March 2011

Royal decrees, regional unrest and the economy

The Middle East is going through a period of turmoil that is affecting the economies of all countries in the region, regardless of whether they have touched by unrest. In response, oil prices have shot up and foreign investors have become more cautious. At the same time, two royal decrees have been issued in the Kingdom that entail large new spending commitments. These events have caused major changes to a number of our economic forecasts. Economic growth will be faster, oil revenues higher and government spending greater than we had previously anticipated.

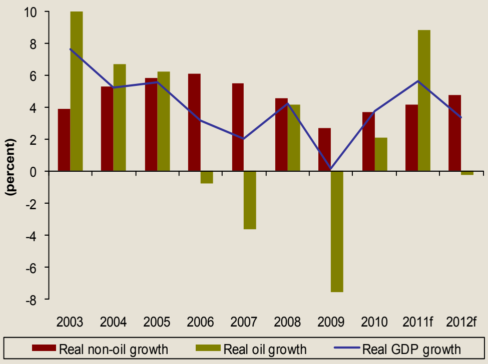
Saudi Arabia has drawn down some of its spare oil production capacity to compensate for a shortfall in Libyan output and we expect the Kingdom's production to be around 7 percent higher in 2011 than it was last year. Nonetheless, there remains a large risk premium attached to oil prices, which have returned to over $100 per barrel. Although oil prices are probably close to their peaks, they are likely to stay elevated for much of the year. With regional tension set to ease, we expect oil prices and production to fall in 2012.

The two royal decrees issued over the past month will boost economic performance. A huge allocation to increase the provision of housing will not only yield large social benefits, it will support strong growth in construction and related industries for a number of years to come. Other polices announced will lift the income, and therefore the spending power, of Saudi nationals, with a focus on those less well off. We have therefore nudged up our forecast for non-oil GDP and project total real GDP growth at 5.6 percent this year, the highest since 2005.

Higher oil revenues mean the new government spending, which will be spread over several years, can be absorbed without the budget moving into deficit. Increased oil receipts will push the current account surplus close to 20 percent of GDP. The inflationary impact of greater consumer spending should be manageable and partially offset by the prospect of more housing. Once the housing supply starts to enter the market, it will play large role in cutting inflation.

The course of events in the region is uncertain. It is clear that for this year economic growth for the region as a whole will slow, which will hit the Kingdom's non-oil exports and potentially the number of religious tourists. All investors are unnerved by events across the region and foreign investors in particular will show greater caution no matter where they are investing and expect a higher risk premium. Although the royal decrees provide an important stimulus to the economy, the longer the regional tensions linger, the tougher it will be to fully restore the confidence of the private sector, which is key to creating sustainable jobs across the region.

Real GDP growth



For comments and queries please contact the author:

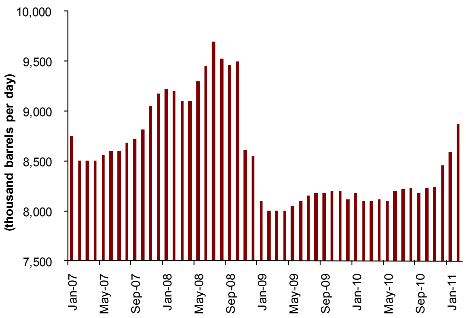
Paul Gamble
Head of Research
pgamble@jadwa.com

or:

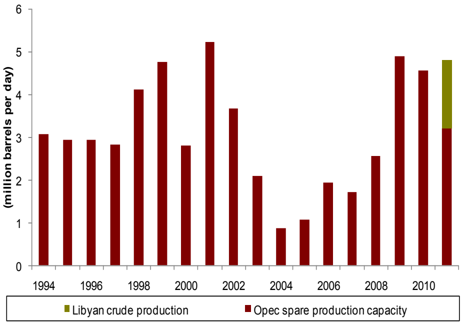
Brad Bourland, CFA
Chief Economist
jadwaresearch@jadwa.com

Head office:
Phone +966 1 279-1111
Fax +966 1 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com

Saudi oil production



Opec spare production capacity



Economic growth

Economic growth is now forecast to hit 5.6 percent this year, the highest since 2005. This is primarily because of higher oil production. The Kingdom has increased oil output to compensate for the disruption to Libyan production. We have also raised our projection for non-oil private sector growth, as spending contained in the two royal decrees will be sufficient to offset a weaker regional economy and reduced foreign investor appetite. Based on our view that regional tension will ease, we expect oil production to fall in 2012, so despite the continuing impact of the government housing program, we forecast that real GDP growth will slow to 3.4 percent.

Oil sector

Saudi Arabia is the only country in the world with significant spare oil production capacity and it has drawn down some of this capacity to make up for the shortfall in Libyan output. The Kingdom does not issue oil production data, but independent estimates generally point to a notable rise so far this year. The closest estimate of Saudi production comes from the Joint Oil Data Initiative website, run by the International Energy Forum (and based on data supplied by producer and consumer countries), but this is only up to January, when it shows a 150,000 barrels per day increase from the December figure to 8.5 million barrels per day.

Data for February are mixed, with that from Reuters and Bloomberg putting production at only a little above the January level, but Opec having it at around 8.9 million barrels, a level that other secondary sources indicate has been maintained in March. We assume that output is in line with the Opec data and that production will stay at this level for several months.

According to reports there has so far been little damage to Libya's oil export infrastructure, so there is potential for the country to rapidly increase exports once the security situation calms, though it is unclear when this will be. With global demand growth still likely to expand and uncertainty over the resumption of Libyan production, we have raised our forecast for average oil production in 2011 to 8.8 million barrels per day. We assume that oil production will fall in 2012 owing to greater stability in the region. The Kingdom's current spare oil production capacity is around 2.5-3.5 million barrels per day, sufficient to cover for a shortfall in production from other regional producers.

Private sector

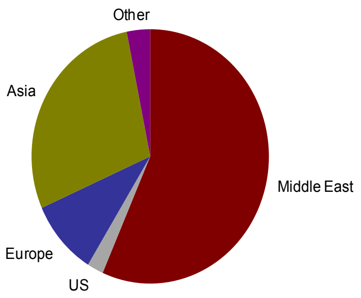
We have raised our forecasts for non-oil private sector growth. The new spending contained in the royal decrees will be sufficient to offset a weaker regional economy and reduced foreign investor appetite. The beneficiaries of the new government policies are concentrated in a few areas, primarily construction and retail; other companies will find conditions tougher.

Recent events have caused adjustments to our non-oil growth forecasts to take account of the following factors:

Huge new construction spending: In the royal decrees the government committed itself to spend SR250 billion on building 500,000 new houses over an unstated period. This will stimulate strong growth in the construction sector and related industries (such as suppliers of construction materials machinery and utilities) and services (architects, plumbers, etcetera). Increasing both the capital of the Real Estate Development Fund and the maximum amount it can lend will also broaden home ownership. This generates important economic gains, both in the short-term (the purchase of furniture and fixtures) and the long-term (the ownership of an asset that accumulates value and can be used as collateral).

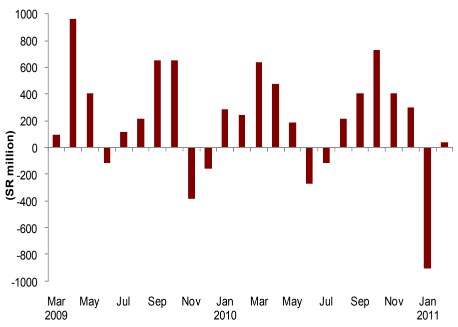
Greater consumer spending: A bonus for all government employees and probably many private sector employees, and higher welfare payments are expected to result in a jump in consumer spending. The largest proportionate gains from the government's spending packages will be enjoyed by those on low incomes, who tend to spend a greater share of their income than those on higher incomes. The retail sector will be the clear beneficiary of the rise in consumers' expenditure. The trickle down beyond this will depend on the goods that are in demand. It is highly likely that the bulk of spending will go on imported goods.

Destination of non-oil exports
(percent)



Weaker regional economic environment: The economies of all countries in the region are being affected by the unrest, even if they are not facing any protests, owing to greater uncertainty hitting investor and corporate confidence. For those countries that experience political change or major protests, the economic effects will be large and long lasting. This will clearly impact local companies with operations in those countries. Weaker economic growth in the region will also reduce demand for Saudi exports; the Middle East and North Africa was the destination for 57 percent of the Kingdom's non-oil exports in 2009 (or 42 percent excluding re-exports). Furthermore, the region accounts for a large number of the religious tourists that visit the Kingdom.

Net purchases through the swap agreement



Lower foreign investment: Foreign investors have been unnerved by events in the region and are demanding a higher risk premium for investment across the region, regardless of the country specifics. Foreign investors through the swap agreement pulled a large amount out of the stock market in January, though there was a small net inflow in February, and other indicators of foreign investor sentiment towards the Kingdom, such as exchange rate forwards or the very lightly traded credit default swaps, show an elevated level of caution. We have yet to detect an impact on direct investment. The Kingdom has clear advantages in the natural resources sector that will not be diminished by regional uncertainty, but postponements of some projects and the derailment of smaller investments elsewhere in the economy is possible.

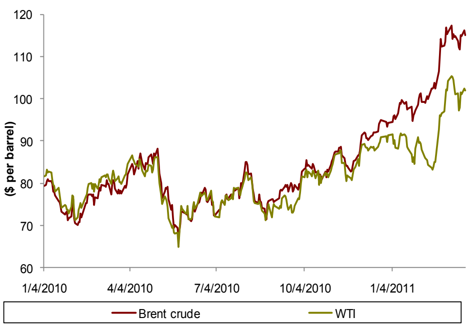
Higher costs: Many companies in the private sector are likely to offer some form of additional compensation to their employees and some large companies have already agreed to provide a bonus of two month's salary, matching the award to government workers. Few companies in the private sector are in as healthy a financial position as the government and the higher compensation could damage competitiveness unless it can be offset, for example by reduced zakat payments or GOSI contributions. In addition, under the royal decrees private sector companies will face tougher enforcement of Saudiization and stricter monitoring to prevent unreasonable price rises. Furthermore, higher oil prices have lifted transportation costs for imported goods and the prices of some raw materials have risen.

Oil prices

Regional unrest has caused oil prices to surge. Brent crude jumped from $94.2 per barrel at the end of last year to a peak of $117.4 per barrel on March 7, for WTI the gain was from $91.4 per barrel to $105.4 per barrel. While there has been some disruption to production, with much of Libya's output now offline, extra output from the Kingdom has compensated for this shortfall. Instead, the rise in prices reflects precautionary buying and the risk premium buyers are prepared to pay given their concerns about the potential spread of the troubles to areas where it would have more impact on oil production or on the transportation of oil to major consumer countries.

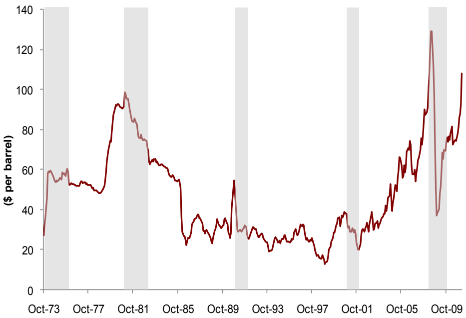
Oil stocks are still high throughout the world, but with uncertainty over production, consumers will require a much greater reserve cushion than usual while tension lingers in the Middle East. Based on our view that regional tensions will ease, but not disappear, we think the risk premium in oil prices is likely to gradually head lower over the remainder of the year. In addition, Opec has already informally increased production, led by Saudi Arabia, and should there be a larger disruption to output or a further spike in prices we expect Opec to formally increase production quotas.

Oil prices



We have raised our 2011 average oil price forecasts to $97 per barrel for Brent crude and $89 per barrel for WTI. With higher Opec production, and greater political certainty reducing the need for precautionary holdings, we have kept our 2012 oil price forecast unchanged, and expect an average of $88 per barrel for Brent crude and $85 per barrel for WTI.

Real oil price and global recessions
(recession is shaded area)

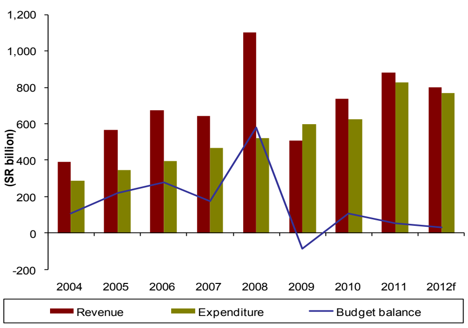


The chart to the left shows that a jump in oil prices preceded the last five global recessions (the oil price in the chart is adjusted for inflation). However, there were generally many other factors behind the economic downturn and while it is likely the global economy would grow faster if prices were lower, we assume that at our forecast level oil prices will not have a great impact on global economic growth or demand for oil. We still expect that the performance of the global economy will be supportive for the Saudi economy.

Budget

Recent events have prompted substantial changes to our forecasts for the government budget. Two massive supplementary spending packages have been announced with a total value put at SR500 billion. Not all of this money will be spent this year; the largest component of new spending is SR250 billion for public housing, which is certain to be spread of a number of years. Nonetheless, there will be a substantial increase in government spending in 2011 and expenditure over the medium term will be greater than we had previously anticipated. However, with both oil prices and oil production also set to be well above our earlier forecast, we think that there will still be a budget surplus in 2011 and 2012.

Government finances



Of the SR500 billion total for the government spending packages, explicit allocations totaling SR350 billion were contained in the royal decrees (see table). While it is difficult to determine the cost of many of the other components, we can identity at least a further SR100 billion of spending. The main components of this are the two month's additional government salary, which we estimate costs around SR40 billion and the 15 percent pay rise, worth around SR32 billion, based on government payroll data.

Key new spending commitments

Item	Allocation (SR billion)
Construction of 500,000 residential units	250
New funding for Real Estate Development Fund	40
Increase in capital of Saudi Credit Bank	20
Additional allocation to Ministry of Health	16
Support for General Housing Authority	15
Other funded commitments in February 24 package[1]	7.8
Other funded commitments in March 18 package[2]	1.75
Total	**350.55**
Other major items of new spending	
Additional two month's salary for government employees	
Fifteen percent pay rise	
Introduction of public sector minimum wage	

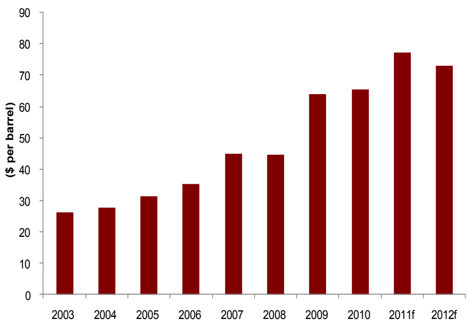
[1] Includes allocations to support those on low incomes and broaden social services.
[2] Includes allocations for construction and renovation of mosques and support for religious institutions.

Not all of the expenditure will take place immediately. Some items, such as the transfer to the Real Estate Development Fund and the payment of the two month's salary, can occur quickly, but others will take more time. Given the need to register and determine the eligibility of benefit seekers, the first unemployment benefit payment will not be made until the end of November. For the construction of residential units, it will take some time to establish the location, draw up the plans and engage the contractors, so we assume that only a fraction of the total will be spent this year and the balance will be spend over at least the next five years.

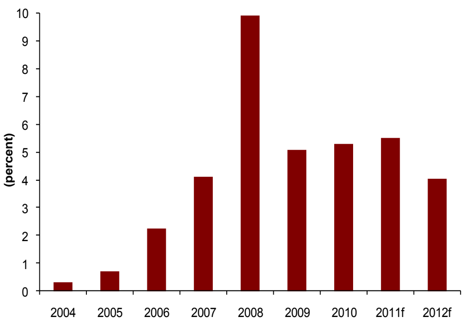
Government spending will fall in 2012 as the two month's salary, funding for the Real Estate Development Fund, Saudi Credit Bank and General Housing Authority and additional allocation to the Ministry of Health are assumed to be one-time items, as are many of the smaller components of the package. For others it will be difficult to remove. For example, we have not adjusted our forecasts to take account of the permanence of the 15 pay adjustment for public sector employees, as we did not foresee this being withdrawn.

Higher oil revenues will be sufficient to ensure that the budget stays in surplus in 2011 and 2012 despite the large additional spending. We forecast a surplus of 2.8 percent of GDP this year and 1.7 percent of GDP in 2012. We estimate it will require an oil price of $77 per barrel (for Saudi export crude; $81 per barrel for Brent) to balance the budget this year. For 2012 the breakeven oil price falls to $73 per barrel (Saudi export crude). Unless the government takes measures to reduce spending, then absent an ongoing increase in production, we assume this breakeven price will rise in subsequent years. The government's vast stock of foreign assets, which were at an all-time high of $445 billion at the end of January, means that it should be able finance any budget deficits for many years to come.

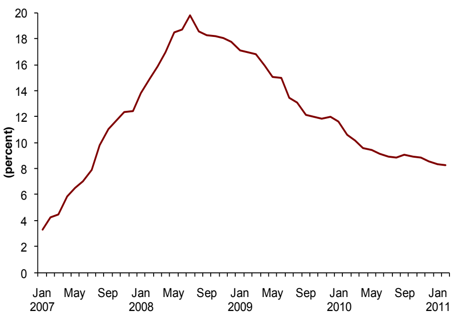
Oil price needed to balance the budget



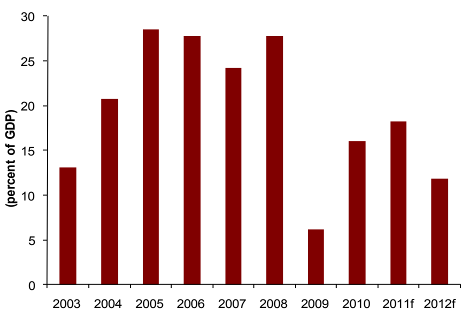
Inflation



Rental inflation



Current account balance



Inflation

Over the short-term we think that inflation will be slightly higher than we had previously anticipated owing to much greater consumer spending, but over the medium term the increased provision of housing will reduce inflationary pressures markedly. The additional two month's salary given to public sector employees will trigger similar awards to the private sector and combined will cause a significant increase in spending in 2011. The payment of unemployment benefit from November will also boost spending, as people on low incomes tend to spend more as a proportion of total income than those on higher incomes. While there were other factors involved, the 15 percent government pay rise in August 2005 probably contributed to the subsequent period of rising inflation (the inflation rate rose in 28 of the following 34 months).

Higher consumer spending is likely to put upward pressure on the price of consumer goods, many of which are imported. Elevated oil prices are adding to transport costs, which will probably also be passed on to consumers in the form of higher prices for imported goods. However, we do not foresee exchange rate moves adding to imported inflation and unlike on previous occasions the rising oil price is not being accompanied by a period of dollar weakness.

Offsetting this, the much greater provision of housing by the government will lower rental inflation, the main source of inflation in the Kingdom. While it will take some time for the first properties to be available for people to move into, the anticipation of a large new supply of housing is likely to discourage those on lower incomes from entering the property market and encourage others currently looking for property to postpone their search. It could therefore have a quick impact on rents, though the additional funds awarded could put some prices pressures to other segments of the rental market. Once the new housing becomes available in large quantities, likely to be 2013 or 2014, there will be a notable fall in rental inflation. We have nudged up our inflation forecast for 2011 to 5.5 percent from 5.3 percent and cut our 2012 prediction to 4 percent from 4.4 percent.

Current account

Higher oil revenues will result in a much larger current account surplus than we had previously anticipated in 2011. Oil export revenues are forecast to reach $243 billion this year, the second highest on record, lifting the trade surplus to $181 billion and the current account surplus to $93 billion. Non-oil exports are also expected to rise owning to higher petrochemical prices. The widening trade balance takes into account the likelihood of higher imports of both consumer goods and construction raw materials and machinery. Over the next few years, the planned massive increase in housing will have a negative impact on the current account. In addition to the need to import the necessary materials, equipment and related specialist services, there is likely to be an increase in the number of expatriate workers required to build the housing, who will probably remit the bulk of their income. We therefore see the current account surplus falling fairly rapidly from 2012.

Key data

	2004	2005	2006	2007	2008	2009	2010E	2011F	2012F
Nominal GDP									
(SR billion)	938.8	1182.5	1335.6	1442.6	1786.1	1397.5	1630.0	1910.9	1909.2
($ billion)	250.3	315.3	356.2	384.7	476.3	372.7	434.7	509.6	509.1
(% change)	16.7	26.0	12.9	8.0	23.8	-21.8	16.6	17.2	-0.1
Real GDP (% change)									
Oil	6.7	6.2	-0.8	-3.6	4.2	-7.6	2.1	8.9	-0.2
Non-oil private sector	5.3	5.8	6.1	5.5	4.6	2.7	3.7	4.2	4.8
Government	3.1	4.0	3.1	3.0	3.7	5.2	5.9	5.0	5.0
Total	5.3	5.6	3.2	2.0	4.2	0.2	3.8	5.6	3.4
Oil indicators (average)									
WTI ($/b)	41.5	56.6	66.1	72.3	99.7	62.0	79.5	89.0	85.0
Saudi ($/b)	34.7	49.5	60.5	68.1	93.4	60.5	77.7	91.7	85.0
Production (million b/d)	9.0	9.5	9.2	8.7	9.2	8.1	8.2	8.8	8.7
Budgetary indicators (SR billion)									
Government revenue	392	564	674	643	1101	510	735	882	801
Government expenditure	285	346	393	466	520	596	627	829	769
Budget balance	107	218	280	177	581	-87	109	53	32
(% GDP)	11.4	18.4	21.0	12.2	32.5	-6.2	6.7	2.8	1.7
Domestic debt	614	475	366	267	237	225	167	160	160
(% GDP)	65.4	40.2	27.4	18.5	13.3	16.1	10.2	8.4	8.4
Monetary indicators (average)									
Inflation (% change)	0.3	0.7	2.3	4.1	9.9	5.1	5.3	5.5	4.0
SAMA base lending rate (%, year end)	2.50	4.75	5.20	5.50	2.50	2.00	2.00	2.25	2.50
External trade indicators ($ billion)									
Oil export revenues	110.4	161.6	188.2	205.3	281.0	163.1	203.2	242.5	203.8
Total export revenues	125.7	180.4	210.9	233.1	313.4	192.2	236.3	278.3	243.1
Imports	41.1	53.8	63.0	81.5	100.6	86.4	87.0	97.4	109.1
Trade balance	84.6	126.6	147.8	151.6	212.7	105.8	149.3	180.8	133.9
Current account balance	51.9	90.0	98.9	93.3	132.3	22.8	69.6	93.0	45.4
(% GDP)	20.7	28.5	27.8	24.3	27.8	6.1	16.0	18.3	8.9
Official foreign assets	127.9	195.5	273.4	359.8	502.0	474.2	520.3	588.3	623.1
Social and demographic indicators									
Population (million)	22.7	23.4	24.1	24.8	25.5	26.3	27.1	27.9	28.8
Unemployment (male, 15+, %)	11.0	11.5	12.0	11.0	9.8	10.5	10.2	11.0	10.5
GDP per capita ($)	11039	13503	14806	15523	18651	14158	16017	18243	17705

Sources: Jadwa forecasts for 2011 to 2012. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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The data contained in this Research is sourced from Reuters, Bloomberg, Tadawul and national statistical sources unless otherwise stated.

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