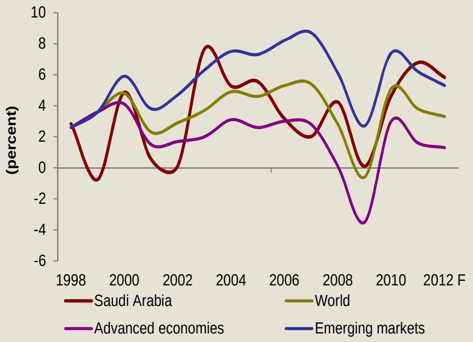
Jadwa Investment

October 2012

Saudi Economy: still shining

Despite the prevailing global economic gloom, the Saudi economy continues on a solid growth path. We have revised some of our 2012 forecasts to take account of a recent flow of data that has generally been stronger than we had expected. Higher oil production despite a difficult global environment will keep the hydrocarbon sector growth elevated at 6.1 percent this year. As a result, we have also raised our projections for both the budget and current account surpluses. We maintain our baseline scenario which is centered on government spending leading non-oil growth to 5.7 percent this year. All in all, we now expect the Saudi economy to expand by 5.8 percent in 2012.

Real GDP growth
(year-on-year change)



The global economy

Highlighting the recent setback in economic activities in both advanced and emerging economies, the IMF revised its global growth projections downward to 3.3 percent (down from 3.5 percent in July) in 2012 and 3.6 percent (down from 3.9 percent) the following year. There, nonetheless, remains a clear divergence between performance in the developed economies where economic activities are likely to remain sluggish and that of emerging markets. While relatively robust, growth in emerging economies is likely to slow due both to spillover from advanced economies through trade and financial linkages and to some homegrown challenges.

Global GDP growth
(percent; IMF projections)

	2009	2010	2011	2012 f	2013 f
World	-0.8	5.1	3.8	3.3	3.6
US	-3.1	2.4	1.8	2.2	2.1
Japan	-5.5	4.5	-0.8	2.2	1.2
Euro Zone	-4.4	2.0	1.4	-0.4	0.2
China	9.2	10.4	9.2	7.8	8.2
Emerging Markets	2.7	7.4	6.2	5.3	5.6
Middle East	2.0	5.0	3.3	5.3	3.6

Recovery in most **advanced economies** remains weak and economic activities are still short of potential. Significant challenges continue to confront several of the advanced economies. These will need to be addressed in order to stimulate recovery in domestic demand, improve confidence and decrease unemployment rates. On the positive side, the recent monetary easing measures taken by both the US Federal Reserve and the European Central Bank will push growth in these regions upward. On the downside, however, weak progress on the fiscal front and weak financial sectors will keep pulling growth downward. The IMF now expects the advanced economies to expand by 1.3 percent this year and 1.5 percent the following year with the risk on the down side if policy makers fail to

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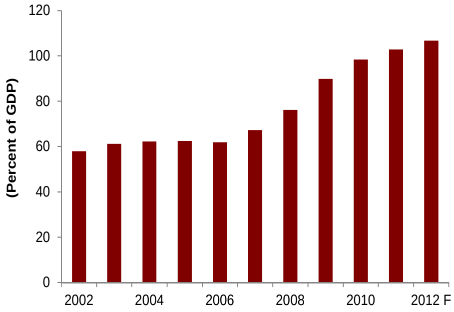
address looming economic challenges.

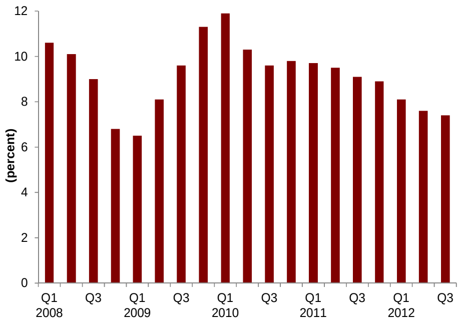
The US faces a number of fiscal challenges that could undermine its recovery. The sharp fiscal contraction of 3-4 percent of GDP due to automatic tax increases and spending cutbacks (known as the fiscal cliff) at the beginning of 2013 would put the US economy back into recession. Coupled with uncertainty concerning federal debt and its current ceiling, the fiscal cliff creates an uncertain environment that could erode private the sector's already weak recovery. This confidence deficit would negatively spillover into emerging and advanced economies alike. The political delay in rising debt ceiling in summer 2011 led some credit rating agencies to downgrade the US rating which was followed by major market turmoil. In the Euro Area, the focus on frontloaded fiscal tightening, the sovereign debt crisis, weak financial sector have all contributed to higher uncertainty and weak recovery in consumer demand and business investment.

United States: Public sector debt



The concerns about government spending and public debt in most advanced economies mean that virtually all economic stimuli will be in the form of looser monetary policy. With interest rates already exceptionally low, and expected to stay low for some time, central banks have been experimenting with unconventional monetary policy which is much less effective than the burst of government spending when the world fell into recession in 2008. Furthermore, the financial sectors in many advanced economies remain weak mainly due to weak growth but also uncertainty stemming from lack of credible policy actions and new regulatory environment. The latter two factors have maintained tight borrowing conditions despite monetary easing measures.

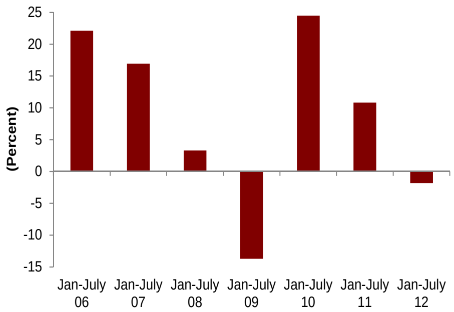
China: real GDP growth
(year-on-year change)



Prospects for **emerging markets** are much brighter, though they will face a different set of issues which are likely to reduce their growth. While leadership transition in China, policy uncertainty in India and weak activity in Brazil and Argentina are likely to weigh on domestic growth drivers, emerging economies continue to reap the benefit of long-term reforms that have stimulated domestic demand and sustained relatively strong economic expansions for many years. With fairly healthy financial sectors, low debt and stronger budgetary positions, they have rebounded rapidly from the global recession and are well placed for healthy growth in 2012.

All these positive domestic factors notwithstanding, the spillover from the advanced economies channeled through slowing trade and volatile capital flows have started to bit. The slowing demand in the advanced economies, particularly in the Euro Area since mid-2011, has weakened the exports from their main trading partners, particularly from Asia. This is compounded by the Euro Area's weak financial system which has contributed to reduce trade financing. Total EU merchandise imports from the leading emerging economies in Asia declined by 2% in the year to July 2012, compared with an average of 18% increase in 2010-11.

Euro Area: imports from major Asian Countries
(year-on-year change)

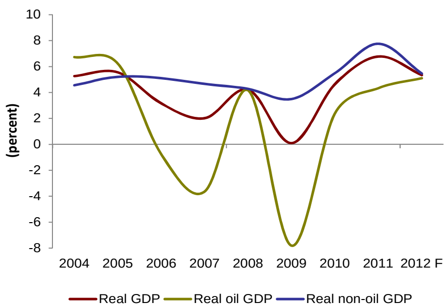


In addition to the trade channel, most emerging economies experienced volatile capital flows caused by the progress and regress of the policy actions in the advanced economies. While most of the capital flows is dominated by progress in the Euro Area, other emerging-market specific factors have also played a role. These include China's currency upward trend in real terms, policy uncertainty in India, geopolitical risks in the Middle East and monetary policy actions in some Latin American countries.

The Saudi Economic update

Despite the prevailing global economic gloom, the Saudi economy continues on a solid growth path. While this year expansion is not likely to match that of last year, it is more likely to register one of the highest growth rates among the G20 countries. Four factors have maintained a buoyant growth this year, namely (i) the hydrocarbon sector, (ii) expansionary fiscal policy with a significant positive impact on the non-oil private sector, (iii) solid domestic consumption and (iv) supportive bank lending to the private sector.

Real GDP growth

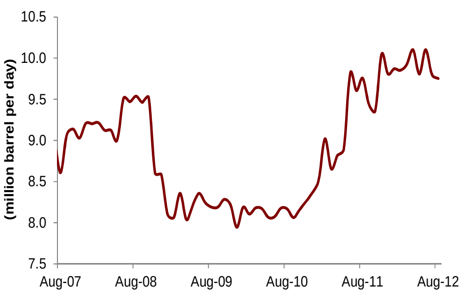


In light of the recent domestic and international data releases and oil market conditions we have made some adjustments to several forecasts. While our baseline scenario remains unchanged, which is centered on government spending leading non-oil growth, overall GDP growth is adjusted to mainly reflect changes in oil production. Given the elevated oil production level which have been maintained throughout most of this year, we increased our projection for real hydrocarbon GDP growth. In addition, higher production and higher oil prices ($109 per barrel) would generate record-high oil revenues of SR1,079.8 billion, or 44.3 percent of GDP, leading to a fiscal surplus of SR347.7 billion in 2012, some 5 percent higher than our earlier forecast. At the same time, the current account balance would benefit from $322.6 billion of oil exports, leading to a surplus of $167.5 billion or 25.8 percent of GDP. Finally, in light of the monthly indicators of economic activities, we have adjusted the growth of some non-hydrocarbon sectors.

The hydrocarbon sector

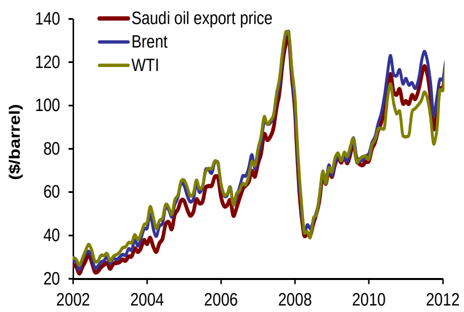
An upward revision to our oil production forecast is the main reason for the increase in real GDP growth projection from 5.3 percent to 5.8 percent in 2012. While we had forecast that Saudi Arabia's crude oil production would average 9.6 million barrel per day (mbpd) in 2012, the actual production level has been raised to a near record high this year with two months (April and June) recording an average production level above 10mbpd. The year-to-August production level has reached 9.9mbpd or 8.5 percent higher than the same period of last year. In addition, the Saudi Oil Minister, Ali Al-Naimi, indicated last month that while the oil market is well supplied, the Kingdom stands ready to increase its production level to meet additional demand and to moderate prices. We expect Saudi crude production to remain elevated throughout the rest of the year particularly as the market conditions are not likely to go through a significant change (see the oil market box). We thus revised our annualized average production level to 9.9mbpd or 6.3 percent year-on-year. This increase in production is likely to translate into a higher real oil GDP growth, which we now expect to expand by 6.1 percent year-on-year in 2012 compared to 5.1 percent previously.

Saudi Arabia will keep production elevated

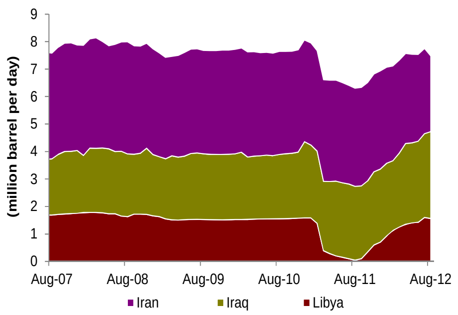


In addition to the increase in the oil production, the Kingdom is likely to benefit from firm oil prices. The average of the latter has held reasonably well this year, though with a higher volatility on the back of geopolitical concerns in the Middle East and global macro-economic data releases. These two factors pull oil prices in different directions, increasing the complexity of forecasting annual average. For instance, while we had anticipated seasonal factors as well as weak economic growth in the advanced economies to pull oil prices down in the third quarter to $105 per barrel (pb) for Brent, the actual realized price rose to $109.4pb on the back of higher than expected demand and geopolitical concerns. For the remainder of the year, we expect geopolitical concerns and low spare capacity to outweigh the impact of weak economic data and to keep oil prices elevated. We thus revise our forecasts for Brent to $114.4pb and $104pb for WTI or 3 percent and 9 percent higher than last year's level, respectively. This will translate to $109pb for the Saudi oil export price in 2012 compared to our previous forecast of $100pb.

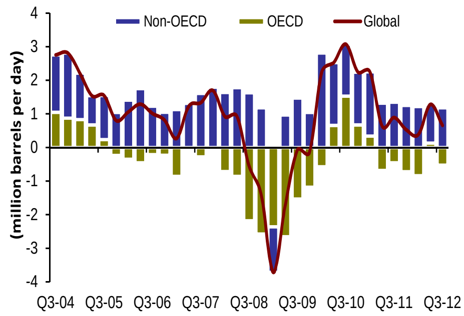
Oil prices



Iraq and Libya oil production are rising



Change in global oil demand
(Annual change)



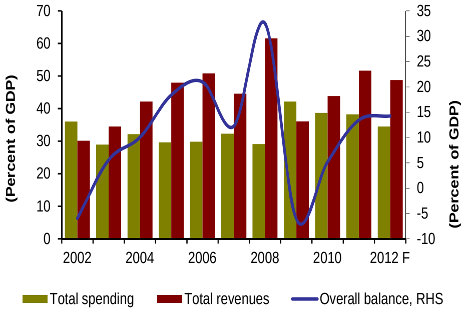
The oil market outlook

The oil market is likely to remain sensitive to two main factors pulling in opposite directions, namely geopolitical risks in the Middle East and risk to the global economic recovery. Fear of instability in the Middle East will leave oil prices elevated while the slower global economic is likely to pull prices downward. As a result oil prices are expected to remain volatile in response to progress and regress on these two factors. While the balance is likely to be tilted toward geopolitical risks and shrinking global spare capacity this year, projecting the balance next year is more complex given the significant implications of the upcoming fiscal and political events. As such, oil prices are expected to remain elevated this year despite balanced market fundamentals. We expect Brent to end the year with an annual average of $114.4pb or 3 percent higher than last year while the Saudi oil export price is expected to average $109 per barrel compared to $103pb last year.

- The key pressure point in global oil markets so far this year has been on the supply side and in particular the impact of the US and EU sanctions on Iranian oil exports and other geopolitical risks in the Middle East. Iranian oil production is estimated by Bloomberg to have declined to an average of 3.2 million barrel per day in the first nine months of this year compared to 3.6 million barrel per day in the same period last year. In contracts, overall OPEC supply have increased to an average of 31 million barrel per day in the first nine months this year compared to 29.7 million barrel per day for the same period last year. The increase is mainly due to higher Saudi and Iraqi productions and the return of Libyan production to the market. In addition, and despite declining production in some regions, non-OPEC supply is expected to rise to 53.2mbpd this year compared to 52.4mbpd in 2011 mainly due to improvements in North America crude production.

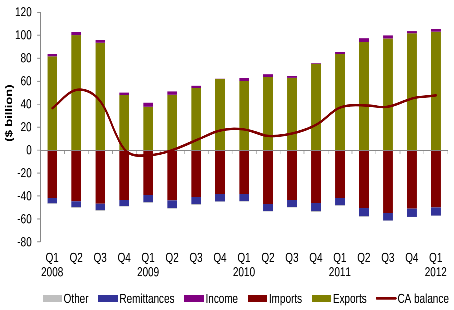
- In contrast, global oil demand is expected to increase only marginally, though the direct impact of the demand side on crude prices is likely to be small. Expectations of demand growth have been consistently higher than actual demand mainly due to weaker than expected global economic recovery. Due to divergence in economic activities, there is a clear difference between OECD oil demand which is expected to decline by 0.28mbpd in 2012 and non-OECD oil demand which is expected to increase by 1.05mbpd. Global overall demand is expected to increase to 89.1mbpd or by less than one present year-on-year compared with an annual growth average of 2.1 percent in the last two years. The downside risk is a significant and robust decline in emerging market crude demand that could trigger a downward swing in oil prices and induce OPEC member countries to cut production.

Fiscal balance will remain strong...



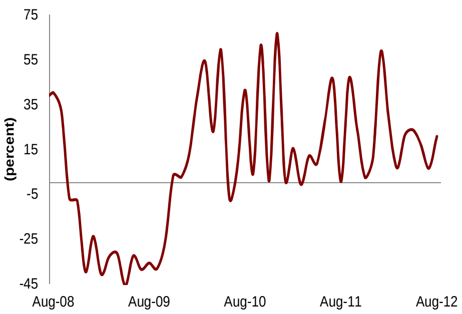
Higher oil prices and production will boost the Kingdom's **budgetary position** further. Despite elevated spending, Saudi Arabia will continue to record fiscal surplus. As oil revenues are the source of around 90 percent of budget revenues, higher oil prices will generate an all-time-high oil revenue of SR1.08 trillion or 4 percent higher than last year's actual revenues. Combined with higher non-oil revenues on the back of expanding non-oil sector, this will lead to total revenue of SR1.19 trillion for the year or 6 percent higher than last year's level. Such revenues are already sufficient for the government to finance all its planned spending this year comfortably. We do not think the government will raise its spending significantly, though we have made an upward adjustment to our forecast to SR841 billion, in part because there look to be more recipients of unemployment benefit than we had anticipated. We thus expect the fiscal balance to reach SR347.7 billion this year (14.3% of GDP) compared to SR291 billion (13.5 percent of GDP) in 2011. As a result, we expect the government to continue to reduce its public debt from 6.3 percent of GDP in 2011 to 5.6 percent this year. Based on our new oil production forecast and the fiscal stance, we estimate that the breakeven oil price for the budget, at which total revenues would cover total expenditure for the year, to be $74 per barrel (Saudi export crude).

…as well as the current account



The **external position** will also benefit from higher oil prices and production. Balance of payments data is only available for the first quarter. It puts the current account surplus at $47.6 billion, 28.7 percent higher than level of the first quarter of 2011, as a result of much higher oil revenues, a trend which we expect to be maintained. In addition, services payments (for such things such as transport, travel and communications) have increased by 23 percent year-on-year on the back of stronger domestic demand. On the merchandise trade side, more recent data is available. Imports over the first eight months of the year are 8 percent higher than in January to August of last year. Based on production and price data we estimate that oil exports averaged $24.6 billion per month so far this year or an increase of 9.7 percent compared to the average of last year, while non-oil exports are up by 4 percent year-on-year in the first eight months, despite a significant decline in August.

New letter of credit opened for total imports
(year-on-year change)

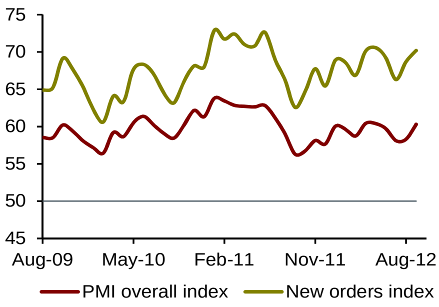


Over the remainder of the year, we expect government expenditure and robust domestic demand to maintain high level imports of goods and services. In fact, letters of credit opened at commercial banks for imports for the three months to end-August are 14 percent higher than in the corresponding period of 2011. Despite rising imports, the significant increase in oil export revenues, will keep the trade balance at a comfortable surplus which we now forecast to improve to $258 billion or by 5 percent year-on-year in 2012. This improvement is expected to offset net factor income outflows and to bring the current account surplus to $167.5 billion (25.8% of GDP) up from $158.5 billion last year. The country's robust external position is reflected in higher net foreign assets, with official foreign reserves expected to register a record high of $700 billion in 2012 up from $621.5 billion at the end of 2011. The downside risk is further deterioration in global growth that could depress oil demand and prices, though this is not our base-case scenario.

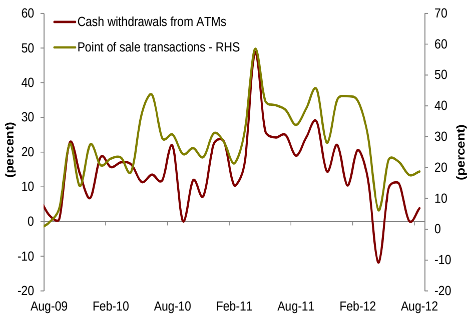
The Non-hydrocarbon private sector

While private sector activity eased in the first half of the year compared to a near record high in the same period last year , growth

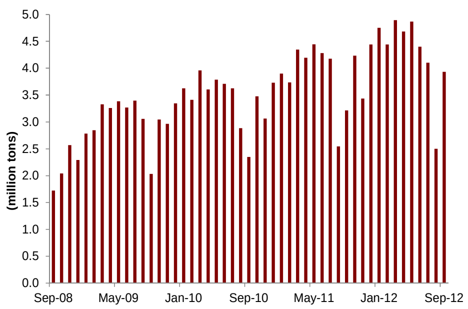
Purchasing manager index



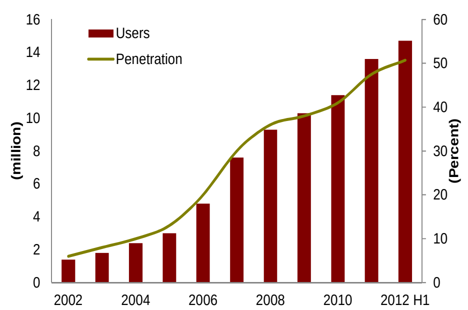
Point of sale transactions and ATM cash withdrawals
(year-on-year change)



Cement sales



Internet penetration



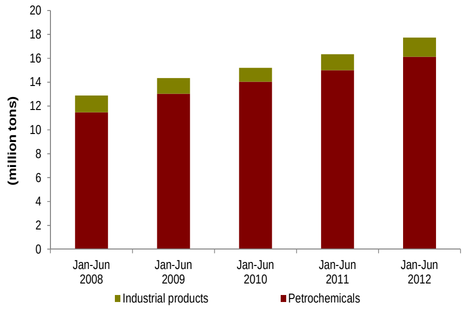
in the non-oil sector is expected to remain solid. Despite month-to-month volatility, the purchasing managers' index (PMI) remained on a gradual upward trend since the all-time low of 56.3 recorded in September last year. The latest PMI rose to 60.3 points from August to September, implying that private sector activity is expanding at a strong pace. Within the overall index, the output PMI rose in September by 2.5 points to 65 compared to August reading of 62.5, while new orders gained 1.5 points to 70.2 in September. Given the strong domestic fundamentals particularly on the hydrocarbon and fiscal fronts, we expect the non-oil private sector to maintain a solid performance this year and expand by 6.1 percent. Our expectations for growth in the main sectors are as follows:

- Monthly data points to very strong growth in **consumer spending** despite a large base effect stemming from last year's two fiscal packages. The value of cash withdrawals from ATMs in the first eight months of this year is 6.1 percent higher than for the same period of last year; for point of sales transactions, the growth is 24 percent. As a result, the wholesale and retail sector expanded by 7.1 percent in the first half of this year compared to 7.4 percent in the same period last year. While we expect consumption spending to have slowed during the third quarter, we expect the Hajj season to increase consumption spending leading to a solid growth in retail sector over the fourth quarter. We thus expect the retail sector to expand by 4.6 percent this year compared with 7.1 percent last year. The direct impact of a strong retail sector is likely to be reflected on the level of imports; the volume of consumer goods imports through the ports over the first six months of this year is 20 percent higher than in the same period of 2011.

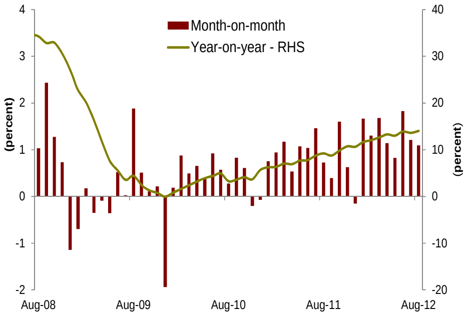
- Data also point to healthy growth in the **construction sector**. Cement sales over the first nine months of the year are 10.7 percent higher than in the same period of last year. The volume of imports of construction goods through the ports between January and June are 42 percent greater than in the first six months of 2011. As a result the sector recorded the highest expansion in the first half of the year at 9.2 percent compared with 10.7 percent for the same period of 2011. While activities are likely to have slowed during the third quarter, we expect a strong recovery toward the end of the year and we expect this sector to expand by 8 percent this year compared with 11.6 percent last year. With the government committed to a substantial infrastructure and house-building programs over the next few years, construction should remain one of the fastest growing sectors.

- Growth of the **telecoms and transport** sector is likely to slow when compared to previous years. In fact, the mobile phone penetration declined to 188 percent (1.88 phones per person) at the end of first half of this year down from its peak level of 198 percent in September last year. The number of mobile phone subscribers also contracted by 0.7 percent year-on-year in the first half of 2012, the first contraction for which data is available. In contrast, the number of internet users increased by 17.6 percent year-on-year in the first half, rising by 1.1 million users compared to 13.6 percent growth in the same period of last year. For transport, rising import volumes, the need to move large amounts of construction materials around the country and the

Petrochemical and indusial exports



Bank lending to the private sector



new transport infrastructure projects will be important sources of growth. We maintain our forecasts for the growth of telecom and transport sector at 7 percent in 2012 compared to 10.6 percent last year.

- Information on **manufacturing** output is not produced, though port data give a guide to the volume of exports of manufactured products. It shows that exports of petrochemicals were 7 percent higher over the first six months of this year compared to the corresponding period of 2011 and those of industrial products were 20 percent greater during the same period. While the manufacturing sector has expanded by 8.7 percent during the first half of this year, we expect weakening of the global economy to dampen manufacturing export growth over the remainder of the year. The domestic demand for manufacturing products especially those used for construction, however, will drive most of the growth in this sector. We thus keep a healthy growth of 4.5 percent in the manufacturing sector compared to 14.9 percent last year.

- An important factor supporting the private sector has been the revival in **bank lending**. Year-on-year bank lending growth is running in line with our expectations at 14 percent in August, the highest since March 2009. Monthly growth has averaged 1.3 percent so far this year compared to 1 percent in the same period last year. High government spending has made lenders and borrowers more comfortable with the economic environment. At the same time, banks have covered all the non-performing loans that built up on their books in recent years and so have much less need to devote funds to building up provisions, rather than lending. The local outlook is supportive for continued growth in bank lending, but this would be disrupted by a dramatic intensification of the banking problems in the Eurozone, even though the Kingdom's banks would probably not be directly impacted.

Key data

	2005	2006	2007	2008	2009	2010	2011	2012 F	2013 F
Nominal GDP									
(SR billion)	1182.5	1335.6	1442.6	1786.1	1412.6	1690.5	2163.1	2438.0	2507.2
($ billion)	315.3	356.2	384.7	476.3	376.7	450.8	576.8	650.1	668.6
(% change)	26.0	12.9	8.0	23.8	-20.9	19.7	28.0	12.7	2.8
Real GDP (% change)									
Oil	6.2	-0.8	-3.6	4.2	-7.8	2.4	4.3	6.1	-1.0
Non-oil private sector	5.8	6.1	5.5	4.6	2.7	5.3	8.3	6.1	6.0
Government	4.0	3.1	3.0	3.7	5.2	5.9	6.7	5.0	4.9
Total	5.6	3.2	2.0	4.2	0.1	4.6	6.8	5.8	3.8
Oil indicators (average)									
WTI ($/b)	56.4	66.1	72.3	99.6	61.7	79.4	95.1	103.7	100.5
Saudi ($/b)	47.9	59.2	67.2	94.0	60.4	77.5	103.5	109.1	105.7
Production (million b/d)	9.2	8.8	9.2	8.2	8.2	9.3	9.3	9.9	9.8
Budgetary indicators (SR billion)									
Government revenue	568	679	643	1101	510	742	1118	1189	1096
Government expenditure	350	398	466	520	596	654	827	841	897
Budget balance	217	280	177	581	-87	88	291	348	199
(% GDP)	18.4	21.0	12.2	32.5	-6.1	5.2	13.5	14.3	7.9
Domestic debt	460	365	267	235	225	168	137	137	137
(% GDP)	38.9	27.3	18.5	13.2	15.9	9.9	6.3	5.6	5.5
Monetary indicators (average)									
Inflation (% change)	0.7	2.3	4.1	9.9	5.1	5.4	5.0	4.6	4.4
SAMA base lending rate (%, year end)	4.75	5.20	5.50	2.50	2.00	2.00	2.00	2.00	2.00
External trade indicators ($ billion)									
Oil export revenues	161.6	188.2	205.3	281.0	163.1	215.2	317.6	322.6	293.3
Total export revenues	180.4	210.9	233.1	313.4	192.2	251.0	364.6	381.6	358.0
Imports	53.8	63.0	81.5	100.6	86.4	96.7	119.1	123.6	138.1
Trade balance	126.6	147.8	151.6	212.7	105.8	154.3	245.5	258.0	219.9
Current account balance	90.0	98.9	93.3	132.3	21.0	66.8	158.5	167.5	122.7
(% GDP)	28.5	27.8	24.3	27.8	5.6	14.8	27.5	25.8	18.3
Official foreign assets	195.5	273.4	359.8	502.0	474.2	520.3	621.5	700.3	820.6
Social and demographic indicators									
Population (million)	23.4	24.1	24.8	25.5	26.3	27.1	27.9	28.8	29.7
Unemployment (male, 15+, %)	11.5	12.0	11.0	9.8	10.5	10.2	11.0	10.5	9.4
GDP per capita ($)	13503	14806	15523	18651	14311	16612	20651	22573	22523

Sources: Jadwa forecasts for 2012 and 2013. 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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