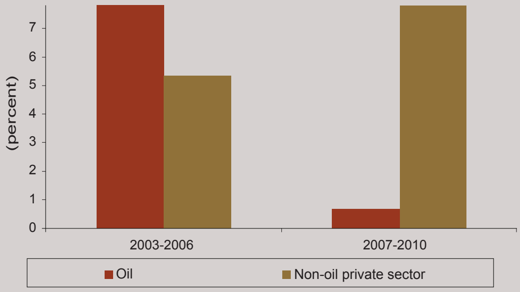
جدوى للإستثمار
Jadwa Investment

July 2007

Growth driver shifting from oil to private sector



The Saudi Economy's Golden Era: Phase Two

Saudi Arabia has enjoyed four years of strong growth driven by rising oil revenues. We now perceive the growth driver shifting to the private sector, marking a new phase in a period of sustained high growth in the Saudi economy. We expect the following themes to dominate the economic and investment environment in the years to 2010:

Private sector growth: Megaproject implementation, broad liberalization and enhancements to the business environment will push real non-oil private sector growth up to an average of nearly 8 percent. Growth will be fastest in manufacturing, communication, finance and construction.

Relatively low inflation: Inflation should peak this year at around 4 percent before falling gradually. Given the rapid pace of economic expansion, this is low. Rents will take over from food prices as the main source of inflation through 2010. Heightened competition will lower the prices of a variety of goods and services, such as telecoms, financial services and transportation.

No change to the riyal peg: None of the arguments put forward for an adjustment to the exchange rate are compelling given the cost in terms of monetary policy credibility, lost revenues, damage to non-oil competitiveness and foreign investment. SAMA has consistently stated that it has no intention of altering the existing exchange rate arrangement and its vast stock of foreign assets gives it the ammunition to successfully defend the peg from any speculation.

Spending not saving: Increasing import-driven project spending means that the years of large fiscal and trade surpluses and rapidly accumulating foreign assets have passed. Nonetheless, continued high oil prices will allow further growth in government spending without the budget falling into deficit.

Steady share price gains: With last year's collapse seemingly behind us, the conditions are in place for steady gains in the stock market. Several blue chip companies are undervalued and many other of the larger listed companies are trading at fair value. The positive macroeconomic backdrop means that profits growth is likely to average 10-15 percent per year, leading to a similar rate of increase for the TASI.

The fundamental dynamics supporting the strong outlook for the economy have been set in motion by reforms that have already been enacted and an investment boom that can not be stopped in its tracks. While there are some risks to our view, we do not foresee anything that would significantly alter the positive underlying story.

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Key data

	2002	2003	2004	2005	2006	2007F	2008F	2009F	2010F
Nominal GDP									
(SR billion)	707.1	804.6	938.8	1182.5	1307.5	1251.3	1340.3	1448.9	1507.5
($ billion)	188.6	214.6	250.3	315.3	348.7	333.7	357.4	386.4	402.0
(% change)	3.0	13.8	16.7	26.0	10.6	-4.3	7.1	8.1	4.1
Real GDP (% change)									
Oil	-7.5	17.2	6.7	7.8	0.2	-6.4	5.0	3.0	1.0
Non-oil private sector	4.1	3.9	5.3	5.8	6.4	7.4	7.3	8.6	8.0
Government	2.9	3.1	3.1	4.0	6.1	6.3	6.0	5.3	4.5
Total	0.1	7.7	5.3	6.1	4.3	2.7	6.3	6.2	5.2
Oil indicators (average)									
WTI ($/b)	26.6	31.1	41.5	57.2	66.1	60.0	60.0	60.0	60.0
Saudi ($/b)	23.7	26.9	34.7	49.5	60.5	57.0	57.0	57.0	57.0
Production (million b/d)	7.5	8.8	9.0	9.5	9.2	8.6	9.0	9.3	9.4
Budgetary indicators (SR billion)									
Government revenue	213	293	392	564	660	567	593	610	617
Government expenditure	234	257	285	347	390	449	507	568	613
Budget balance	-21	36	107	218	270	119	86	43	4
(% GDP)	-2.9	4.5	11.4	18.4	20.6	9.5	6.4	2.9	0.2
Domestic debt	660	660	614	475	380	320	270	250	260
(% GDP)	93.3	82.0	65.4	40.2	29.1	25.6	20.1	17.3	17.2
Monetary indicators (average)									
Inflation (% change)	0.2	0.6	0.3	0.7	2.3	3.5	3.3	2.7	2.2
SAMA base lending rate (%, end year)	2.00	1.75	2.50	4.75	5.20	5.50	5.50	5.25	4.50
External trade indicators ($ billion)									
Oil export revenues	63.6	82.0	110.4	161.1	188.6	159.0	166.9	171.9	173.6
Total export revenues	72.3	93.0	125.7	180.1	213.6	183.5	192.4	200.5	204.5
Imports	29.6	33.9	41.1	54.6	60.7	71.0	82.3	94.7	107.9
Trade balance	42.6	59.1	84.6	125.5	152.9	112.5	110.1	105.8	96.6
Current account balance	11.9	28.1	51.9	90.0	95.4	53.1	47.7	44.6	37.4
(% GDP)	6.3	13.1	20.7	28.5	27.4	15.9	13.4	11.5	9.3
Official foreign assets	73.3	97.1	127.9	195.5	273.2	318.5	355.9	393.2	419.9
Social and demographic indicators:									
Population (million)	21.6	22.1	22.7	23.2	23.9	24.6	25.5	26.3	27.1
Unemployment (male, 15+, %)	7.6	8.2	8.5	8.8	9.1	9.0	8.8	8.5	8.2
GDP per capita ($)	8729	9696	11043	13575	14613	13537	14017	14691	14834

Sources: Jadwa forecasts for 2007 to 2010. 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.

Growth

Saudi Arabia's economic boom will continue until at least 2010. After four years of exceptional growth in oil revenues driven by external factors, domestic demand will take over as the main engine of growth for the period 2007-2010. High oil revenues have stimulated massive project spending. In addition, important steps have been taken to improve the business environment. With further reform anticipated, oil prices expected to remain high and a supportive global backdrop, we believe that the Kingdom is set for its strongest period of non-oil growth since the 1970s.

The table below shows how the economic boom over the period 2007-2010 will differ from that of the preceding four years. The first phase of the boom was an oil story. At an average of 8.4 percent, the oil sector was the fastest growing over this period. By contrast, we expect oil to be the slowest growing sector between 2007 and 2010, at just 0.7 percent. Instead, manufacturing, transport and communication, finance and construction will lead the way.

Average real GDP growth by sector (%)

	2003-2006	2007-2010
Agriculture	1.8	1.5
Oil & natural gas	8.4	0.7
Manufacturing	6.8	9.4
Electricity, gas and water	6.1	6.4
Construction	6.0	7.8
Wholesale & retail trade	4.8	5.6
Transport & communication	7.8	9.3
Finance	4.9	8.1
Government services	3.4	4.4
Total	**5.8**	**5.1**

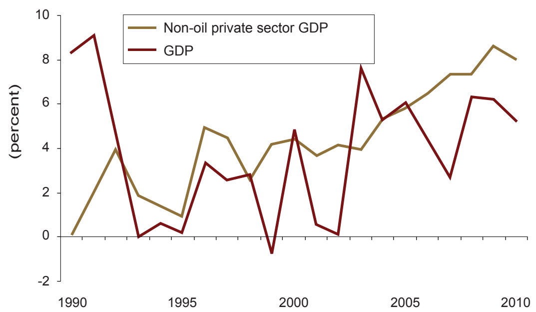
The following factors underlie our expectation of exceptional non-oil growth over 2007- 2010.

- **Megaprojects:** Figures vary widely for the value of projects on the table owing to escalating costs, but it is certainly above $300 billion. Oil and gas, defense, petrochemicals, infrastructure and real estate account for the bulk of project spending. The heavy role of the private sector means that projects are generally based on sound commercial projections.

- **Liberalization:** Liberalization of the financial service and telecom sectors will spur competition, resulting in a higher quality and broader range of services at a lower cost. As virtually all companies and consumers use financial and telecoms services, these benefits will be felt throughout the economy, generating further economic momentum.

- **WTO membership:** WTO membership since December 2005 has to date had little direct effect on the economy. This will change. As the sustainability of the current period of strong economic performance becomes evident, more and more foreign companies will enter the Kingdom. The opening of foreign banks is an important step in this regard,

Non-oil sector takes over growth momentum through 2010



as it should make companies from the same domicile as these banks more confident in doing business in Saudi Arabia.

- **Economic policy reforms:** Further supportive economic policy reforms are likely. New company and contract laws are planned, commercial courts will be beefed up and standards of corporate governance should rise. Although a GCC single currency is not expected by 2010, the single market (allowing free movement of labor and capital) is still on course for the end of 2008. Finally, GCC trade deals with the EU and some Asian countries are a possibility.

Supply bottlenecks will place a ceiling on how fast the economy can grow. The project boom extends throughout the GCC and with demand also growing rapidly in China and India, raw material prices have shot up. As a result, some projects will be scaled back and others may be postponed until prices ease. Major skill shortages have also emerged. Structural deficiencies hindering the local labor market will not be overcome by the end of the decade, forcing companies into strong competition with those from elsewhere in the region to attract skilled labor.

The global economic backdrop

Key to our long-term outlook for the Saudi economy is the global economic environment, since this drives the oil market. The global economy has experienced a period of sustained high growth since 2002, expanding by $16.6 trillion (53 percent) since the end of 2001 according to the IMF. Real global growth between 2002 and 2006 averaged 4.5 percent per year, compared to an annual average growth rate of 3.2 percent in the 1990s.

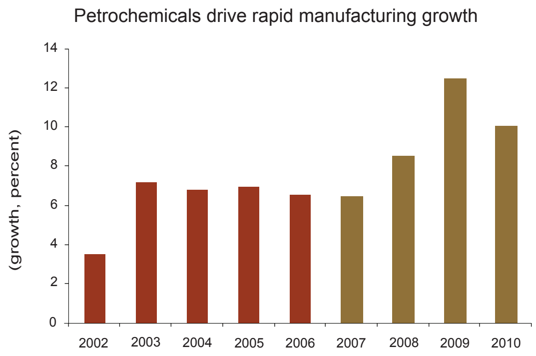
GDP Growth (percent)

	2002	2003	2004	2005	2006	2007	2008
World	3.1	4.0	5.3	4.9	5.4	4.9	4.9
US	1.6	2.5	3.9	3.2	3.3	2.2	2.8
Japan	0.3	1.4	2.7	1.9	2.2	2.3	1.9
EU	0.9	0.8	2.0	1.4	2.6	2.3	2.3
UK	2.1	2.7	3.3	1.9	2.7	2.9	2.7
China	9.1	10.0	10.1	10.4	10.7	10.0	9.5
India	4.3	7.3	7.8	9.2	9.2	8.4	7.8
Emerging Markets	5.0	6.7	7.7	7.5	7.9	7.5	7.1
Middle East	3.9	6.5	5.6	5.4	5.7	5.5	5.5

Source: IMF

The IMF forecasts global growth at 4.9 percent in both 2007 and 2008. Emerging markets are expected to expand at a faster rate. As these countries are the main source of growth in oil demand, this suggests that oil prices will remain high. We think it likely that this above-trend growth continues through 2010. However, the global economy remains subject to the business cycle and the US is due for a recession over our forecast period. The last recession was a brief and shallow one at year-end 2000. Recent periods of expansion between recessions have lasted about 8-10 years.

The global economy affects the Saudi stock market and it is therefore important for local investors to watch it. Keep an eye out for any signs that the US is entering recession. The US barely escaped falling into negative growth in the first quarter of 2007, but it seems to now be rebounding.

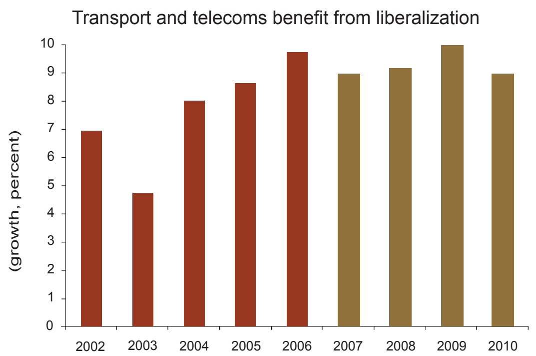


Manufacturing is forecast to be the fastest growing sector over the period to 2010. This will be led by petrochemicals, which in turn is dominated by Sabic. Sabic, in conjunction with foreign and local partners, has three massive petrochemical projects—Yansab, Sharq and Kayan—set to come on stream over 2008 and 2009. A variety of smaller, though still substantial, plants will further boost Sabic's production over the years to 2010. In addition, Saudi Aramco will enter the petrochemicals sector through the $10 billion Petro-Rabigh complex, which is likely to commence production around the turn of 2009. Other smaller operators will contribute further increments in output.

Availability of feedstock and escalating costs will be issues for the petrochemical sector over the next few years. Although non-associated gas has been found in the Empty Quarter since foreign companies were awarded exploration blocs in 2003, it will not enter the petrochemical production chain by 2010. Instead, some of the new facilities will use liquids as feedstock (naphtha at Petro-Rabigh and propylene at Yansab and Kayan). Sharply rising costs and shortages of equipment and human resources have the potential to delay some projects, though as most of the major projects commenced relatively early in the current cycle of region-wide capacity expansion and have costs locked in, we do not think any will be derailed.

The outlook for the kingdom's smaller manufacturing industries is also positive. A significant increase in cement production capacity will be completed in 2009, allowing local firms to benefit more fully from the ongoing construction boom. Strong local demand and high international prices will continue to stimulate metal production and a major metal refining project is likely to come on stream around 2010.

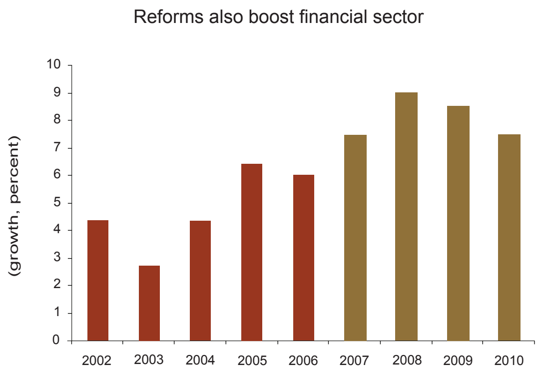
While the investment boom will provide a supportive backdrop for **transport and communications,** it is recent deregulation that should make this sector grow by over 9 percent per annum over the period to the end of 2010. During the first half of 2007 three new fixed-line providers were licensed, breaking the monopoly of Saudi Telecom (STC), and a third mobile license was awarded.



The new mobile operator, MTC of Kuwait, is likely to begin operations toward the end for the year. Existing operators STC and Mobily have begun price cutting to preserve market share and with competition set to intensify, further rapid growth in the take-up of mobile phone services is expected. Although Mobily has gained 6.5 million users since it won the second license in 2004, mobile penetration was only 82 percent at the end of 2006, compared to over 100 percent in Qatar and Bahrain and 127 percent in UAE.

It will take longer for the fixed-line operators to become functional. The new entrants are expected to start operations in the second half of 2008 and Kingdom-wide coverage is not anticipated for a further seven years. As part of the process, two of the new operators were awarded licenses for radio spectrum technology (facilitating wireless internet connectivity). Fixed-line connectivity is low at 16.4 percent, compared to 30 percent in UAE, and demand for new lines is strong, particularly to enable internet access. The new fixed-line operators will take over as the engine of growth momentum in the telecoms sector toward the end of our forecast period.

Liberalization will contribute to robust growth in the transport sector. The two low-cost domestic airlines that began services earlier this year will scale up their operations and in response national carrier, Saudi Arabian Airlines, has indicated that it will launch a low-cost service. Transport will also benefit from



a rising volume of trade and the huge amount of raw materials that have to be moved to construction sites throughout the Kingdom as part of the investment boom. Enhancements to physical infrastructure through the completion of major rail, port and airport expansions will further stimulate growth in transport.

Finance is expected to be one of the most dynamic sectors over the next five years. Recent liberalization has opened the banking and insurance industries and forthcoming legislation is set to boost the nascent mortgage market. Greater competition is expected to stimulate a broadening and deepening of financial services. However, the influx of new entrants is causing significant skill shortages that will prevent the financial sector from growing at double-digit rates.

By the end of June licenses had been awarded to 56 investment companies and another 50 applications were being examined. While the bulk of the new entrants are focused on wealth management, strong demand for corporate advisory and project finance and the increasing take up of mutual funds provide fertile ground for the larger of the new companies. In anticipation, several major foreign banks have already formed partnerships with new investment companies. Consolidation among the investment companies appears inevitable over time.

Proliferation of financial service providers

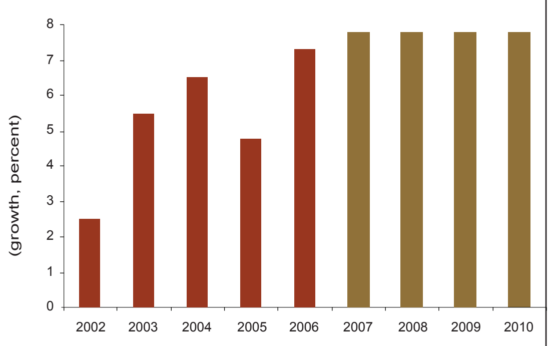
	End 2004	Mid 2007
Commercial banks	10	22
Investment companies	0	56
Licensed insurance companies	1	14
Total	11	92

While the existing commercial banks may suffer from the new competition, they will continue to prosper. Lending to the private sector is expected to recover after a stock-market induced slowdown last year, while the healthy outlook for the non-oil private sector should stimulate a pickup in lending to corporates. With local banks remaining cash rich, they will probably expand their footprints abroad.

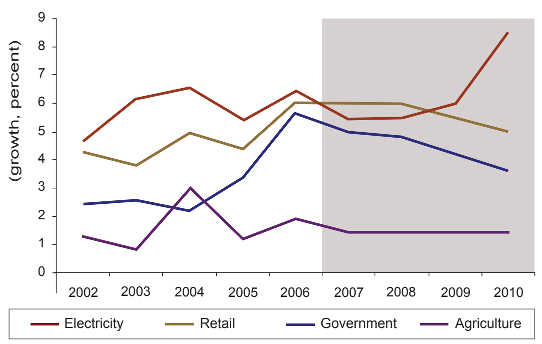
Banks should also benefit from a rapid expansion of the mortgage market. The enactment of a mortgage law over the forecast period should clarify the legal framework. Other issues hampering the development of the sector, such as the supervisory framework, property registration and the absence of sufficient long-term financing for lenders, are likely to be gradually addressed. The demands of a rapidly growing population are likely to spur rapid growth in the provision of housing finance well before all the above barriers have been cleared.

Liberalization will drive strong growth in the insurance sector. In October 2006 licenses were awarded to 13 insurance companies as part of a restructuring of the industry. Plans for universal health insurance (currently only 5 percent of the population are covered) provide a major dynamic for the sector. The bulk of the new insurance companies are joint ventures with foreign partners.

Megaproject implementation strengthens construction



Agriculture to remain slowest growing sector



Construction will be one of the main beneficiaries of this phase of the economic boom. All of the $300 billion or so of projects that have been announced have a construction element and for infrastructure and real estate developments, particularly the planned economic cities, this is substantial. Construction growth will remain high as more and more projects enter their implementation phases.

While there may be a downturn in certain parts of the property market owing to local and regional factors (land prices in prime areas of Riyadh and Jeddah have risen rapidly and real estate prices look set for a correction in Dubai) this will not disrupt the momentum within the sector. However, shortages of skilled labor and high raw material costs will limit the pace of growth.

New investment will support solid growth in **electricity, gas and water**. A model for private sector participation via independent water and power projects has been developed and several major projects are underway. The bulk of new capacity is set to come on stream during 2009 and 2010 and prior to this growth in supply may struggle to keep up with growth in power demand of around 7 percent per annum. Development of power-hungry industries and population pressures should stimulate further investment in the generation, transmission and distribution infrastructure over the forecast period.

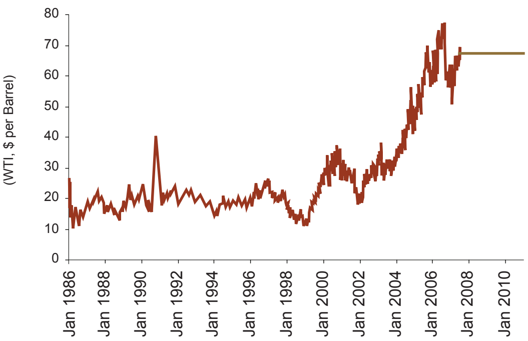
The strong outlook for the non-oil economy should bolster consumer confidence and provide a healthy backdrop for **wholesale and retail trade**. Preliminary 2006 GDP data show that growth in the sector did not slow owing to the collapse in share prices (despite earlier indications to the contrary). Nonetheless, now that consumers' attention has shifted from the stock market, retail spending is likely to pick up in the near term. Faster job creation and higher salaries in the private sector should continue to support the retail sector over the forecast period. An easing of ownership restrictions on foreign retailers by the end of 2008 in accordance with the WTO deal may encourage new entrants in subsequent years.

Despite continued double-digit growth in spending, we expect that the **government** sector will remain a relative drag on growth. Output of government services has risen, notably in 2006, reflecting higher allocations to healthcare and education, but actual output of government services continues to be some way below increases in government spending. We do not expect major improvements in productivity in the public sector and therefore forecast that growth in the government sector will slow in line with slowing growth in government expenditure.

Performance of the **agricultural sector** will remain weak. Owing to pressing demands elsewhere, the government will continue to discourage the production of water-intensive crops. This is in addition to its commitment to the WTO to lower support for the sector. With foreign competition likely to benefit from the dismantling of domestic support, agriculture is likely to be the only significant area of the economy negatively affected by Saudi Arabia's WTO membership. We forecast that agricultural growth will fluctuate near the 1.5 percent level, depending on the weather conditions.

Outlook for the Saudi oil sector and the global oil market

Oil price will remain high



We forecast that the oil price will average $60 per barrel (WTI, equivalent to $57 per barrel for Saudi crude oil), through 2010. The rationale for our forecast is that:

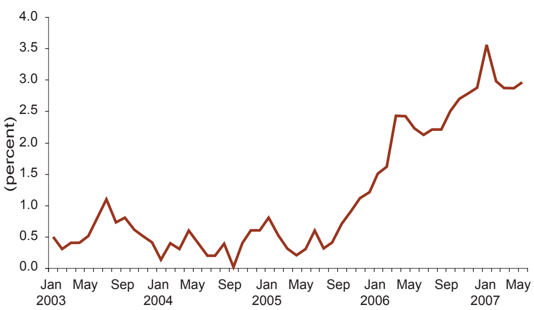
- The oil market balance is likely to remain generally tight. Demand for oil will grow steadily in line with robust global economic growth, outpacing growth in supply, especially from outside OPEC.
- OPEC will seek to maintain a price as high as possible without slowing global economic growth and demand for oil or stimulating excessive investment in the industry. That price appears to be roughly $60 per barrel today.
- OPEC has the collective willpower to cut production when needed to support prices, as demonstrated by the production cuts in late 2006 and early 2007 that prevented prices from falling below $50 per barrel.
- Countries that have the resource base to put significantly more oil on the market over time—Iraq, Venezuela and Russia—face political or security constraints that make output increases that would significantly alter the market balance unlikely before 2010.

Saudi Arabia stands to benefit from this scenario. The Kingdom will have 12.5 million barrels per day (b/d) of production capacity by 2009, compared to 11.3 million b/d today, from which it produces about 8.5 million b/d, 10 percent of world oil output. While we believe prices will average roughly where they currently are through 2010, the Kingdom's output is likely to rise somewhat, thus gradually increasing oil revenues.

The oil market, however, will not be a source of high growth for the economy. Oil prices tripled between 2002 and 2006, as did Saudi oil revenues (which rose from $65 billion to $202 billion over the same period, according to our calculations). Such growth is unlikely to continue, but a gradual rise from current levels is still strongly supportive for the economy.

Inflation

Inflation has taken off



Inflation is inevitable in a rapidly growing economy such as Saudi Arabia. When supply can not keep up with demand, prices will rise. This has already happened. Annual inflation hit an 11-year high of 3.6 percent in January, compared to an average of just 0.7 percent in 2005. Bottlenecks associated with the rapid pace of growth will take some time to ease, but the near-term outlook for some of the other factors that have pushed up inflation is more promising. While certain price rises have attracted headlines, for us the real story is that inflation is already near its peak and as such will be remarkably low for a country experiencing such a strong and broad-based economic expansion.

Inflation breakdown

	2002	2003	2004	2005	2006	Q1 2007
Foodstuffs & beverages	0.4	0.6	4.9	3.0	5.3	7.7
Fabrics, clothing & footwear	-0.7	-0.5	-2.4	-1.5	-0.6	-2.0
Renovation, rent, fuel & water	-0.1	0.0	0.3	-0.1	0.8	4.1
Home furniture	-0.6	-0.6	-1.7	0.4	0.3	0.9
Medical care	0.1	0.2	0.4	0.0	1.3	2.1
Transport & telecoms	0.1	-1.7	-0.6	-2.5	-3.2	-4.4
Education & entertainment	-0.2	-0.6	-0.6	0.3	0.3	0.0
Other expenses & services	2.0	2.5	0.6	2.4	7.7	6.5
Overall	0.2	0.6	0.3	0.7	2.3	3.1

It is clear from the breakdown in the table above that inflation currently comes from three sources. Thus, there is no generalized rise in prices. On the contrary, prices of some goods and services are falling. The three areas experiencing significant inflation are:

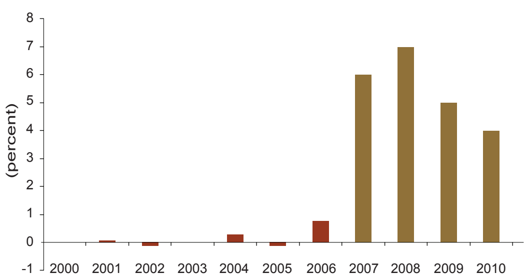
- **Food prices:** Rising food prices are a global phenomenon. This has been exacerbated by local factors including a cold winter, the reduction of agricultural subsidies in line with WTO commitments and concerns about bird flu.

- **Jewelry prices:** Jewelry is the main component of the "other expenses and services" category of the cost of living index. The increase in jewelry prices reflects higher international gold and silver prices.

- **Rents:** Rents are the major new source of inflation in the Kingdom. Prices of prime real estate and certain types of accommodation (such as expatriate compounds) have risen much faster that the headline growth in rents, but outside of the main cities, most rents are stable.

Food and jewelry price inflation is expected to ease. For jewelry this is already happening. Gold and silver prices are not far from their highs of last year, but in measuring inflation it is the annual rate of increase that is relevant and this is not expected to approach anything like the 35 percent average for 2006. It appears that a shift in global production and consumption habits will lead to a period of higher than average increases in food prices. However, some of the recent food price rises are the result of poor growing conditions, which we assume will normalize over the forecast period.

Rents will be main source of inflation through 2010



Rents are forecast to become the leading source of inflation over the years to 2010. An influx of expatriate workers stimulated by the economic boom and rapid growth in the national population will exacerbate an existing shortage of accommodation. This will be compounded by internal migration to the big cities. Although a large amount of real estate is being developed, this will take time to come onto the market. Rental inflation is forecast to peak at an annual average of 7 percent in 2008. The rate of increase will vary substantially with the type of property and its location. Higher rents will raise costs for businesses across all sectors; those businesses with pressure on margins are likely to pass these costs on to consumers in the form of higher prices.

The skill shortages and escalating costs that are restraining growth will have an impact on inflation, but it is likely to be modest. This is because the cost of living index measures the prices that final consumers pay for the goods and services they purchase. Very little of the output from those sectors hitting capacity constraints is sold directly to final consumers. For example, the bulk megaproject output is exported (in which case foreign consumers absorb the rise in costs) or sold at a fixed price (the producer absorbs the rise in costs). In others, such as financial services, the shortages are driven by greater competition, which will put downward pressure on prices. Nonetheless, given the extent of the run-up in costs, some pass through to the cost of living index is inevitable.

We believe it is a similar story for imported inflation, with most of the costs resulting from the recent weakness of the riyal being absorbed (in this case by importers) rather than being passed on to consumers. The riyal is likely to remain on a downward trend, but only for goods where there is no competition from local or US providers will rising import costs be fully passed on to consumers.

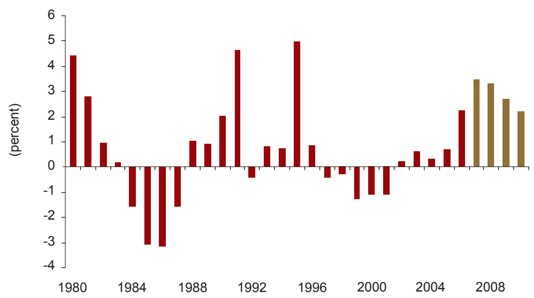
While the economy will face continuing price pressures over the years to 2010, the following factors will ensure that inflation remains contained:

- **Government-controlled prices:** Prices of various consumer staples, utilities and foodstuffs (including petroleum, natural gas, water, electricity, bread, flour and milk) are controlled by the government. We do not foresee changes to the prices of any of these goods.

- **Cheap and abundant expatriate labor:** A large and growing pool of expatriate workers keeps labor costs low and stable. Although the government may aspire to reduce the number of foreign workers, implementation of much of the investment boom is reliant on cheap unskilled and semi-skilled imported labor.

- **Heightened competition:** The introduction of new competition in a variety of sectors will inevitably lower prices. This occurred after the launch of the second mobile phone service, and we expect that the entry of a third mobile provider will drive down prices further. Fixed line and other telecoms costs (such as internet access) should fall once the new licensees begin operations. The expected entrance of more foreign companies will intensify competition in many parts of the economy and play an important role in controlling inflation.

Inflation will be mild given the pace of non-oil growth

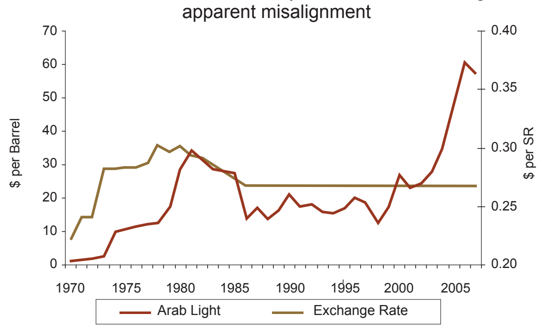


Inflation has become a prominent issue, but it will not be a major problem. Rising food prices catch consumers' attention as similar baskets of food products are bought on a regular basis and so price changes are readily apparent. By contrast, stable and even falling prices for goods such as electronics, clothing and furniture tend to be noticed less as purchases are made irregularly and the goods are highly differentiated. While bottlenecks in the economy and high global commodity prices will continue to cause a period of well above average inflation, structural factors will keep inflation low on a regional and global basis. Inflation is already near its peak and as the bottlenecks ease, it will fall.

Monetary policy

The riyal's peg to the US dollar will remain unchanged at the current level of SR3.75 throughout our forecast period. None of the arguments that have been put forward for an adjustment to the exchange rate are compelling given the cost in terms of monetary policy credibility, lost revenues and damage to non-oil competitiveness. SAMA has consistently stated that it has no intention of altering the existing exchange rate arrangement and its vast stock of foreign assets gives it the ammunition to defend the peg. Therefore, while there may be occasional speculative pressure on the peg, it will not change. As a result Saudi interest rates will continue to be broadly in line with corresponding rates in the US.

Costs of revaluation exceed any benefits of addressing this apparent misalignment



Advocates of an adjustment to the riyal generally base their views on the need to tackle inflation and a perceived misalignment of the currency following the sharp run-up in oil process. Various alternative exchange rate arrangements have been proposed including a one-time revaluation, the movement to a basket system, or the floating of the riyal. We will examine the exchange rate issue in more detail in a forthcoming report. For now, we have outlined below the reasons that justify our confidence that the riyal's peg to the dollar will not be changed:

- **Official policy:** SAMA has stated its commitment to the existing exchange rate arrangement and has the means to fight off any speculation.

- **Credibility:** If the peg is altered significantly it will damage the credibility of the exchange rate, potentially harming investment and economic growth and causing uncertainty about future changes as oil prices fluctuate.

- **Inflation:** We do not believe that imported inflation is or will be a major factor behind rising prices in the Kingdom.

- **Lost revenue:** A revaluation would impair the riyal value of oil revenues and assets denominated in dollars held by the government, banks and companies.

- **Non-oil competitiveness undermined:** A revaluation would raise the price of many non-oil exports into foreign markets and lower the price of competing imports into Saudi Arabia.

- **Discourages foreign investment:** The introduction of exchange rate uncertainty caused by an adjustment to the peg would act as a deterrent to foreign investors. A revaluation would also make foreign investment more expensive.

- **Volatility:** Allowing the currency to float freely would add another element of uncertainty to an economy that is already vulnerable to oil price fluctuations.

GCC member states are planning to launch a single currency in 2010. Preparations have experienced a variety of setbacks recently and we do not expect a new currency to be in place by the end of our forecast period.

With the dollar peg unchanged, interest rates will continue to closely shadow corresponding rates in the US. There is some uncertainty over the trajectory of US interest rates at present owing to the countervailing forces of inflation above the Fed's comfort zone and concerns about housing market weakness. It appears likely that these factors will offset each other and rates will be unchanged over the course of 2007. With globalization helping to limit inflation, even under strong growth forecasts interest rates would likely stay lower than 6 percent and with a major slowdown in global growth unlikely, neither will rates decline much. Therefore we see US interest rates remaining in a range of 4-6 percent over our forecast period.

Abundant local liquidity and speculation on revaluation pushed Saudi three-month interest rates below equivalent dollar rates through 2006 and the first half of 2007. Although we expect the local liquidity position to remain strong, the risk premium that usually keeps Saudi rates above corresponding US ones by 25-50 basis points (0.25-0.5 percentage points) will reassert itself.

Fiscal policy

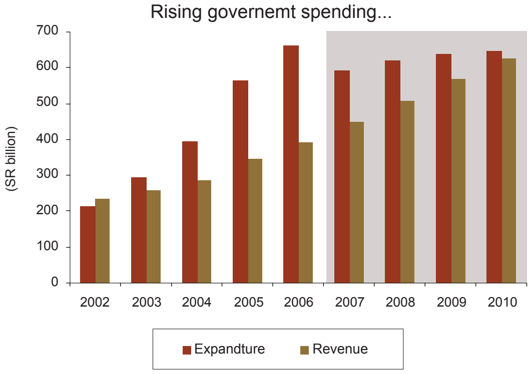
Increases in government spending will cause the budget surplus to fall in each of the years to 2010, by which time it will have virtually disappeared. The elimination of the surplus should not pose any fiscal problems for several years after that, as domestic debt servicing will be at a comfortable level and a vast stock of foreign assets will provide a substantial cushion in the event of oil price weakness.

Double-digit growth in government expenditure is expected in each year of our forecast, but this is likely to be contained to less than 15 percent. The government has stated on several recent occasions that it is trying to limit the inflationary impact of its spending and it is notable that the 13 percent budgeted rise in 2007 is relatively conservative given the run-up in construction and raw material costs.

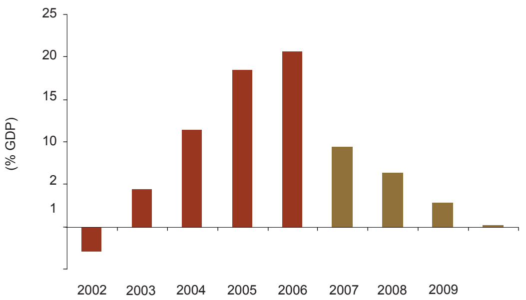
Spending trends are likely to be in line with recent years with defense, education and healthcare accounting for the largest allocations. Plans are in place for large capital expenditure in order to upgrade the social and physical infrastructure. Greater private sector involvement in infrastructure projects, education and healthcare should gradually ease the burden on the public sector.

Oil will remain the source of around 90 percent of revenues. After an anticipated fall of over 10 percent in 2007, owing to lower production and prices, oil revenues are expected to rise modestly over the remainder of our forecast period as production is increased. Non-oil revenues are predicted to climb as a result of rising investment income and customs revenues. No new taxes or changes to existing tax rates are anticipated.

Rising governemt spending...



...sharply cuts budget surplus



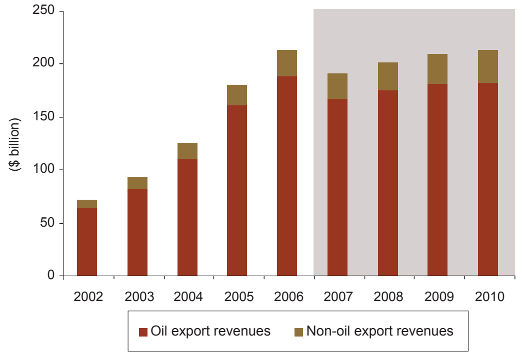
Budgetary indicators (SR billion)

	2005	2006	2007	2008	2009	2010
Revenue	564	660	567	593	610	617
Oil Revenue	505	599	505	530	546	552
Expenditure	346	390	449	507	568	613
Budget balance	218	270	118	86	42	4
% GDP	18.4	20.6	9.5	6.2	2.9	0.2
Domestic Debt	475	380	320	270	250	260
% GDP	40.2	29.1	25.6	20.1	17.3	17.2

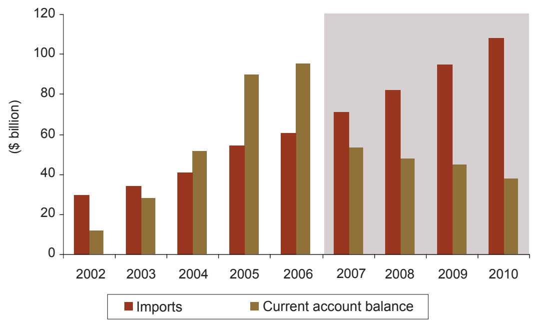
Over the first phase of the oil boom, much of the budget surplus was used to cut domestic debt. We think that the government will be comfortable with domestic debt at around 15-20 percent of GDP and therefore do not expect much further repayment. We believe that the bulk of the future budget surpluses will be saved.

External trade

With export revenues remaining strong...



...greater import spending can be comfortably absorbed



In the first phase of the current boom the story for trade and external capital flows was one of export revenues being deposited with SAMA, leading to a massive accumulation of foreign assets. In the second phase of the boom it will be one of export revenues being spent. Most megaprojects are heavily dependent on imports. Around two-thirds of project-related capital goods will be imported. Much of the related expertise also needs to be imported, as does more low-skilled labor. Payments for these goods and services will be the main force driving down the current account surplus.

Import growth is expected to average 15 percent per year between 2007 and 2010, with capital goods accounting for most this expansion. The annual rate of growth is likely to decline over the forecast period as the bottlenecks that have caused the recent run-up in raw material costs ease. Growth in imports of consumer goods should be strong, in line with the healthy performance of the non-oil economy.

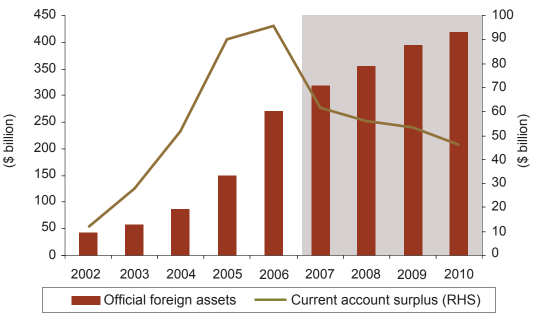
Payments for foreign services will rise owing to strong demand from local companies and a lack of domestic expertise. Shortages of skilled professionals are likely to persist in a wide range of areas, forcing local firms to turn to foreign providers. Many skilled foreign nationals will be lured into the Kingdom and with further influx of low skilled labor (particularly construction workers) under way, outflows of expatriate remittances are forecast to rise.

Oil will remain the dominant source of revenues. After falling in 2007 owing to lower production and prices, oil export revenues will rise over the remainder of our forecast period, though they will be below their peak of $189 billion in 2006. Non-oil exports are forecast to increase at a much less rapid rate than in recent years. Although there will be sizeable growth in the volume of non-oil exports (especially petrochemicals), international prices are likely to fall. Nonetheless, non-oil exports in 2010 will be three times the level of 2002. Investment income (earned on Saudi Arabia's foreign assets) will be the other main source of income. Revenues from this source will rise in line with the continued accumulation of foreign assets.

External sector ($ billion)

	2005	2006	2007	2008	2009	2010
Oil exports	161.1	188.6	159.0	166.9	171.9	173.6
Other exports	19.0	25.0	24.5	25.5	28.6	30.8
Imports	54.6	60.7	71.0	82.3	94.7	107.9
Trade balance	125.5	148.5	112.5	110.1	105.8	96.6
Receipts	12.1	14.5	17.0	19.4	20.3	21.2
Investment income	5.0	6.9	9.0	10.8	11.2	11.5
Oil sector	0.5	0.6	0.5	0.5	0.5	0.5
Other	6.7	7.0	7.5	8.1	8.6	9.2
Payments	47.7	67.7	76.4	81.7	81.5	80.4
Freight & insurance	4.9	5.6	6.4	7.4	8.5	9.7
Oil sector	5.0	9.7	11.5	13.5	12.0	10.0
Other private services	9.6	12.8	15.0	16.0	15.0	13.5
Other government services	14.2	25.0	28.0	28.0	28.0	28.0
Private transfers	14.0	14.6	15.5	16.8	18.0	19.2
Services and transfers balance	-35.5	-53.2	-59.4	-62.3	-61.2	-59.1
Current account balance	90.0	95.4	53.1	47.7	44.6	37.4
% GDP	28.5	27.4	15.7	13.1	11.5	9.1
Official foreign assets	150.3	273.2	318.5	355.9	393.2	419.9

Pace of foreign asset accumulation slows owing to lower external surplus



Diversification of holdings of foreign assets

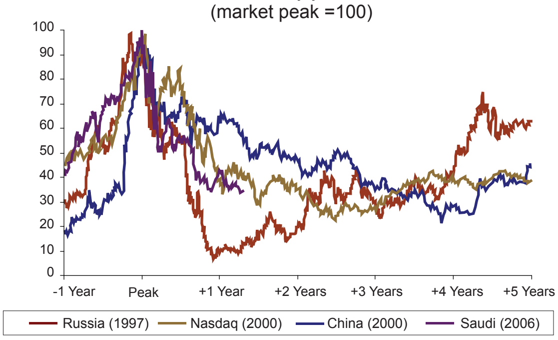
The rapid accumulation of foreign assets by Saudi Arabia and other countries in the GCC has generated much international attention. Official foreign assets have jumped from $73 billion in 2002 to $273 billion in 2006 in Saudi Arabia alone. With the current account forecast to say in surplus through 2010 foreign reserves are expected to rise further, to $420 billion, though the pace of accumulation will be slower than in recent years. These reserves will be far in excess of what is necessary to defend the currency, giving the central bank confidence to diversify its portfolio from what we believe is largely holdings of (principally US) government debt. By 2010 the reserves held by Saudi Arabia and other GCC governments will be increasingly diversified across asset classes and will become an important source of financing for global companies (either directly or through private equity firms).

How to use these themes to invest

The macroeconomic and stock market conditions are in place for steady gains in share prices on the Saudi stock market. At mid-year 2007 the major downturn appears to be over. Many listed companies can reasonably be considered to be at fair value or undervalued. In particular, the 10 largest companies by market capitalization trade collectively at a price-to-earnings (P/E) ratio of 13; for the top 25 stocks, the P/E is 14. The remaining 68 stocks trade at a collective P/E ratio of 34, which we view as overvalued.

Because the stock market index, the TASI, is an all-share index weighted by market capitalization (meaning every stock in the market is part of the index and its weight in the index is determined by its capitalization), the stocks with large market capitalizations mainly determine the movement of the index. As the large-cap stocks appear reasonably valued, the TASI is in our view not likely to decline much further from the lows it recently established in the upper 6,000s. Nonetheless, smaller stocks could still decline sharply because of their high valuations, though this would not be reflected in a similar move in the index. For investors therefore, the Saudi market has become a "stock-pickers" market, meaning choose carefully, as many stocks are likely to continue sharp declines as others move up.

Crashes often followed by years of consolidation
(market peak =100)



The current state of the market, combined with the macroeconomic forecast outlined above, shapes our view of the performance of the market to 2010. As with the aftermath of other major sell-offs, we expect the Saudi market to remain in a consolidation phase through 2010. Because of the strong macroeconomic fundamentals, however, we expect steady, if unspectacular, gains. Profit growth for listed companies should range from 10-15 percent per year, and that should be the gain expected for the index annually as well, as we expect the market to trade at a similar P/E ratio for some time. We would not be surprised to see the P/Es of large-cap stocks rise into the higher teens, or in market jargon, to experience "multiple expansion" in 2009 and 2010, as optimism about the economy continues to build and as the 2006 crash is put further behind us. An annual rise of 10 percent in the TASI from a fair-value level we currently put at 7,500, would place the index at 9,980 at year-end 2010. An annul rise of 15 percent from our fair value level would put the TASI at 11,400 at end-2010. We think this range is a reasonable expectation to work from.

How can investors profit in this market over the next 3 years? We advise:

- Focus on larger companies with reasonable valuations.
- Pay attention to objective research for "buy" recommendations. The days of everything moving up are over for the time being. While large companies are currently more cheaply priced, there are some "hidden gems" among the smaller stocks on the market, with good profitability and strong competitive positions in fast-growing sectors of the economy.

Also, work the macroeconomic themes to your advantage:

- There will not be a revaluation of the riyal. This favors companies that export, as the competitiveness of their products will not be harmed by the exchange rate. It also helps projects and companies that count on foreign spending and investment, such as travel and tourism, the economic cities, and petrochemical megaprojects. Conversely, if you thought importers, such as retailers and distributors would be getting a boost in profits from a revalued riyal, it will not happen.

- In general, inflation will subside. This should help share prices because high inflation reduces the price that investors will pay today for future company earnings. However, continued high growth in rents will put pressure on the profitability of companies that have high rental expenses. While inflation at the consumer level will be contained, prices for goods at the corporate level ("wholesale" price inflation) will be higher, hurting some companies in sectors such as construction and building materials.

- Continued economic reform means increased competition in some sectors. For example, while we expect high growth in financial services, the rapid opening of the market and influx of foreign players will inevitably erode the profitability of existing banks.

Risks

There are risks to the healthy outlook for the Saudi economy that we have detailed in this report, but nothing significant enough to alter the underlying positive story. Much of the momentum for the years to 2010 comes from reforms that have already been enacted and can not be reversed (WTO accession, telecoms and financial service liberalization) and an investment boom that can not be stopped in its tracks.

The principal risks to our forecast that we have identified are as follows:

- **Oil price:** Oil prices are volatile. The oil market is subject to a multitude of risks, both downside and upside. The table below shows how the economy would perform if WTI averaged $40/b (equivalent to $38/b for Saudi crude oil), through 2010 rather than our forecast of $60/b.

Economic performance under a lower oil price

	2007	2008	2009	2010
Central scenario - WTI averages $60 per barrel				
Real GDP growth (%)	2.7	6.3	6.2	5.2
Inflation (%)	3.5	3.3	2.7	2.2
Fiscal balance (% GDP)	9.5	6.4	2.9	0.2
Current account balance (% GDP)	15.9	13.4	11.5	9.3
Exchange rate (SR/US$)	3.75	3.75	3.75	3.75
Low oil price scenario - WTI averages $40 per barrel				
Real GDP growth (%)	0.2	2.7	3.8	3.3
Inflation (%)	3.3	3.0	2.4	1.9
Fiscal balance (% GDP)	-4.4	-5.7	-5.4	-4.1
Current account balance (% GDP)	-0.8	-1.4	0.6	1.0
Exchange rate (SR/US$)	3.75	3.75	3.75	3.75

Under the lower oil price scenario the fiscal and external positions both deteriorate markedly. There is limited scope for an adjustment in project spending and related imports in the near term, as it is generally easier to complete a part-built project rather than put it on hold. Furthermore, an oil price of $40 per barrel would not affect the commercial viability of most oil, gas, petrochemical and metals projects. By the end of the forecast period we expect that spending would have adjusted to the lower oil price. The deficits anticipated would be comfortably financed by a drawing down of reserves. The growth of those sectors reliant on the project flow would be affected by 2010, but for those where the growth dynamic is driven by reform (such as telecoms and financial services), the impact of a lower oil price would be minimal. An oil price of $40 per barrel would also imply lower oil production, as OPEC would be cutting quotas to try to raise prices.

- **Global economy:** The global economy faces a variety of risks, the most significant for Saudi Arabia being that of a slowdown in the US economy. A recession in the US would impact the oil price. During the modest recession in 2000, the oil price fell from $36 per barrel in November 2000 to about $28 per barrel in February 2001. A similar proportional decline in oil prices in today's market over the course of a shallow recession in the US would take about $15 per barrel off oil prices, depending on several factors, such as OPEC supply management.

- **Rise in global long-term interest rates:** Long-term interest rates are at unusually low levels. If the yield curve steepens it would significantly increase the cost of borrowing for Saudi companies. If this were combined with the return of emerging market risk premiums to historical norms then Saudi borrowers could be facing long-term rates much higher than their current levels. In such circumstances, there would likely be a slowdown in the amount of new private sector investment. Projects already under way should be less affected as most have secured long-term financing.

- **Loss of spending discipline:** The only significant Saudi-specific economic risk looking ahead is that government spending runs well above our expectations. We are not greatly concerned by this possibility given the government's acknowledgment of the importance of controlling expenditure and the major role played by the private sector in many of the major public-sector projects. Private-sector enterprises should be more responsive to higher costs and will adjust their spending plans accordingly, though there may be some problems where large projects have commenced without being able to secure all the necessary inputs. A final consideration is that even if individual projects appear viable, the multitude of projects under way throughout the GCC may lead to overcapacity in certain sectors, such as petrochemicals.

- **Political/security events:** Saudi Arabia is in a volatile regional. It also faces domestic political and security issues. It is therefore subject to a variety of potentially destabilizing events. The initial result of any such event would be a spike in the oil price, which would boost the Kingdom's finances. However, the increased perception of risk would have a damaging impact on foreign investment over the longer-term. While event risk is very real, the economy has thrived in recent years despite heightened regional tensions and an exodus of expatriate workers following a series of attacks in 2004.

We have deliberately concentrated on the downside risks to our forecast. There are, however, a variety of possible events—higher oil prices, faster global economic growth, rapid decline in the prices of raw materials, alleviation of skill shortages and a resolution of regional disputes—that would make the economic picture even stronger.

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