



## The Saudi economy in 2013

We expect another year of solid economic performance in 2013. Non-oil growth will be strong and inflation should slightly ease. Lower oil production will cause total real economic growth to slow, and combined with lower oil prices, will reduce the budget and current account surpluses. High government spending will remain the engine of the non-oil economy.

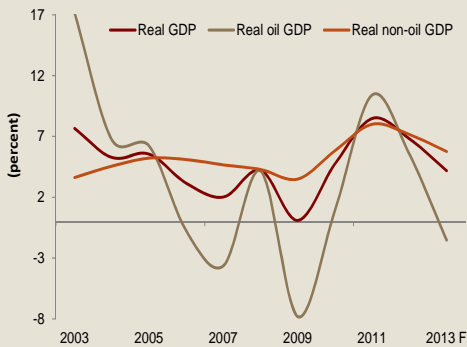
We expect economic growth to fall to 4.2 percent in 2013, down from 6.8 percent in 2012. This decline is because oil production is forecast to drop after a 5.5 percent rise in 2012. Growth in the non-oil economy will be 5.8 percent. Government spending will be supported by greater bank lending and high consumer spending. Construction and transport, the main beneficiaries of government spending, should be the fastest growing sectors.

Budgeted government spending for 2013 is slightly below the actual level for 2012, however we do not view this as withdrawal of the stimulus or a rethinking of the ongoing expansionary fiscal stance. Investment is budgeted at a record high and total spending will provide an important stimulus to the economy. We expect another budget surplus in 2013. The government will draw down its foreign assets, which stood at around \$634.8 billion at the end of November 2012, to finance its expenditure plans in the event of any shortfall in revenues.

Inflation is forecast to moderate to an annual average of 4.3 percent in 2013. Negligible external price pressures, which are due to lower commodity prices and subdued inflation in trading partners, will underpin the decline. This will be supported by declining rental inflation, as more properties enter the market. However, its impact on inflation is likely to be limited. These factors should offset any local inflationary pressures caused by the high level of consumer and government spending. Interest rates will remain exceptionally low which will bolster the economy. It will, however, hinder the government should it need to tackle inflation. We do not expect any change to the riyal's peg to the dollar.

The main risks to our forecast stem from the external environment. A significant slowdown in global growth and geopolitical tensions constitute key risks. While not our baseline forecast, a sharp drop in oil prices could lead to an even higher cut in Saudi oil production than we currently forecast. While this will lower oil sector growth and weigh on the fiscal balance, this is likely to have a small impact on other sectors of the real economy. This is because the growth momentum in the Kingdom is centered around the government maintaining an elevated spending that is afforded comfortably. Furthermore, regional political uncertainty will continue to hang over the economy and any heightening of tensions would hit business and consumer confidence. Absent serious reform, ongoing high growth in government spending and domestic energy consumption mean that long-term fiscal and income diversification challenges will remain.

**Real economic growth**  
(year-on-year change)



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## The global economic outlook

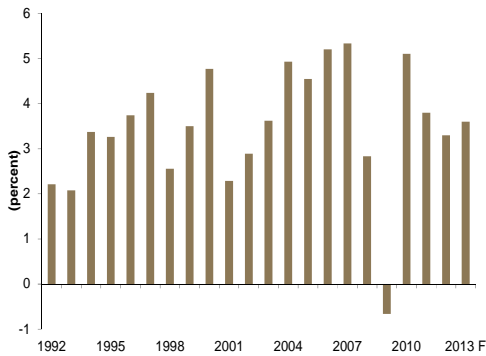
Four years after the global credit crisis, the global economy still faces a great deal of uncertainty. The IMF estimates that the global economic growth has weakened further in 2012. It also forecasts that this year's growth is not likely to reach the 3.8 percent growth in 2011, with growth in advanced economies even lower. Consensus forecasts present even a gloomier outlook for the global economic growth this year than that of the IMF's (see table on next page). Diverging central bank policy, uneven progress towards sovereign debt sustainability, fiscal austerity, progress and regress in euro crisis, geopolitical risks, political change and growing emerging economies will be the main economic themes in 2013.

Recovery in most **advanced economies** remains weak while economic policy uncertainty hinders the growth potential. While the **US economy** has been performing relatively better recently supported by accommodative monetary policy, the fiscal drag combined with lack of credible long-term fiscal plan is likely to weigh on growth in 2013. A last minute agreement to avert the full extent of the fiscal cliff was reached last week. In particular, the deal includes the following:

- Bush tax rate cuts are extended permanently for individuals earning less than \$400,000 for individuals and \$450,000 for families. Earnings above those amounts would be taxed at a rate of 39.6 percent, up from the previous 35 percent. Personal exemptions will be phased out and itemized deductions will be limited for individuals making \$250,000 or more for families making \$300,000 or more.
- The Social Security payroll tax cut will not be extended, and rates will rise to 6.2% from 4.2% for all.
- The alternative minimum tax (AMT) will be permanently indexed to inflation.
- Taxes on capital gains and dividend income exceeding \$400,000 for individuals and \$450,000 for families would increase from 15 percent to 20 percent. The estate tax rate will be increased permanently to 40% (from the current 35%), but only for estates worth more than \$5 million.
- Emergency unemployment benefits were extended for one year.
- Other measures: the deal extended child tax credit and the college tuition credit for five years, individual and business tax breaks for two years. It also blocks a 27 percent cut in Medicare payments to doctors for one year.
- Tax breaks (college-expense related, earned income and child tax credits) have been extended for five years for working families. Some business tax breaks were extended for one year.

According to the Congressional Budget Office (CBO), the agreement will probably increase GDP growth in 2013 by about 1.5-1.75 percentage points compared to what would have happened under the prior law. While this tackles some of the short-term concerns which reduce the downside risk to US economic growth, the outlook for government spending remains a concern. Within the next few months, US policy makers still have to agree on spending cuts (\$109 billion), the debt ceiling as well as its debt sustainability in the long-term. The lack of agreement in this space means that total fiscal tightening could rise further creating an uncertain environment that would slow the pace of private sector investment and hiring.

**Global GDP growth**  
(year-on-year change)





Beyond the fiscal cliff, the Federal Reserve (the US central bank) will maintain its current accommodative monetary policy this year expanding its balance sheet throughout 2013 at \$85 billion per month. The Fed also announced that the federal funds interest rate will remain at its current level (between 0.0 and 0.25 percent) as long as the unemployment rate remains above 6.5 percent and the one-to two-year inflation forecast is at or below 2.5 percent. With the concerns about government spending, this means all economic stimuli in 2013 will be in the form of looser monetary policy.

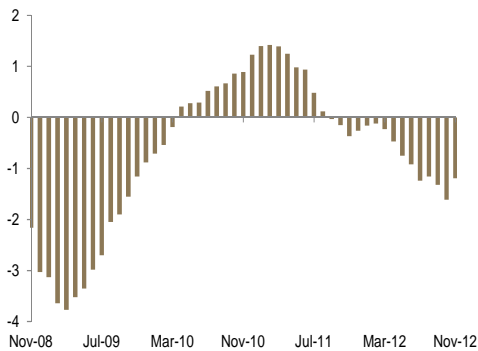
**Global GDP growth**

(percent; IMF and consensus\* projections)

	2010	2011	2012 E		2013 F	
			IMF	Consensus	IMF	Consensus
World	5.1	3.8	3.3	2.2	3.6	2.4
US	2.4	1.8	2.2	2.2	2.1	2.0
Japan	4.5	-0.8	2.2	1.7	1.2	0.6
Euro-Zone	2.0	1.4	-0.4	-0.4	0.2	-0.1
UK	1.8	0.8	-0.4	-0.1	1.1	1.1
China	10.4	9.2	7.8	7.7	8.2	8.1
Emerging Markets	7.4	6.2	5.3	...	5.6	...
Middle East	5.5	4.9	3.2	...	3.3	...

Note: \*Bloomberg poll.

**Euro Zone: Business climate**



**US Dollar/Japanese Yen**



Recovery in most **Euro area** remains also weak with a very substantial fiscal consolidation, notably in the periphery. While both consumer and business confidence remains on the low side, they are expected to gradually improve during 2013. This has resulted especially from a number of new policy initiatives such as the European Central Bank's (ECB) Outright Monetary Transactions (OMT) instrument and steps towards greater fiscal integration and coordinated financial supervision and regulation. While these measures address some of the structural issues that have threatened the stability of currency union in the past few years, they are not sufficient enough to fully restore output growth and employment in the short-term. Economic growth in the euro area is also likely to remain weak given the current fiscal austerity measures occurring in a number of countries. Consensus forecasts put GDP growth at -0.1 percent in 2013.

In **Japan**, economic growth is expected to slow to 0.6 percent in 2013 compared with an estimate of 1.7 percent last year. The reason for the lower growth is that most of the reconstruction work and recovery from the earthquake-related disasters of 2011 is expected to fade away during the current year. Furthermore, exports faced strong headwinds from the slowdown in global demand, but the recent yen depreciation could push exports growth upward. In fact, the expected aggressive expansion of the Bank of Japan's Asset Purchase Program has pushed the US dollar/Japanese yen exchange rate to 2-year low. The new government is also considering further fiscal easing, such as increased infrastructure and defense spending which will be positive for growth, but could ultimately push its fiscal balance even further into deficit.

**Emerging markets** will continue to perform relatively better than advanced economies, led by Asia. Growth in domestic demand should offset most of the negative impulse from the weaker global economy. Banks are also much healthier than in developed markets. There is also far more scope to ease fiscal and monetary policy in



emerging markets than in advanced economies. The IMF's forecast for emerging markets growth were set at 5.6 percent in 2013 compared with 5.3 percent last year. Supportive fiscal policy in China will improve retail sales, industrial output and sentiment indicators. As a result the risk of a hard landing has abated. Recently issued foreign investment and other fiscal policy reform measures in India should gradually improve growth outlook. A pick up in exports and stronger domestic demand should improve economic activity in Korea while lagged effect of monetary policy and prospect for further easing in Brazil should lead to a rebound in growth.

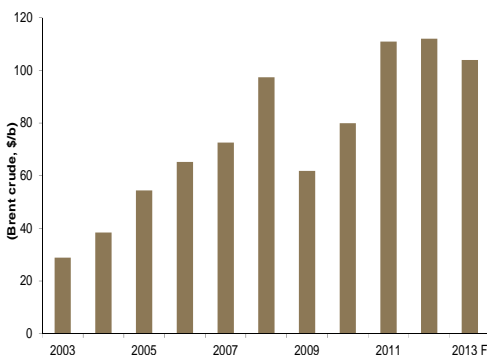
The main **risks to the outlook** are on the downside and center on the Euro-zone and fiscal concerns in the US. The steps Euro-zone and US leaders need to take to deal with the crisis are understood, but a lack of political commitment to the necessary concessions is hindering implementation. As a result, the pace of change is much slower than that required by financial markets. The longer the wait, the higher the cost and the greater risk that the situation gets out of control. For the US, the inability of the two main parties to agree on a comprehensive fiscal agreement could have an immediate as well as a long-term impact on the economy. Budgetary problems remain a serious concern for Japan and while the country has been able to maintain a rising debt burden for many years, at some point this will become unsustainable particularly given the potential for further fiscal easing. Uncertainty in the advanced economies could also hinder the growth potential in emerging markets though trade channel and volatile capital flows.

### The oil market in 2013

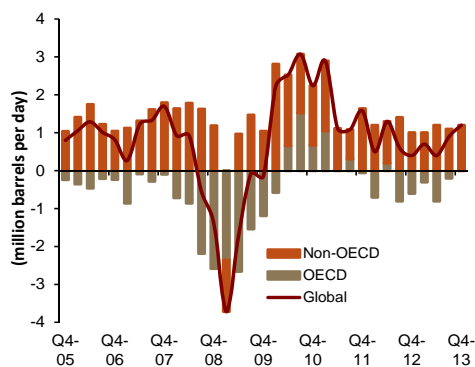
Oil prices are forecast to fall in 2013 owing to a weakening of the global economy and further ease in global oil balance. We forecast that Saudi export crude will average \$99.4 per barrel (equivalent to \$104 per barrel for Brent). With output from Iraq and North America steadily rising, we expect Saudi oil production to fall to 9.6 million barrels per day (mbpd) from 9.8mbpd in 2012.

- Global oil demand is expected to rise in 2013 as a result of relatively sound performance in emerging markets. Oil demand growth in the non-OECD countries mainly driven by China, India and the Middle East is expected to outpace a fall in oil demand from the OECD region. According to the International Energy Agency (IEA), Asia alone will be the source of over 50 percent of global oil demand growth in 2013. Demand growth from elsewhere will remain subdued as economic growth recovers gradually. European oil demand is expected to shrink by 0.2mbpd next year. A further deterioration in the Euro-zone growth would weigh on oil prices.
- Total world oil output should also rise in 2013 despite higher disruption risks particularly among some of the Middle Eastern oil producers. While political unrest in Syria, Yemen, Sudan, South Sudan and sanctions on Iran will maintain the pressure on the oil market, the full return of Libyan oil production, and the strong oil production growth coming from Iraq and North America will ease such pressure. All in all, non-OPEC supply is expected to rise by 0.9mbpd most of which is coming from North America according to the IEA. We expect OPEC to reduce its production marginally in 2013. The latter is mainly due to low Iranian oil production which is likely to remain at the current level throughout next year with risk tilted to the downside. We also

Average oil price



Change in global oil demand (IEA data)





expect Saudi Arabia to slightly cut production to balance the market.

- The current high commercial oil stocks should pose negative element for oil prices. OECD crude stock levels remains at a comfortable level when measured in days of demand coverage as well as relative to their five-year average. This reflects a strong build over the second half of last year.

Geopolitical risks and increased liquidity poured into the system from central banks also need to be considered when forecasting prices. The turbulence in the Middle East and North Africa added a risk premium to prices in 2012 and this will likely remain the case for most of next year as uncertainty is likely to linger. Tensions surrounding Iran have also the potential to cause oil prices to remain elevated.

Financial flows have also influenced oil prices in recent years. The US, Japan, and EU monetary easing measures have been supportive for oil prices, though the impact is relatively short lived as weak global fundamentals start making their negative impact on the market. In 2013, the prices could come under some pressure as uncertainty over Europe recovery and US fiscal stance.

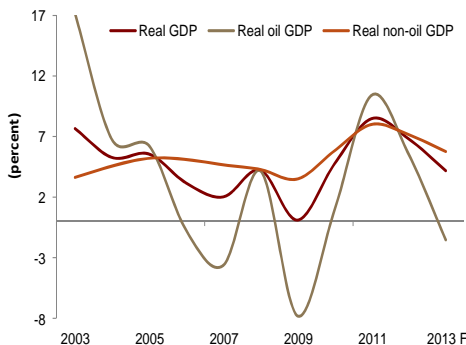
### Saudi economic growth

The Saudi Central Department for Statistics and Information released last week new revised GDP figures for the last three years showing that the economy expanding by 4.7, 8.5 and 6.8 percent in 2010, 2011 and 2012, respectively. In light of these revisions and based on our outlook for the current year, we forecast economic growth to reach 4.2 percent in 2013. While large base effects plays a role in reducing the economic growth this year, it is mainly the lower oil production compared to last year. In fact, the Kingdom has already started to scale down its oil production since reaching a peak of 10.1mbpd in June 2012. As we discussed above, we expect the annual oil production to fall by 2.3 percent year-on-year in 2013 compared with an expansion of 5.5 percent year on year last year. As a result, the oil sector is set to contract by 1.5 percent this year compared with an expansion of 5.5 percent in 2012.

The non-oil sector will benefit from elevated government spending as well as corporate lending and solid domestic consumption. We expect 2013 to be the fifth consecutive year that the economy is driven by expansionary fiscal policy. We forecast that the total government expenditure will be equivalent to 31 percent of GDP compared with an average of 30.4 percent in the last ten years. High public sector expenditures particularly investment spending is psychologically important for the private sector. Non-oil private GDP growth is forecast at 6.3 percent compared with a 4.9 percent average for the last ten years. This willingness and ability to support the economy will be important in 2013 as international and regional events are dampening sentiment and have the potential to damage the economy. The main economic risk is from the situation in the Euro-zone and fiscal uncertainty in the US. The fluid regional political situation will continue to make foreign investors wary and impact the sales of companies that export to the region; it also brings the risk of stock market and oil price volatility.

The impact of government spending across the sectors of the economy will depend on the nature of such spending. While

**Real GDP growth**  
(year-on-year change)





government investment spending is budgeted at a new all-time high, we expect an over spending that will take investment spending to 10.3 percent of GDP compared with 7.8 percent in the last ten years. This will maintain a solid performance by the private non-oil sector particularly construction activities. We expect the latter to maintain its position as one of the fastest growing sectors in 2013. We also expect construction companies and producers of associated goods and raw materials to benefit greatly from the government investment spending. The power and electricity and transport sectors are also likely to be directly affected by such spending.

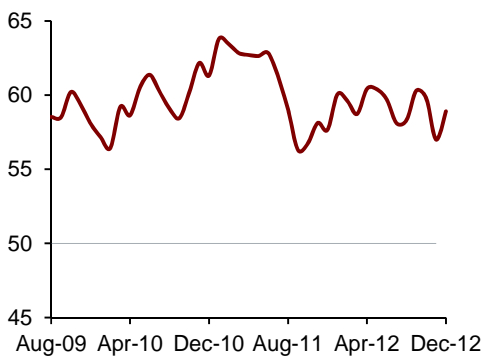
Other sectors that make up the non-oil GDP will also benefit from the rising government consumption spending, the ongoing labor market reform initiatives and rising bank lending. The permanent fiscal measures that were introduced in 2011 such as the higher minimum public sector wages along with new minimum wage for the Saudization program are likely to maintain an elevated private consumption level. The wholesale and retail, financial and communication sectors will be the clear beneficiaries of these measures. For all these sectors, however, the large base effect is likely to reduce this year expansion compared to the level observed in the last few years.

Recent economic data highlight that the economy has maintained a robust performance in line with the recent GDP growth figures. Indicators of consumer spending, such as point of sales transactions and cash withdrawals from ATMs, point to healthy growth during the year. Cement sales, a good gauge of construction activity, are 10 percent higher than they were in the same period of the previous year. Furthermore, the performance of listed companies continues to improve albeit at a slower pace than previous years, with profits up by 4 percent year-on-year in the third quarter. Central bank data shows that bank lending rose consistently during 2012 with net credit issued reaching SR125 billion, the highest level since 2008. In an environment of very low interest rates and low investment returns available elsewhere, banks are likely to put more emphasis on lending to smaller business that have struggled to access credit in recent years. Finally, the latest Purchasing Manager Index at 58 indicates that the private sector remains in an expansionary mood.

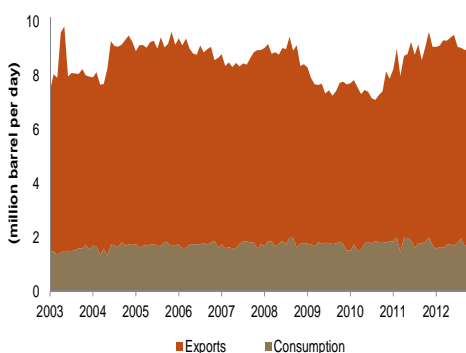
Although we expect non-oil economic growth to pick up, the trend varies across the key sectors of the economy. Our expectations for growth in the main sectors are as follows:

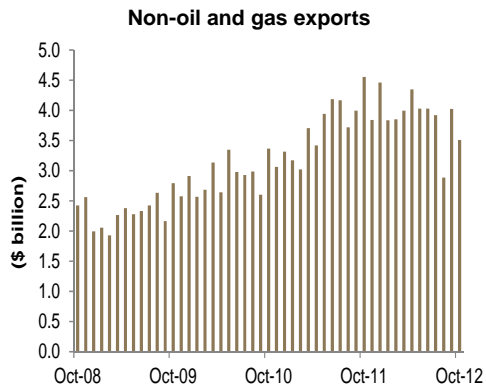
- **Oil sector**, the largest sector of the economy, accounting for around 21 percent in real terms, is forecast to contract owing to a decline in oil production (see oil market in 2013). The Kingdom increased its oil output by 5.5 percent year-on-year in 2012 to offset the drop in Iranian production (15.7 percent year-on-year) as well as to meet the rising domestic demand (7 percent year-on-year). With Iraq and North America production on the rise, OPEC current production being above its quota and troubles in the advanced economies hitting demand, we think that production will be cut in 2013 by 2.3 percent year-on-year to 9.6 million barrel per day. It is likely that the oil sector will contract by 1.5 percent in 2013, lower than the decline in oil output given the project work taking place in the sector. Most of this work is concentrated on exploring and developing the Kingdom's gas reserves including Karan gas field and the recently announced Midyan natural gas field.

**Purchasing Managers Index**



**Total Saudi oil production**

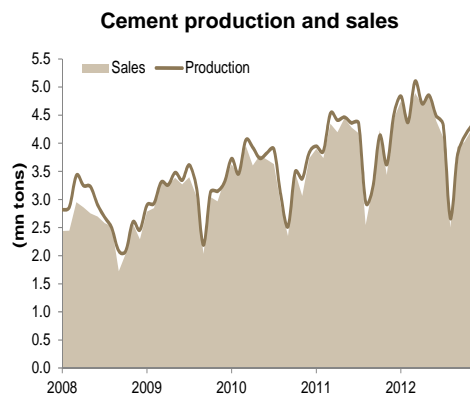




- Manufacturing** growth is likely to slow in 2013. The sector expanded by 7.6 percent last year compared with 13.7 percent in 2011. While this remains robust, the slower growth is mainly due to the subdued global demand on manufacturing goods, particularly petrochemicals. Annual increase in petrochemical and plastic exports slowed to 9 percent year-to-October 2012 compared with 36 percent year-to-October 2011. We think export volumes of such products will remain weak as the global slowdown extends into 2013. In addition, political uncertainty will continue to impact on performance of many other countries in the region, which will dampen demand for other locally manufactured exports. Investment in refinery projects, however, is expected to positively contribute to manufacturing growth in 2013. According to Middle East Economic Digest, there were SR36.9 billion worth of oil and gas projects in 2012 (9 percent year-on-year) most of which are in the refining sector. Furthermore, local demand for manufactured products, especially those used for construction, such as cement and steel, will pick up. Other manufacturing projects that are scheduled to be operational in 2013 include, Maaden's new aluminum smelter in Ras Al-Khair, Jubail Refinery and Petrochemical Complex, Jubail Polyolefins Complex and Jazan's aluminum smelters.

**Real GDP growth**  
(percent)

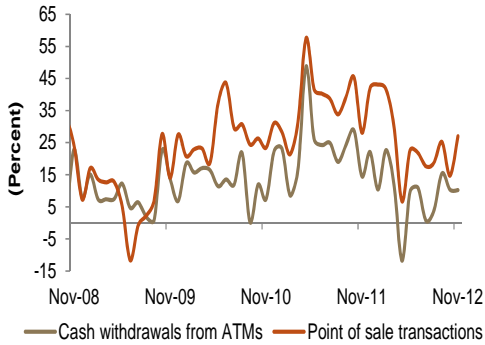
	2009	2010	2011	2012 E	2013 F
Agriculture	-0.5	-1.0	2.2	2.6	0.5
Manufacturing	1.5	6.6	13.7	7.6	5.5
Electricity, gas and water	6.8	7.9	5.2	7.3	5.7
Construction	0.6	7.3	9.9	10.3	7.5
Wholesale & retail trade	2.5	7.7	7.3	8.3	4.5
Transport & communication	7.4	6.4	13.8	10.7	6.2
Finance	2.6	2.1	2.1	4.4	3.3
<b>Non-oil private sector</b>	<b>2.7</b>	<b>5.8</b>	<b>8.0</b>	<b>7.2</b>	<b>6.3</b>
Oil	-7.8	0.9	10.4	5.5	-1.5
Government services	5.2	6.8	7.9	5.2	4.3
<b>Total</b>	<b>0.1</b>	<b>4.8</b>	<b>8.5</b>	<b>6.8</b>	<b>4.2</b>



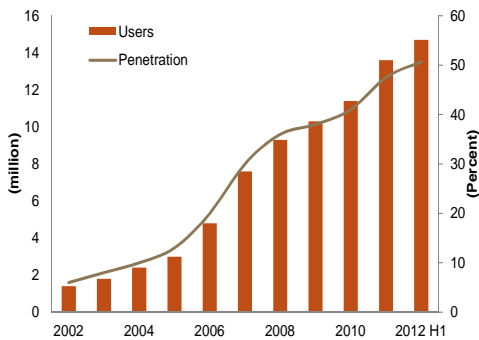
- Electricity, gas and water** will remain one of the quickest growing sectors of the economy. Sectoral growth has averaged 6.3 percent in the past decade and should be faster in 2013 with new housing, commercial and office space coming on stream in addition to rising industrial demand. Several major projects are coming to fruition in 2013, the largest of which are Al-Qurayyah Power and Plant II Rabigh IPP - Phase 1, both with capacity of a 1,200 megawatts. We do not expect any change in utility pricing, even though such change would slow consumption growth and promote more efficient use.
- Construction** is forecast to be the fastest growing in 2013, driven by the high level of government investment spending. According to Middle East Economic Digest, there are projects underway or planned in the Kingdom worth \$782 billion; virtually all of these involve some element of construction. New letter of credit opened for imports of building material expanded by 16.8 percent in the first eleven months of 2012 compared with 12.2 percent for the same period in 2011, suggesting that more



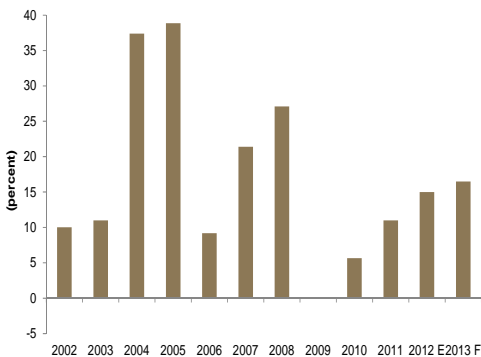
**Indications of consumer spending**  
(year-on-year change)



**Internet penetration**



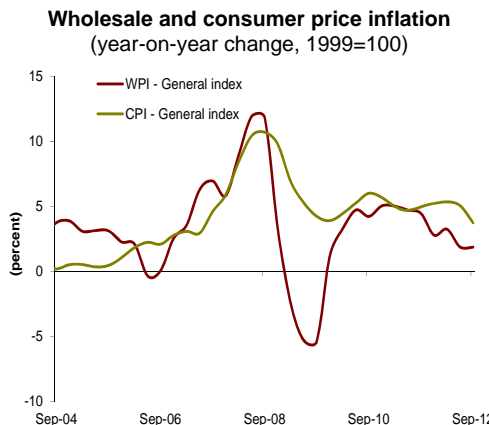
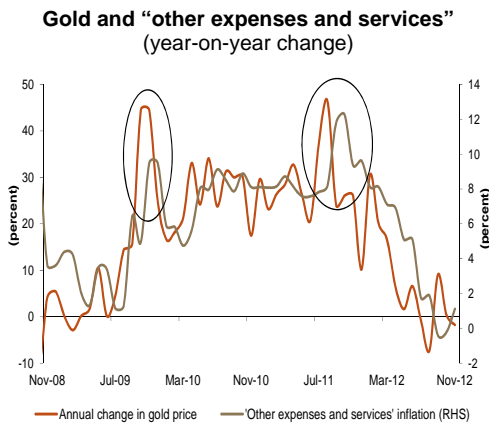
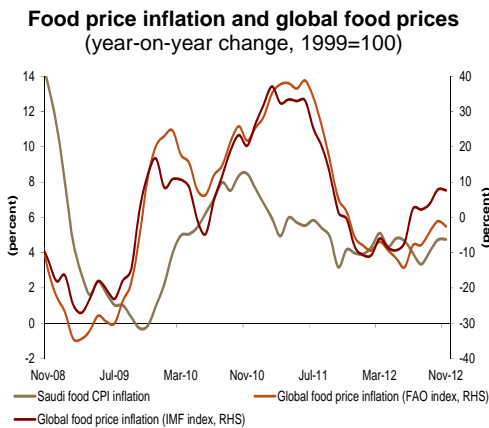
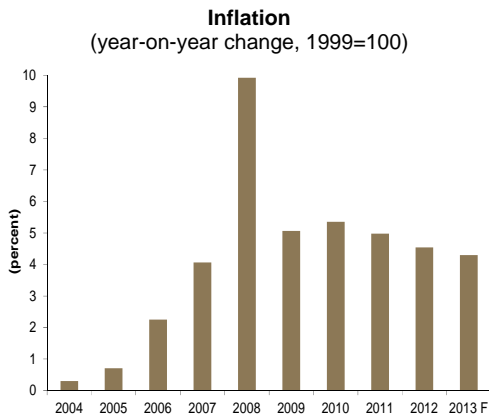
**Bank lending to private sector**  
(year-on-year change)



projects have moved from the planning stage to actual construction. In addition, annual growth in cement sales in 2012 remained robust despite seasonal volatility. We expect the sector to also benefit from the government's plan to build 500,000 new housing units, announced in March 2011, as such plan gains more momentum in 2013. Strong demand for residential accommodation and improved availability of bank credit also means that the private sector will be a growing source of demand for construction projects during the year.

- The ongoing improvement in the economy should boost the **wholesale and retail** sector. Data on point of sales transactions and cash withdrawals from ATMs suggest that consumer spending has picked up in 2012 and we anticipate positive growth in 2013. The government consumption spending and the push to increase Saudi employment in the private sector all will contribute to the expansion of the sector. In addition, spending by low income consumers should rise as a result of the new minimum wages for Nitaqat (the Saudization initiative) and for public sector employees, and the expected influx of low-wage expatriates due to the ongoing and planned construction projects. Those on low incomes tend to spend a high proportion of their salaries.
- We expect growth for the **telecoms and transport** sector to slow but remain above 5 percent. This is because the stimulus resulting from the surge in mobile phone use in recent years will fade. Mobile phone penetration declined to 187 percent (1.87 phones per person) at the end of the first half of 2012 from 188 percent at the end 2011. Mobile subscriptions contracted by 0.7 percent over the first six months of 2012, compared to an annual average growth of over 29 percent in the previous five years. It is likely that the most dynamic part of the telecoms sector will be the provision of content and applications as well as internet and broadband services. In fact, the expansion of both internet and broadband services has improved, and with penetration at 50.7 percent and 36 percent at the end of the first half of 2012, respectively, there is more room for growth. We expect the transportation component of this sector to grow in line with a rising volume of imports and exports and the ongoing implementation of infrastructure projects that involve the movement of equipment and material around the Kingdom. The recent SR200 billion budget allocation for city transport projects is likely to maintain a solid performance in this sector for the next few years.
- The revival of private sector activity should feed into higher growth for the **finance sector**. On top of the anticipated rise in bank lending, we think that many investment banking transactions put on hold in the past few years will resume. There is also room for growth in the nascent insurance industry. The increase in the supply of housing will lift the value added generated by real estate services (such as estate agents). Business services such as legal, marketing and consultancy (which are all captured in the finance sector) will benefit from the greater use of financial services and the broader pick up of the private sector.





## Inflation

Inflation is expected to slightly fall to an average of 4.3 percent owing to an easing of price pressures from outside of the Kingdom, though weaker dollar could lead to higher import costs. We think there will be some local inflationary pressure as a result of the high level of consumer and government spending. Rental inflation should continue its gradual decline as more properties enter the market, despite higher consumer disposable income, which would put limited pressure on property pricing trend.

International conditions provide a benign backdrop to inflation in the Kingdom particularly food prices. Food accounts for 30.4 percent of the total basket of goods and services that make up the Kingdom's Consumer Price Index (CPI). While increase in global food prices have been a leading source of inflation in the past few years, these should be more favorable in 2013. According to the UN Food and Agriculture Organization (FAO), global food prices have been falling since they hit an all-time high in July 2011. By November 2012, they contracted by 2.6 percent year-on-year. We, nonetheless, do not expect such contraction to lead to a significant decline in food prices inside the Kingdom, as for issues with domestic supply networks, falls in global food prices tend not get entirely passed on to domestic consumers.

The other commodities that directly feed into inflation are precious metals, particularly gold which we think their impact on jewelry prices play a large role in the "other expenses and services." The latter accounts for 13 percent of the Kingdom's CPI. There were two periods in the last three years (end of 2009 and end of 2011) in which a significant increase in gold prices (above 35 percent year-on-year) have led to an increase in the other expenses and services component of the Saudi CPI to more than 8 percent year-on-year. The recent fall in the annual change in gold price has also contributed to slowing inflation in the other expenses and services category (see chart). Gold is one of the most difficult commodity prices to forecast as its use as a hedge or safe haven has much greater impact on prices than physical demand and supply conditions. The consensus forecast is for a slight increase in gold prices in 2013. Prices of other commodities, such as base metals, minerals and construction materials which are captured in the wholesale price index are expected to rise modestly.

Wholesale price inflation data does not point to strong inflationary pressures in the pipeline. In the third quarter, year-on-year wholesale price inflation was 1.9 percent, down from 4.5 percent a year earlier. Vast construction work planned, high demand for some building materials in the Kingdom could cause supply bottlenecks and will put upward pressure on the prices. Although it takes some time for raw materials to find their way to consumers in the form of finished goods, the data do not indicate any lag between changes in wholesale and consumer prices (see chart). Prices of raw materials are also heavily influenced by demand from emerging markets, particularly China. So the ongoing strength of these countries should put upward pressure on prices. However, metals prices have maintained a positive trend last year, partly because of financial inflows, but expected to moderate in 2013 owing to concerns about the pace of the global economic recovery.

A fall in the dollar vis-à-vis other trading partner currencies would



add to these imported inflation pressures and would spread them to other imported goods. Given the concern about the US fiscal policy, the rising public sector debt and the aggressive loose monetary policy, there is a potential downside risk for the dollar against the euro and many emerging market currencies. We nonetheless expect such decline to be moderate given the dollar safe haven status owing to the liquidity, size and breadth of its capital markets.

Inflation in trading partners is another important contributor to inflation in the Kingdom. With weak growth likely in the US and in the EU (combined, these are the source of 40 percent of the Kingdom's imports in 2011) inflationary pressures in these areas should subside. While major central banks are likely to maintain their aggressive loose monetary policies throughout this year, the transition of such policies to global inflation is likely to remain weak. This is due to fiscal austerity in a number of advanced countries, the Euro-zone crisis and US fiscal contraction all of which will reduce pressure on commodities prices. For advanced economies as a whole, the IMF forecasts that inflation will drop to 1.6 percent in 2013 from 1.9 percent in 2012; for emerging and developing economies, the fall is predicted to be to 5.8 percent in 2013 from 6.1 percent in 2012, suggesting that this should also not be a concern.

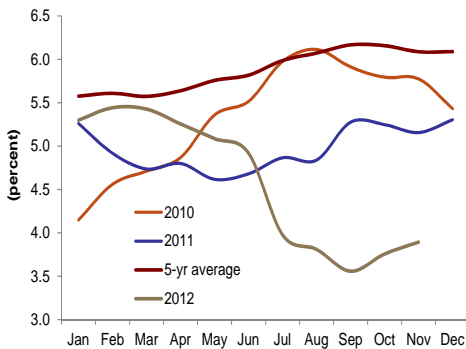
**Inflation breakdown**  
(percent, 1999=100)

	2009	2010	2011	2012 E	2013F
Foodstuffs & beverages	1.9	6.3	5.2	4.4	4.0
Renovation, rent, fuel & water	14.2	9.5	7.8	8.0	6.7
Fabrics, clothing & footwear	0.5	-0.6	0.3	2.9	2.2
Home furniture	8.5	2.8	0.5	3.5	3.4
Medical care	0.7	0.4	0.8	0.1	0.3
Transport & telecoms	1.0	1.1	2.1	1.8	2.0
Education & entertainment	1.4	0.8	1.5	3.1	3.0
Other expenses & services	4.3	7.4	9.0	3.7	2.4
Core inflation	3.4	3.1	3.6	2.9	2.5
<b>Overall</b>	<b>5.1</b>	<b>5.4</b>	<b>5.0</b>	<b>4.5</b>	<b>4.3</b>

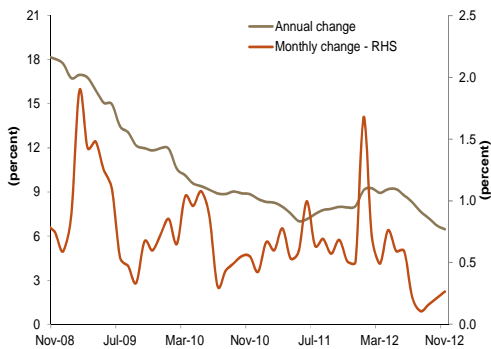
While the external factors contribution to inflation in the Kingdom will remain subdued, we expect domestic inflationary pressure to remain relatively strong. High consumer spending, double-digit money supply growth, rising bank lending and exceptionally low interest rates will maintain positive inflation in areas such as home furniture, education and entertainment, transport and telecoms and medical care. However these components have low weights in the CPI basket leading to a lower contribution to overall inflation print. Jadwa's core inflation measure which exclude food and housing related services slowed to 3 percent year-to-November 2012 compared to 3.5 percent the same period of 2011.

Rent has been the main source of inflation in the Kingdom for most of the past six years. It, however, was on a downward trend in the second half of 2012 despite the increase in consumers' disposable incomes. This is mostly due to large base effect but also to new property entering the market. Over 2013, we maintain our view that while rental inflation will ease, it will remain fairly high and will resume its position as the largest single contributor to inflation in the Kingdom. Finally, even if domestically generated inflation is above our forecast we do not see headline inflation getting to anywhere near the last five year average.

**Annual inflation**  
(year-on-year change, 1999=100)

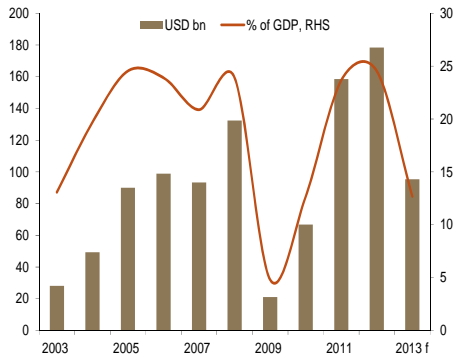


**Rental inflation**  
(1999=100)





**Current account balance**



## Current account

We expect a large fall in the current account surplus in 2013 because of lower oil export revenues. The surplus is forecast to decline to 12.7 percent of GDP from 24.5 percent of GDP in 2012. In dollar terms the surplus is expected to almost halve to \$95.4 billion down from the all-time high of \$178.5 billion recorded in 2012. Imports should grow on the back of solid domestic performance and are likely to be faster than the expansion of non-oil exports. The invisibles balance, which consists of flows of remittances, incomes and payments and receipts for services, will remain in a large deficit.

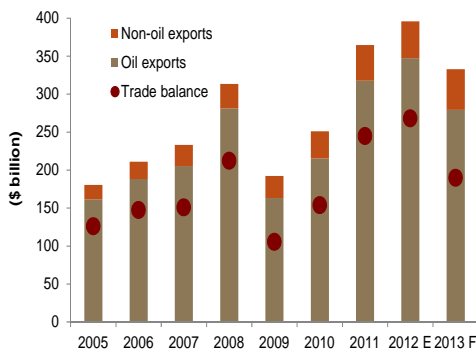
Oil revenues constitute between 85-90 percent of total export revenue, so the decline in oil production and prices we are forecasting for 2013 will cause a 15.9 percent fall in total exports in 2013, though total exports will remain elevated at \$332.9 billion. Non-oil exports should rise modestly. Petrochemical and plastic products account for more than 60 percent of total non-oil exports. While demand on such products is likely to weaken due to weak economic performance in advanced economies, demand from Asia is likely to keep the growth of non-oil export in the positive territory in 2013.

### Current account

(\$ billion)

	2009	2010	2011	2012 E	2013 F
Oil Exports	163.1	215.2	317.6	347.2	279.4
Other Exports	29.1	35.8	46.9	48.8	53.6
Imports	86.4	96.7	119.1	128.0	143.3
<b>Trade balance</b>	<b>105.2</b>	<b>153.7</b>	<b>244.7</b>	<b>268.0</b>	<b>189.6</b>
<b>Invisibles balance</b>	<b>-84.3</b>	<b>-87.0</b>	<b>-86.3</b>	<b>-89.5</b>	<b>-94.2</b>
<b>Current account balance</b>	<b>21.0</b>	<b>66.8</b>	<b>158.5</b>	<b>178.5</b>	<b>95.4</b>
(percent of GDP)	4.8	12.7	23.7	24.5	12.7

**International trade**



Import growth is expected to pick up owing to the ongoing infrastructure work and the expansion of the economy. High consumer spending will boost imports of household goods, vehicles and electronics. Therefore, we expect the trade surplus to fall to \$189.6 billion in 2013 from a record high of \$268 billion in 2012.

Remittances of foreign workers will remain the main source of outflows from the invisibles accounts. The huge amount of construction work will necessitate a continued inflow in foreign workers. Despite measures to increase the number of nationals in the private sector, we think that the total number of foreign workers will rise and their remittances will approach \$31 billion in 2013. There will also be higher outflows to foreign companies providing construction and related services. As the economy expands, payments to foreign providers of other services, such as communications, insurance and financial, should also rise.

Returns on the government's investment portfolio are the main source of non-trade revenues. We expect a little growth in 2013, as the stock of foreign assets will rise further. The bulk of these revenues are invested in foreign government bonds, primarily US, and with global interest rates expected to remain very low, investment inflows will remain relatively small.



## Fiscal policy

High government spending will continue to underpin the economy. The 2013 budget projects a surplus of SR9 billion, based on revenues of SR829 billion and expenditure of SR820 billion. This is the second consecutive year since 2008 that the Kingdom has budgeted for a surplus. Education and healthcare remain the focus of government spending, accounting for 37 percent of total spending. The government also allocated SR200 billion from the 2012 budget surplus to implement transport projects inside cities.

The budget highlights again the government's intention to continue to stimulate the economy. Budgeted investment spending, raised by 28 percent to an all-time high of SR285 billion, will support healthy economic growth and provide encouragement and opportunities for the private sector at a time of global and regional uncertainty. While revenue projection is less conservative than in previous years, in the event of a shortfall in revenues, any deficit can be financed comfortably by drawing from SAMA's huge stock of foreign assets, which stood at \$635 billion at the end of November.

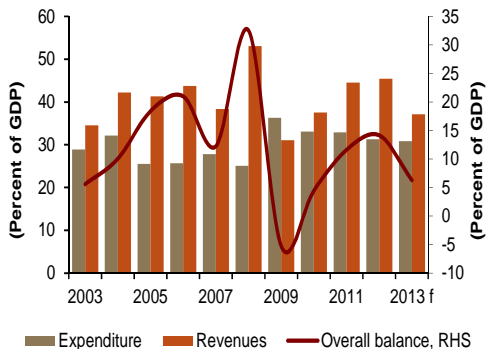
The revenue projection maintained the less conservative approach which started in last year's budget. We estimate that a price of \$66 per barrel for Saudi export crude (around \$70 per barrel for Brent) and production of 9.6 million barrels per day are consistent with the revenue projection contained in the budget. We expect both revenues and expenditures to be above the budgeted level and forecast a budget surplus of SR177 billion (6.3 percent of GDP) based on oil price of \$104 per barrel for Brent. The oil price level necessary for revenues to balance our forecast level of government spending, known as the fiscal breakeven price, is \$67 per barrel for Saudi export crude (equivalent to around \$71 per barrel for Brent). This is based on our assumption of 9.6 million barrels per day, domestic consumption of 2 million barrels per day and an oil export/revenue transfer ratio of 88 percent. Output from the Karan gas field, which is likely to reach full capacity this year, and the recently announced Midyan natural gas field should take some of the burden from oil as the fuel for domestic energy consumption this year.

## Monetary policy

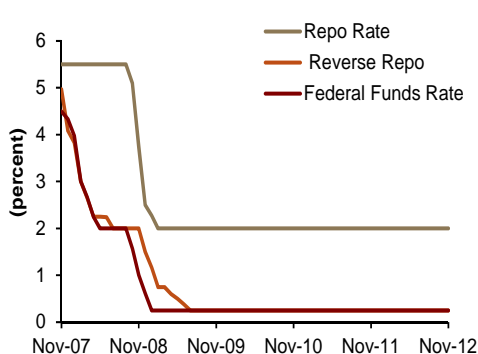
Interest rates will remain exceptionally low in 2013. This will support the economy, though it will hinder the government should it need to tackle inflation. As a result of the exchange rate peg and the open capital account, interest rates in the Kingdom need to shadow those in the US. Although the US economy is growing, it is still weak and unemployment is high. The US Federal Reserve (central bank) recently announced that the fed funds rate is likely to remain at the current near-zero level as long as the unemployment rate remains above 6.5 percent and the one- to two-year inflation forecast is at or below 2.5. As the consensus among economists do not expect these thresholds to be violated within the next few years, we think the Saudi repo and reverse repo rates to remain at 2 percent and 0.25 percent respectively in 2013.

While SAMA has some scope to move interest rates independently from the US to contain any emerging inflationary pressures, we do not expect to see this happening this year. Though serious domestic inflationary pressure is not included in our baseline scenario, we expect SAMA to adopt other policy tools if such risk materializes. Treasury bills, government agency sukuk could be used for liquidity

Budgetary performance

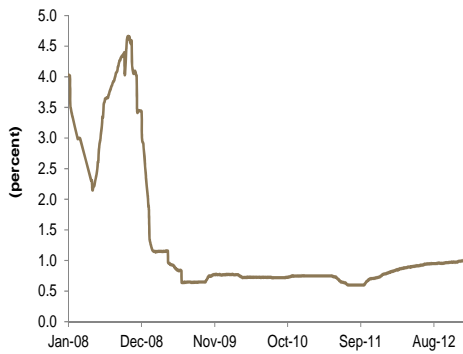


Interest rates





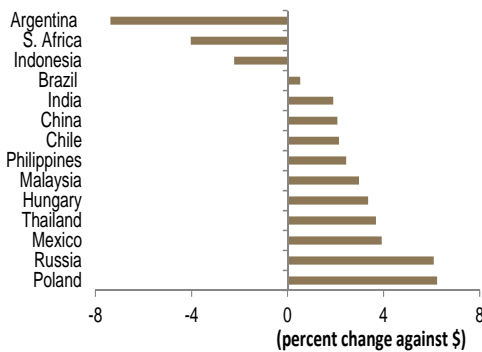
**Interbank rate**



**Dollar/euro**



**Emerging market currencies appreciation since July 2012**



management if the current annualized double digit growth in the monetary base (13.7 percent in November) and the broader money supply (13 percent) translate to higher domestic inflation. Adjustments to bank reserve requirements could also be used if inflation begins to take off.

Saudi interbank interest rate (Saibor) is expected to rise in response to regional geopolitical risks and international financial conditions. This is the rate at which banks lend to one another and provide the basis for much corporate borrowing. The three-month interbank rate has maintained an upward trend since the beginning of last year, rising from 0.78 percent in early January 2012 percent to 0.996 percent today despite the banking system comfortable liquidity position. We think the rise is more reflective of local banks' anxiety about a possible global slowdown and regional geopolitical risks than a fundamental tightness in local credit and banking liquidity.

### Exchange rates

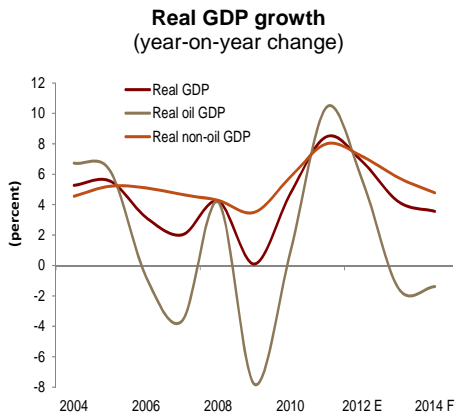
The riyal will remain pegged to the US dollar. We do not expect any serious discussion on breaking the peg or speculative pressure against the peg. We expect currency movements to be subject to swings in sentiment about the relative health of the economies of the US, Japan and Euro-zone. Consensus forecasts point to a modest strengthening of the dollar against euro and yen by the end of 2013, though lack of a credible long-term fiscal plan and concerns about debt dynamics in the US present a serious downside risk to such forecasts. The dollar will also benefit from its status as a safe haven and the liquidity, size and breadth of its capital markets at a time of ongoing uncertainty in the global economy, particularly in the Euro-zone.

The Euro-zone is the largest single source of the Kingdom's imports, at 22 percent in 2011, so the anticipated weakness of the euro against the dollar will ease local inflationary pressure. A further depreciation of the dollar against emerging market currencies is anticipated (see chart). The more robust economic performance of emerging economies will continue to draw in financial flows from developed economies, which will be exacerbated by creation of aggressive monetary easing in advanced economies. It is unlikely that such dollar movements against other currencies will be a major source of inflation. While emerging markets accounted for 43 percent of imports in 2011, our assumption of high levels of global risk aversion and reasonable US economic performance means the dollar depreciation will not be too great.

### The outlook for 2014

Global economic growth will pick up modestly from 2013, but conditions will be far less benign than they were in the few years prior to the global financial crisis. The outlook for the US and EU will improve, though government austerity, banking sector caution and high unemployment will keep growth low. Emerging markets will continue to lead the way and will pull up oil demand. Oil supply is also forecast to be up, both from OPEC and non-OPEC producers. With the political situation in the Middle East stabilizing, we expect the risk premium on oil prices to gradually fall, and as a result forecast that Saudi export crude will slip to an average of \$96.2 per barrel (equivalent to \$100 per barrel for Brent).

An improving global economy and relatively high oil prices provide a



reasonable environment for the Kingdom's economy, but the activity will remain dependent primarily on elevated government spending. Work on the housing program will accelerate and infrastructure improvement will continue which should contribute to a solid performance by the non-oil private sector. Real GDP growth is forecast to reach 3.6 percent, with oil production contraction leading the oil sector to -1.4 percent growth, and non-oil growth remaining close to 5 percent. Bank lending growth should be in line with 2013. Policy interest rates are likely to remain low on a historical basis and negative when adjusted for inflation.

With more of the planned supply of housing entering the market, we expect inflation to fall further, to an average of 3.9 percent. The improvement in the global economy is unlikely to be sufficient to lift global inflation or commodity prices, though it will probably cause a modest weakening of the dollar. Domestic inflationary pressure should lessen. Total oil revenues are expected to be lower than in 2013 as prices and production fall and domestic consumption maintains the upward trend, albeit at a slower pace. With both imports and government spending growing, we therefore expect the current account and budget surpluses to shrink, but remain in the positive territory. We do not foresee any change to the exchange rate peg to the dollar.



## Key data

	2006	2007	2008	2009	2010	2011	2012 E	2013 F	2014 F
<b>Nominal GDP</b>									
(SR billion)	1,552	1,676	2,075	1,641	1,976	2,511	2,727	2,819	2,905
(\$ billion)	413.9	447.0	553.3	437.7	526.8	669.5	727.3	751.6	774.5
(% change)	12.9	8.0	23.8	-20.9	20.4	27.1	8.6	3.3	3.0
<b>Real GDP (% change)</b>									
Oil	-0.8	-3.6	4.2	-7.8	0.9	10.4	5.5	-1.5	-1.4
Non-oil private sector	3.1	3.0	3.7	5.2	5.6	8.7	6.2	6.3	5.0
Government	5.1	4.7	4.3	3.5	6.5	8.0	7.2	4.3	4.0
Total	3.2	2.0	4.2	0.1	4.8	8.5	6.8	4.2	3.6
<b>Oil indicators (average)</b>									
Brent (\$/b)	65.4	72.7	97.6	61.9	79.6	111.1	112.0	104.0	100.2
Saudi (\$/b)	59.2	67.2	94.0	60.4	77.5	103.8	106.1	99.4	96.2
Production (million b/d)	9.2	8.8	9.2	8.2	8.2	9.3	9.8	9.6	9.4
<b>Budgetary indicators (SR billion)</b>									
Government revenue	679	643	1,101	510	742	1,118	1,239	1,047	990
Government expenditure	398	466	520	596	654	827	853	870	859
Budget balance	280	177	581	-87	88	291	386	178	131
(% GDP)	18.1	10.5	28.0	-5.3	4.4	11.6	14.2	6.3	4.5
Domestic debt	365	267	235	225	168	136	99	90	85
(% GDP)	23.5	15.9	11.3	13.7	8.5	5.4	3.6	3.2	2.9
<b>Monetary indicators (average)</b>									
Inflation (% change)	2.3	4.1	9.9	5.1	5.4	5.0	4.5	4.3	3.9
SAMA base lending rate (% , year end)	5.20	5.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
<b>External trade indicators (\$ billion)</b>									
Oil export revenues	188.2	205.3	281.0	163.1	215.2	317.6	347.2	279.4	263.4
Total export revenues	210.9	233.1	313.4	192.2	251.0	364.6	396.0	332.9	319.6
Imports	63.0	81.5	100.6	86.4	96.7	119.1	128.0	143.3	156.8
Trade balance	147.8	151.6	212.7	105.8	154.3	245.5	268.0	189.6	162.8
Current account balance	98.9	93.3	132.3	21.0	66.8	158.5	178.5	95.4	66.1
(% GDP)	23.9	20.9	23.9	4.8	12.7	23.7	24.5	12.7	8.5
Official foreign assets	273.4	359.8	502.0	474.2	520.3	621.5	643.3	690.4	723.0
<b>Social and demographic indicators</b>									
Population (million)	24.1	24.9	25.8	26.7	27.6	28.4	29.3	30.2	31.1
Unemployment (male, 15+, %)	12.0	11.0	9.8	10.5	10.2	11.0	12.0	10.0	9.5
GDP per capita (\$)	17,157	17,921	21,458	16,417	19,113	23,594	24,859	24,926	24,916

Sources: Jadwa forecasts for 2012-14. 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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