term challenge. In the meantime, politicians in the “core” (typically northern) eurozone countries would have to convince their voters that further large financial transfers to the periphery would be necessary during the adjustment process. Political presentation will therefore be as important as economic reform if a breakup of the eurozone is to be avoided.

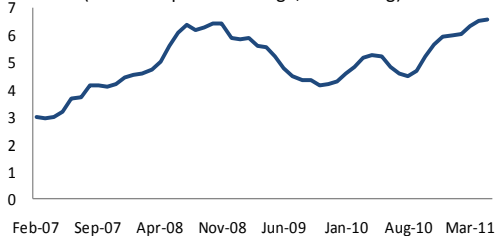
China: Manufacturing PMI

(SA; China Federation of Logistics and Purchasing)



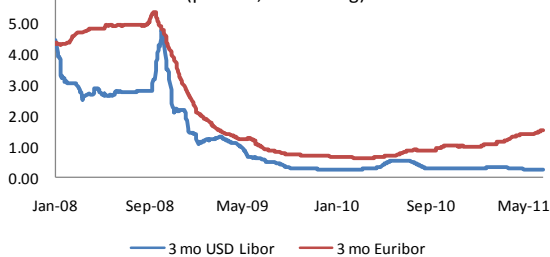
Brazil: Consumer Price Index

(12 month percent change; Bloomberg)



Euribor vs Libor

(percent; Bloomberg)



Emerging Markets: managing their success

Emerging markets have for the most part performed exceptionally well, both during and after the financial crisis. Many EMs are in structurally much better shape than their OECD counterparts, with low debt, comfortable fiscal positions, burgeoning domestic demand (driven in large part by structural factors such as urbanisation) and growing intra-regional trade. They are enjoying brisk rates of GDP growth and the main task for authorities in EMs is to **manage inflation**. In the wake of growing price pressures most EMs have moved into tightening mode—a trend that is likely to continue for the next few months at least. This has already had some impact on domestic demand and growth rates have cooled. Authorities have also been helped by softer global commodities prices, which have helped take the heat out of inflation (albeit with a negative current-account impact since EMs account for much commodity production).

In general, we remain bullish about emerging markets. We expect growth to edge down to a still-impressive average **6 percent** in 2011 as tightening takes effect, rebounding to **6.5 percent** in 2012.

Box 2: Interest rates and currency outlook

In the immediate wake of the default by Lehman Brothers in 2008 central bankers coordinated policy to slash **interest rates** and pump out emergency liquidity. Since then, policy has gradually lost cohesion, with the US sticking to an extremely accommodative stance, while other areas of the world have seen renewed tightening—most notably emerging markets, where inflation has become a significant issue, but also the eurozone.

We think that this division will prevail for the next year or so. Emerging market authorities will continue to adjust interest rates (and currencies) upwards, though the pace of tightening will slow as inflationary pressures stabilise. In July, the European Central Bank raised its key policy rate by another 25 bps. However, the US Federal Reserve now seems likely to keep policy accommodative at least until the second half of 2012—even then, it might keep the Fed Funds rate unchanged, but withdraw liquidity from the system using other methods.

The outlook for the world’s major **currencies** is perhaps more cloudy than usual. Unease about Greece—and more recently Italy—has pushed flows towards the US dollar in recent weeks; nevertheless, yield differentials still favour the euro. We expect eurozone debt concerns to stabilise (or at least become “normalised”) over the next few months and with the ECB having raised rates again, the dollar should resume its weakening path against the

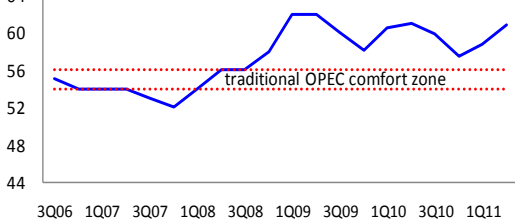
EUR vs USD
(Bloomberg)



euro as we move through the second half of the year and into the first half of 2012. However, Greek debt will most likely need to be restructured at some point over the next year or two (albeit in a “managed” way). With eurozone growth also set to slow next year and the US set to tighten policy, the outlook points to a stronger dollar and weaker euro as we move into the second half of 2012 and into 2013. Beyond this, debt dynamics and economic fundamentals suggest that emerging market currencies should outperform both the euro and the dollar in the medium term.

Saudi Arabia will remain wedded to the US dollar peg for the foreseeable future. Although price pressures remain elevated, inflation is nowhere near the level of 2008 when there was strong pressure (at least from analysts) for a break with the peg. In any case, a flexible currency would only have a partial impact on imported inflationary pressures, while domestically the freedom to raise interest rates would have little effect since private sector credit growth is not currently an important driver of inflation (see Inflation).

Oil: OECD Industry Stocks
(days of forward demand; IEA)



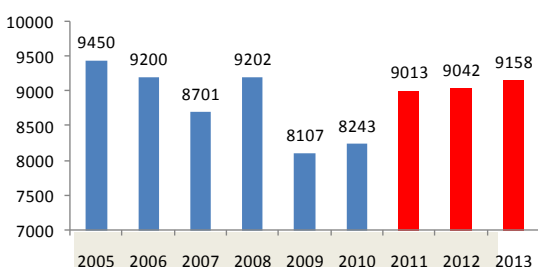
Oil: IEA and Saudi Arabia act to keep markets well-supplied

On June 22 the International Energy Agency (IEA) announced that it would **release 60 million barrels of oil** from strategic stocks in the coming month in response to the ongoing disruption of oil supplies from Libya. This follows the failure of OPEC to agree on a production increase at its June 8 meeting in Vienna. Saudi Arabia, the linchpin of OPEC, subsequently indicated that it would, along with other GCC members, go ahead and raise output to meet demand regardless of the lack of a formal agreement.

While physical markets are currently well supplied, the IEA is concerned that the seasonal surge in oil demand in the third quarter will lead to a sharp tightening that could threaten the still-fragile global economy. In addition, the IEA’s release of 2m b/d during July will provide the kind of oil markets (especially in Europe) actually want, in contrast to the mostly heavy sour crude which makes up Saudi Arabia’s spare capacity.

The IEA is clearly hoping to dampen oil prices, and these duly fell sharply following its announcement, with Brent dropping \$6/b to \$107/b and WTI down \$4/b to \$91.50/b. But with Libya likely to stay off line for some time, and traders still focused on medium to long-term capacity issues, we think prices will probably regain ground and we are holding with our **\$95/barrel** forecast for WTI in 2011 and 2012. A slight increase to **\$100/b** is envisaged for 2013.

Saudi Arabia: Crude Oil Production
(’000 b/d; PFC, Samba)

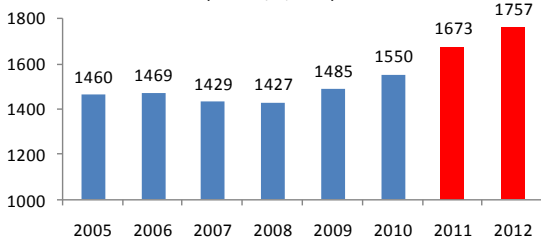


Saudi Arabia: Macroeconomic Forecast 2011-13

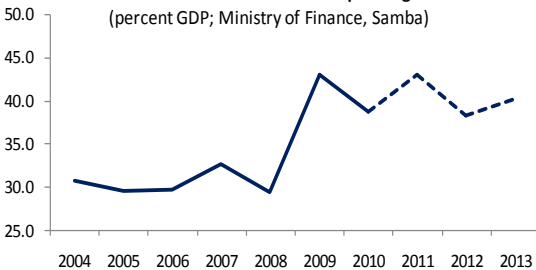
Oil output: set to rise by 9 percent this year

The Kingdom’s stance has seen oil output increase quite sharply this year. According to PFC Energy, output has been ramped up to an average 8.8 million b/d in the first half of 2011, from around 8.3m b/d in the second half of 2010 (May 2011 production was 9.1m b/d according to the firm). We expect output to increase further over the next few months, peaking at

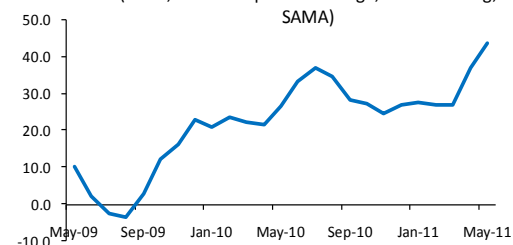
Saudi Arabia: NGL production
(’000 b/d; PFC)



Saudi Arabia: Government Spending
(percent GDP; Ministry of Finance, Samba)



Saudi Arabia: Points of Sale Transactions
(value, 12 month percent change, 3 mo mov avg; SAMA)



around 9.5m b/d, before easing a little in the final quarter. This will give average output of just over **9m b/d**, some 9 percent higher than 2010. Average output in 2012 is likely to increase only slightly (given the high level of stocks) before picking up at a moderate pace in 2013.

Saudi Arabia might be somewhat less concerned than previously about the impact of changes in its crude output levels thanks to significant gains in output of **natural gas liquids** (NGLs). These NGLs, which are sold at a premium, can be produced with impunity as they fall outside the OPEC regime. According to PFC, Saudi NGL output is likely to reach 1.7 million b/d in 2011, an 8 percent gain on 2010.

These increases in crude and NGL output will see hydrocarbons GDP rise by **9.5 percent** in real terms this year—the fastest rate of growth since 2003, when crude output was ramped up during the US invasion of Iraq.

Government spending: set to surge 30 percent this year

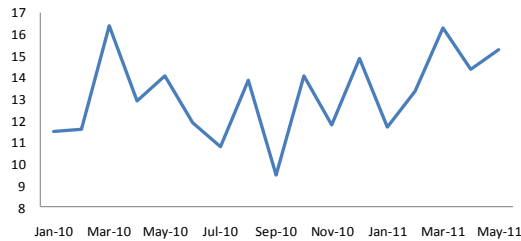
The oil sector will provide the government with a solid platform for a year of exceptional fiscal stimulus. We were already anticipating a year of firm government spending even before King Abdullah’s announcements in February and March of an additional combined **SR460 billion** of spending (our estimate) or 24 percent of our forecast for GDP. Some of the elements in the spending package—housing for example—will take years to fully roll out; however, other features, such as the two months’ additional salary for public sector workers, have already been disbursed. Consequently, we think that around SR195 billion of the pledge will be spent this year. This will push total spending up to a colossal **SR840 billion in 2011** (43 percent of GDP) or more than a third higher than the previous year (in fact, more than twice the level recorded as recently as 2006).

It seems likely that spending will edge down next year—the economy would find it difficult to digest another increase after such a surge in 2011—but it will remain high in historical terms at around 39 percent of GDP. Indeed, it seems to us that government **spending has shifted up a gear** and is likely to stay in a rough 40-45 percent of GDP range, up from around 30-35 percent in the previous decade. Drivers of this shift include higher-than-estimated population growth, urbanisation, rapidly evolving industrialisation, and political considerations. This spending can be accommodated by substantial oil surpluses, but dependence on oil revenue is increasing, not lessening—see fiscal outlook, below.

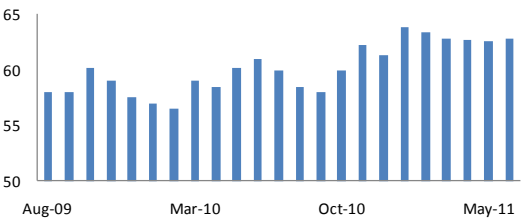
Private sector: demand and output on the rise

The sustained increase in government spending witnessed since the beginning of 2009 has been of enormous support to private sector confidence. This can be measured from both demand (consumers’ spending) and supply (output and investment by Saudi firms). Looking first at demand, it is clear that **Saudi consumers have stepped up spending** quite markedly this year. Data for May put the three month moving average of points of sale transactions (which are a proxy for retail sales) up 44 percent year-on-year

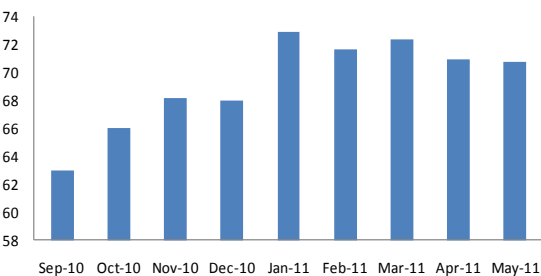
Saudi Arabia: Private Sector Import Spending
(new letters of credit opened, SR bn; SAMA)



Saudi Arabia: Nonoil Private PMI
(50=no change on previous month; HSBC/Markit)



Saudi Arabia: Nonoil Private PMI New Orders
(HSBC/Markit)



in value terms—a trend that seems likely to harden as Saudis continue to spend their salary windfalls.

Most of this spending will “leak out” into imports, which do not count towards GDP growth. Nevertheless, a good deal of spending will find its way towards locally-produced goods and services—especially the latter, since these are often “non-tradeables” (real estate services, accountancy, office cleaning, taxi rides, etc). Further support for the consumption outlook comes from demographic factors, notably population growth (recently revised up to 3.4 percent for 2005-10) and growing urbanisation.

Businesses have also been busy. The most detailed series for corporate activity comes from the Markit purchasing managers’ index (PMI). These data are based on a survey of purchasing managers in around 400 Saudi firms, weighing a number of factors such as the level of output, new orders, purchases, input prices, employment, inventories, and suppliers’ performance on a month-to-month basis. A number above 50 denotes expansion of activity, while below 50 signals a contraction.

The overall index has been trending down so far this year. This is unsurprising given regional political concerns, which have acted as a drag on private investment to a certain extent. Nevertheless, the index remains well above the 2010 average, and edged up again in June (to 62.8), with respondents continuing to paint a picture of **robust expansion in output, new orders, and employment**. Most of the new orders have come from the government, according to respondents, though export demand (mainly for petrochemicals and steel) has also hardened. The increase in employment is particularly encouraging, with 20 percent of respondents saying that staff numbers at their firm had increased in May compared to April (employment data were unavailable for June). The bulk of new hires are likely to have been expatriates, who tend to save more and spend less, but new legislation may encourage firms to tap deeper into the Saudi national market (see Box 3, below).

Box 3: New employment regulations

The Ministry of Labour has unveiled a new plan called *nitaqat*, aimed at weaning private sector firms off expatriate labour. The ministry will initially categorise companies either as “excellent”, “green”, “yellow” or “red”, based on the proportion of Saudi nationals they employ. Companies rated in the “excellent” or “green” categories would be allowed to hire expatriate staff directly from those that fail to meet the required standards, while also benefitting from faster visa approvals. In addition, some 70 categories of professions currently limited to Saudis would be opened up to expatriates. Conversely, there will be severe penalties for companies falling in the “red” category, such as the inability to renew their current expatriate labour licenses or hire new expatriate labour. The new plans are expected to become operational in September.

The new system marks a certain degree of evolution of Saudiisation: *nitaqat* allows smaller firms a greater proportion of expatriate workers, and, though the penalties for noncompliance are onerous, they might encourage private

companies to invest more in training, raise wages and improve other benefits. Against this, there is clear potential for small firms to suffer, given that the marginal cost of hiring a national will be higher for them than for a larger firm. And, if they fail to meet the targets, the penalties might be enough to send them out of business (note that a more lenient system for companies with fewer than ten employees is likely to remain in place). This is potentially a major concern, since SMEs are the backbone of all successful economies, and are in fact the main driver of employment growth in the Kingdom (albeit largely of non-Saudi employment growth). Quota regimes of this type also have the potential to deter foreign direct investment, which is an important potential source of employment growth and technology transfer.

Nevertheless, if *nitaqat* does serve to enhance labour market flexibility for those firms that meet the quota requirements, then it will mark a step forward—particularly as it is being combined with continued focus on enhancing education and skills among Saudi nationals.

Overall growth: moving into “BRIC” territory

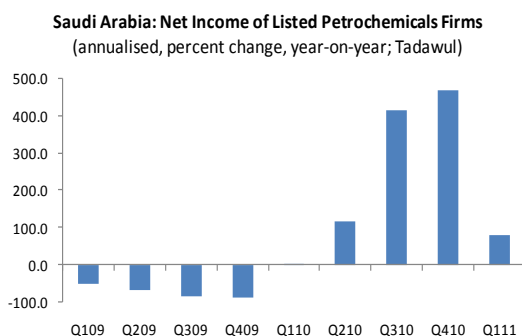
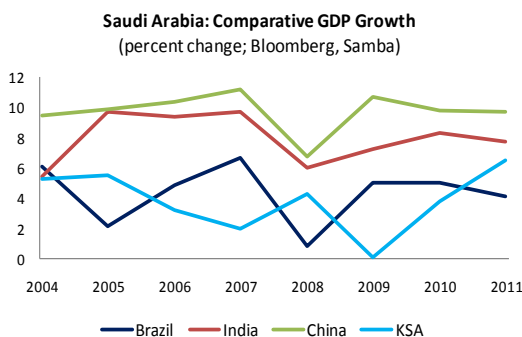
All this points to robust overall economic growth in 2011. We think real growth will reach **6.5 percent** this year, the highest level since 2003, and comparable to the rates seen in the most dynamic emerging markets. Next year we expect some moderation in growth to **4 percent**. However, this largely reflects the levelling off of crude oil output; **the nonoil sector should continue to thrive**, growing by 5.2 percent (down from 5.4 percent in 2011). A recovery to 4.5 percent overall growth is envisaged for 2013 as the nonoil sector continues its 5 percent-plus rate of expansion and oil output edges up once more.

GDP per head is set to reach around **\$18,300** this year, climbing to \$19,300 by 2013. GDP per head has doubled in less than ten years.

Key sectors: Construction, Petrochemicals, Retail

Which sectors are likely to do well? **Construction and contracting** firms will continue to benefit from robust public infrastructure investment, especially in refining, power, transport and education. As ever, Saudi Aramco will be a major source of contracts, and Saudi contractors—particularly in the Eastern Province—are awaiting a more sustained flow of gas-related contracts as we move through the year. Saudi contractors do face some challenges: the increasing involvement of Chinese firms—which tend to source all material and personnel themselves—and the introduction of new caps on expatriate labour for example, but in general the sector should continue to thrive.

Petrochemicals firms should also continue to do well, with East Asia’s demand for basic chemicals apparently insatiable. Nevertheless, they too face challenges, such as possible moves to raise the price of gas feedstock (as well as the more general scarcity of gas). The feedstock issue points to some narrowing of the field in the medium term, with Saudi Aramco best placed to take full advantage.



With Saudi consumers spending briskly, the **retail** sector (including restaurants) should also continue to do well. However, performance is likely to vary, with medium- to large outlets continuing to flourish, but “hypermarkets” still struggling to gain traction. Meanwhile, smaller outfits might find the *nitaqat* employment quotas burdensome. In terms of malls, existing outlets are doing well, but there is overcapacity in the sector, and substantial fresh investment is unlikely this year.

Inflation: lower than anticipated, but pressures still building

The headline rate of inflation in H1 2011 has not been as strong as we were anticipating and we have lowered our overall forecast for average inflation this year. Nevertheless, price pressures are still present and are set to build again in the second half of 2011.

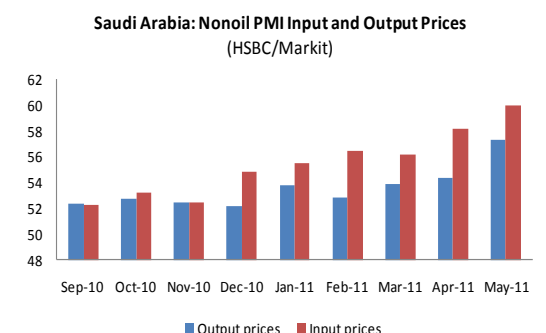
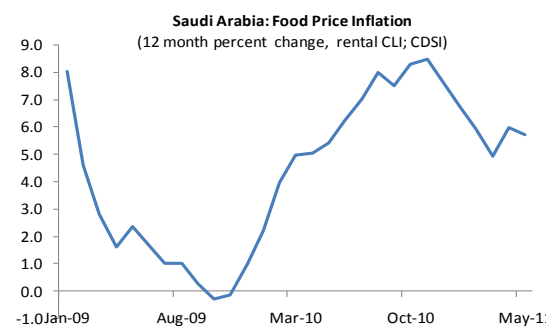
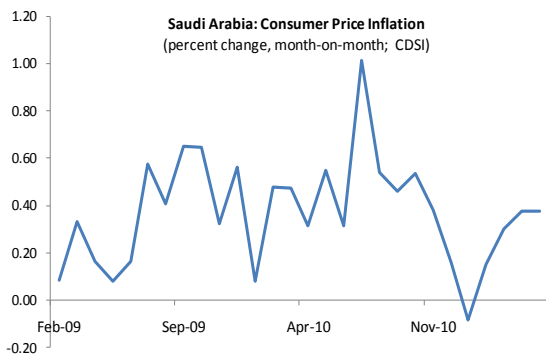
There are three main drivers of inflation in Saudi Arabia: international food prices; trading partners’ inflation; and domestic rents. Taking each of these in turn:

The outlook for **global food prices** is always uncertain, given the vagaries of global weather and the pronounced impact that drought or flood can have on international grains prices. Yet we think that increases in Saudi Arabia’s food price index will soften appreciably in the second half of 2011, mainly because of base effects (food prices climbed steeply in the second half of 2010 and they would have to accelerate significantly in the second half of this year to register major year-on-year gains). Beyond this, prospects for better harvests in the northern hemisphere suggest that global wheat prices might continue to soften (Saudi Arabia remains heavily dependent on imported grains). Additional subsidy spending by the government will also help to dampen food price inflation.

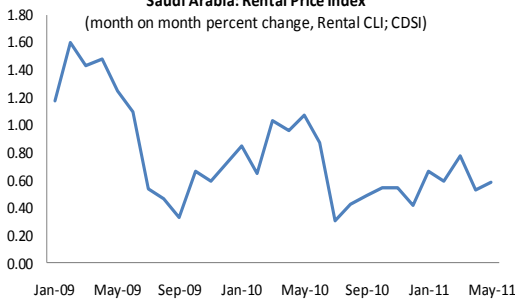
It is clear that **trading partners’ inflation**, which could also be described as general imported inflation, is already an issue. The Markit PMI shows a sharp pickup in input prices for Saudi firms, which remain heavily dependent on imports of raw materials and other commodities for their production. Some 23 percent of respondents reported higher purchase prices in May compared to April. Just as tellingly, firms also reported higher output prices as they attempted to maintain profit margins (17 percent of respondents reported higher output prices in May).

There are two main factors at play here. First, global commodity prices are higher than they were a year ago, and this feeds directly into raw materials’ prices. Second (and intimately related to this) the US dollar has continued to weaken: when measured against the currencies of the US’s main trading partners, the dollar has fallen 4.5 percent so far this year. For Saudi Arabia, with its fixed peg to the greenback, there has therefore been a “double hit” of higher commodity prices and a weaker exchange rate.

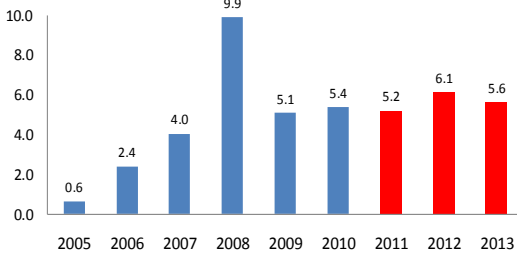
The outlook for trading partners’ inflation is mixed. Commodity prices have come off recent highs in the wake of portfolio rebalancing and signs of a slowdown in global economic activity. Yet the consensus is for renewed commodities’ strength in the second half of the year in line with an expected



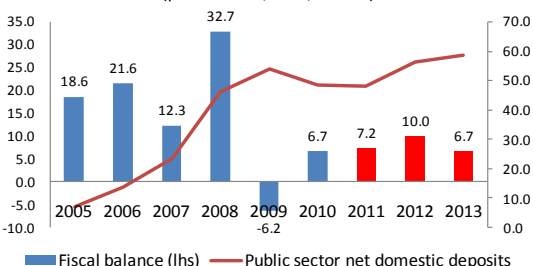
Saudi Arabia: Rental Price Index
(month on month percent change, Rental CLI; CDSI)



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



Saudi Arabia: Fiscal Outlook
(percent GDP; MOF, Samba)



pickup in economic activity. The outlook for the dollar is particularly difficult to discern, but on a trade-weighted basis we would expect further gentle weakness given higher interest rates in both the eurozone and most emerging markets.

Rents will provide the main domestic driver of price pressures. King Abdullah’s focus on expanding the domestic housing stock will pay dividends, but only in the medium term; for the moment, the domestic economy is expanding at more than 5 percent, while the existing housing stock remains largely static. Consequently, rents are likely to continue to rise.

Beyond these core drivers of inflation, more general price pressures will be generated by the substantial government transfers made to Saudi citizens. Some of the additional two months’ salary payments has been saved, and some used to pay down debt, but as the points of sale data show, a fair amount is being spent at the shops. As noted above, much of this will be channelled towards imported goods, but there will inevitably be additional demand for domestic goods and services too.

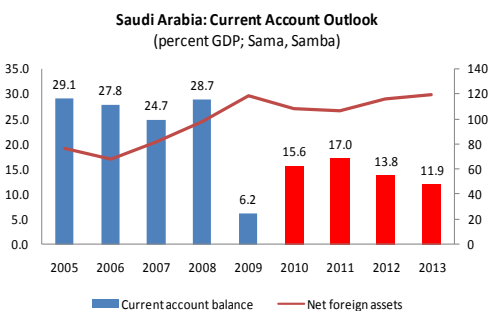
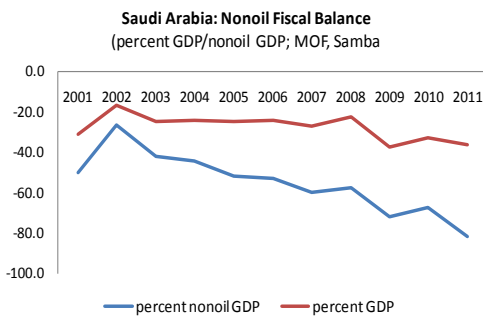
Given these pressures, it is somewhat surprising that the official CPI has not shown a greater increase in H1 2011. It may be that the government has stepped up spending on subsidies more forcefully than we were anticipating, or that retailers are choosing to absorb more of the increase in costs. Either way, it seems likely that average inflation this year will be weaker than we had initially expected, at **5.2 percent** this year, down from 5.4 percent in 2010.

Nevertheless, the fundamental drivers of higher prices have not changed, and we still see quite strong price growth in H2 2011 and into next year. Inflation is set to average **6.1 percent** in 2012 as brisker global economic activity pushes commodity prices higher again, and domestic rents continue to track higher. Positive risk comes from the outlook for the euro, which could weaken sharply against the dollar if debt management begins to unravel. This would provide some relief to Saudi Arabia since the eurozone remains a major import market.

We expect the rate of inflation to fall back to **5.6 percent** in 2013 as additional housing stock begins to come on line, which should help to calm rental inflation. A tighter global interest rate environment and stronger dollar should also help cool imported inflation. It is important to note that changes in domestic interest rates are unlikely to have a marked impact on inflation: domestic banks are extremely liquid, meaning that changes in interbank borrowing costs are unlikely to materially affect their willingness to lend, at least in the short run. In any event, regulatory caps have reduced the importance of consumer credit as a channel of inflationary pressure.

Fiscal outlook: positive on one level, but structural issues are a concern

The outlook for the fiscal position remains comfortable, at least from the “top line” perspective. Crude oil revenue is set to rise by 33 percent this year, following last year’s 47 percent gain. Crude revenue is expected to



flatten out in 2012-13, but overall revenue should be boosted by growing contributions from other hydrocarbons sources, such as NGLs. Non-hydrocarbons revenue sources, such as fees and charges, are also likely to grow in line with the buoyant domestic economy. noted above, expenditure is set to surge this year, and stay high in 2012-13. But even allowing for this, revenue gains will be enough to allow fiscal surpluses of an average **8 percent of GDP** over the 2011-13 period.

Structurally, however, the fiscal position is not so positive. Expenditure growth over the past decade has been pronounced, averaging 13 percent a year during 2002-11 versus just 2 percent in the previous ten-year period. This growth has increased the dependence on oil revenue, a relationship that is best captured by the increase in the nonoil fiscal deficit. The nonoil fiscal deficit as a percentage of nonoil GDP has increased from around 25 percent in 2002 to a projected **82 percent** in 2011. Clearly, an oil-based economy will always have a large nonoil fiscal deficit, but the rapid deterioration in this position is of concern since it increases the vulnerability of the government to any pronounced and sustained downturn in oil prices. We are certainly not anticipating any such downturn, but the vulnerability remains. Moreover, the vulnerability can become more pronounced with additional current spending commitments, since these, unlike capital spending, can become entrenched and be difficult to reverse.

Current-account outlook: large surpluses forecast, but structural issues mirror those on the fiscal side

To a large extent, the current-account outlook mirrors that of the fiscal account. Robust oil export earnings will allow substantial current-account surpluses in the region of **14 percent of GDP** over the next three years, allowing a further build-up of net foreign assets, which we expect to reach about **\$700 billion** by end-2013 (120 percent of GDP). As with the fiscal channel, the balance of payments remains vulnerable to a sharp and sustained downturn in oil prices given the sustained growth of import spending over the past decade (16 percent annual average growth). Nevertheless, the stock of NFA provides a substantial buffer to maintain balance of payments equilibrium should the need arise.

Saudi Arabia: Baseline Macroeconomic Forecast	2008	2009	2010	2011f	2012f	2013f
Nominal GDP (\$ bn)	473.0	369.7	431.5	520.8	544.5	588.5
GDP per capita (\$ '000)	18338.5	13868.0	15657.1	18275.9	18479.9	19314.6
Real GDP (% change)	4.3	0.1	3.8	6.5	4.0	4.5
Hydrocarbon GDP	4.2	-7.6	2.1	9.5	1.0	2.5
Non-hydrocarbon GDP	4.3	3.5	4.4	5.4	5.2	5.3
Nominal GDP (% change)	23.8	-21.8	16.7	20.7	4.6	8.1
Hydrocarbon GDP	37.1	-38.8	25.0	31.0	1.0	7.4
Non-hydrocarbon GDP	7.5	4.7	9.1	9.9	9.0	8.9
Commercial bank deposits (SR bn)	846.1	940.5	984.9	1169.7	1376.2	1637.3
% change	15.4	11.2	4.7	18.8	17.7	19.0
Commercial bank loans (SR bn)	766.6	762.3	808.1	939.6	1093.7	1263.2
% change	24.6	-0.6	6.0	16.3	16.4	15.5
3 month deposit rate (end year, percent)	2.9	0.8	0.7	0.7	1.0	1.8
CPI inflation (% change, average)	9.9	5.1	5.4	5.2	6.1	5.6
Hydrocarbon exports (\$ bn)	281.4	163.3	215.2	282.9	278.1	291.1
% change	36.9	-42.0	31.8	31.4	-1.7	4.7
Current account balance (\$ bn)	135.9	22.9	67.5	88.5	75.0	70.0
(% GDP)	28.7	6.2	15.6	17.0	13.8	11.9
External debt (\$ bn) ¹	79.5	86.1	77.5	81.4	85.4	89.7
(% GDP)	16.8	23.3	18.0	15.6	15.7	15.2
(% current account receipts)	23.1	38.8	27.7	23.1	24.4	24.0
Fiscal revenue (SR bn)	1100.0	509.5	735.0	980.5	984.7	1031.4
(% change)	71.1	-53.7	44.3	33.4	0.4	4.7
Fiscal spending (SR bn)	520.0	595.0	626.5	839.1	780.1	884.3
(% change)	11.5	14.4	5.3	33.9	-7.0	13.4
Fiscal balance (SR bn)	580.0	-85.5	108.5	141.4	204.6	147.1
(% GDP)	32.7	-6.2	6.7	7.2	10.0	6.7
Public sector deposits with banking system (SR bn)	1056.0	923.1	992.6	1134.0	1338.6	1485.6
(% GDP)	59.6	66.7	61.4	-	-	-
Public sector gross domestic debt (SR bn)	241.9	182.3	214.0	-	-	-
(% GDP)	13.7	13.2	13.2	-	-	-
Public sector net deposits with banking system (SR bn)	814.1	740.8	778.6	934.0	1138.6	1285.6
(% GDP)	46.0	53.5	48.2	47.9	55.8	58.3
Memoranda:						
Oil price (WTI; \$/barrel)	100.0	62.0	78.0	95.0	95.0	100.0
Crude oil production (m b/d)	9.2	8.1	8.2	9.0	9.0	9.2
Net Foreign Assets (\$ bn)	463.5	435.6	466.6	555.2	630.2	700.1
(% GDP)	98.0	117.8	108.1	106.6	115.7	119.0

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

Sources: SAMA; Ministry of Finance and National Economy; Samba.

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