Slow but sure
Saudi Arabia set for steady 2010 recovery

- Economic growth likely to accelerate to 3.9% in 2010, with private sector growing 3.7% on steady turnaround in commercial activity
- Saudi private sector and banks poised to gradually move away from risk aversion this year, claims on private sector seen growing 8% in 2010, up from 2.1% in 2009
- Real estate shortages, public spending on infrastructure and a revival in global petrochemical demand among factors to support non-oil sectors
- Productivity has been declining in government and private sectors, which could lead to challenges for future job creation, restrain economic multipliers

Saudi Arabia’s economic recovery this year will most likely follow a gradual, steady track. Economic growth should accelerate following a stagnant and difficult year, inflation will remain at manageable but historically high levels and expansion of the private sector is set to take a turn for the better along with credit expansion at Saudi banks. The government, through a stimulatory public spending programme, will continue to lead the pick up in the economy as Saudi oil averages around $74 a barrel and low levels of government debt bolster the kingdom’s fiscal position. A higher oil price environment will enable Saudi Arabia to experience comfortable budget and current account surpluses.

While many key elements are in place to support a recovery in the Middle East’s largest economy, we are reducing slightly our 2010 economic growth forecast for the kingdom to 3.9% from 4% based on our view that improvements in business activity will be gradual and cautious. The government’s commitment to counter-cyclical fiscal expansion remains solid. Banks are likely to loosen up on their reluctance toward lending to the public and private sectors, one barrier that choked the private sector during 2009. Last year, claims on both sectors by banks contracted by almost 5%, following growth of 30% during 2008. This year, banks will have little choice than to lend more as they emerge from a period of challenging revenues and an unfavourable low interest rate environment.

It was not only banks that stifled non-oil private sector growth in 2009; Private Saudi companies themselves shelved many projects as international credit became more scarce, and businesses deleveraged and restructured. Assessing the private sector’s appetite to expand is as important as examining banks’ willingness to lend. In our view, the private sector’s eagerness to invest and grow is intact, albeit at more cautious levels than 2008.
Small and medium-sized enterprises have not yet been major beneficiaries of the public funds pouring into the economy. The kingdom is handing out major oil, manufacturing and petrochemical expansion contracts to big private sector players, which in itself should create a multitude of indirect business for banks, small and mid-segment contractors, building materials companies and traders. This could act as the backbone for nourishing the growth of small and medium sized establishments. A great deal can be done to revive the small and medium-sized contracting sector which has largely disappeared since the mid-1980. The size of current construction projects provides potential for a trickle down into the subcontracting segment.

Still, after rising for most of the decade, productivity among private sector enterprises is slipping. This underpins the challenge the government will face in the coming years to both boost public sector productivity and build a better platform for private sector growth to accelerate. Productivity improvements are a key catalyst for sustainable economic growth. Higher productivity increases national welfare and improves competitiveness of companies and national economies. It allows for growth without inflation and pulls together the proper backdrop for social spending. In our view, productivity is – in the long run – the only sustainable engine for job creation for the private sector.
The Saudi economy registered better-than-expected growth of 0.15% in 2009, while nominal GDP, subject to oil price fluctuations, contracted around 21%, according to government estimates. A smaller-than-anticipated decline in oil sector output of 6.4% enabled GDP to grow last year as most major world economies fell into recession. We had expected a 9.1% contraction in the oil sector, which underestimated Saudi Aramco’s investments in oil sector expansion.

The private sector’s investment appetite subsided and overall domestic demand declined, contributing to low non-oil private sector performance. The private sector expanded 2.5% down sharply from 4.7% a year earlier. International and local credit was scant and prompted many businesses to postpone and cancel projects as they opted to hoard cash. The 2009 private sector growth rate was, as a result of this reticence, the lowest in 14 years.

Some businesses were wary, trying to meet credit obligations as the global credit crisis widened and stock markets collapsed. Even real estate transactions came to a standstill by the second quarter, keeping prices of prime real estate virtually unchanged as few investors opted to buy or to sell. Automobile sales, one barometer of consumer demand, fell more than 25% in some months during the first half of the year. A revival in demand for cars later in the year pared full-year sales declines to about 7%.
We are cautiously optimistic that 2010 will witness an improvement in the private sector’s performance, although we do not expect the sector will grow at trend levels. The downside risks we foresee are linked to both the willingness of banks to provide credit and on the private sector’s willingness to undertake investments. We anticipate private sector GDP will expand at 3.7% this year, accounting for more than 47% of GDP at constant prices.

With oil prices standing around $80 a barrel and key global economies beginning to return to growth, Saudi Arabia, a seminal oil and petrochemical products exporter, is likely to benefit from the improvement in global economic conditions. We foresee real growth for the Saudi economy of 3.9%, this year, including a 4.1% rise in real oil GDP activity (accounting for 28% of total GDP). GDP growth should rise to 4.8% in 2011, the fastest pace in six years, once banking sector and business momentum is back in full swing.

We expect the government sector – which accounts for just above a fifth of GDP – to grow by 4.1% in 2010, accelerating slightly from its 4% growth level last year, as the state continues to take the lead in the economic recovery. Government sector growth above 4% has happened only three times in the last 20 years – 2005, 1997 and 1992. To support an improvement in the economic climate, the government has pledged to keep spending at historically high levels throughout the current five-year plan (2009-2013), including investment commitments of $400 billion in building infrastructure and oil and gas output expansion. It continues to overspend its budget by, in the case of 2009, 16%.

In the 2010 budget, this expansionary stance culminated in a 13.7% rise in projected state expenditures to a record level of SR540 billion. The largest budget in Saudi history is designed to encourage private sector businesses to loosen their purse strings and urge banks, awash with liquidity, to jumpstart lending following a slow 2009.

According to government budget projections, which we estimate are based on an average oil price of $44 per barrel for Saudi crude, the state’s fiscal deficit will widen to SR70 billion in 2010 after a smaller-than-expected shortfall of SR45 billion in 2009.
We are more optimistic about the oil price environment as well as in the growth in global energy demand, particularly from Asia. The Energy Information Administration (EIA) forecasts world oil consumption will grow by 1.1 million barrels per day in 2010 to 85.2 million bpd. According to our forecasts, government revenues should reach to SR699.2 billion and expenditures SR621.3 billion, enabling the state to produce a surplus of SR77.9 billion.

We anticipate the private sector’s rate of growth will get impetus from these trends as key sectors benefit from the higher oil price environment and an improvement in global demand for petrochemicals. A pick up in domestic demand is also likely to follow, prompting retailers and wholesalers to import more stocks to meet a rise in demand for goods and services.

Below is a breakdown of some of the key trends we expect in non-oil economic sectors this year:

**Finance**

Finance sector GDP growth rates continued their declining trend in 2008 - 2009 as both bank profit and asset growth registered weak performance. The growth rate dropped to 2.8% in 2008 and 1.8% in 2009. Last year, in particular, bank lending to the private sector slowed to a crawl. Despite being awash with liquidity, bank claims on the private sector rose only 2%, down from 27% expansion a year earlier. Total domestic credit growth (including lending to public entities) fell about 5.4% last year.

As risk appetite among banks cautiously returns this year, we expect the finance, insurance and real estate sector will grow 3.8% in 2010, more than double its rate of growth last year. We expect the pace of credit recovery will accelerate by the second half of 2010, leading to healthier loan-to-deposit levels at Saudi banks. Banks will not, however, gallop to support the private sector this year.

Debt repayment troubles faced by prominent Saudi family conglomerates Saad Group, run by Maan al-Sanea, and Ahmad Hamad Algosaibi and Bros contributed to risk aversion among banks last year.

Saudi banks have taken steep provisions this year against possible loan losses related to these and other firms, and the situation has prompted lenders to hold on to their liquidity rather than part with it. Banks, for instance, have been parking their cash in large quantities at the central bank and investing in foreign assets. Bank reserves held in SAMA’s reverse repo window stood at SR89.85 billion at the end of November – more than double their level at the end of 2008. Foreign assets held by banks, too, climbed 32% in the first 11 months of 2009 to SR203.74 billion.

We believe the crisis of confidence is slowly easing and we anticipate an advancement in bank lending to the private sector this year. A primary reason for this will be necessity; if banks want to avoid a repeat of their lacklustre 2009 profit performance, they will have to energise the pace of credit expansion. Certainly, credit growth will have to be balanced. Banks will need to abide by prudential obligor limits on some corporations. But we think there is enough pent up demand from the private sector to unlock credit growth during this year, particularly in the second half.

Bank claims on the private sector have grown month on month in the six months to November, although the year-on-year rate of growth slowed for a fourth month to a low 0.8% in November.

According to our forecasts, claims on the private sector by Saudi banks should rise 8% in 2010, from 2.1% in 2009, a small gain on what we earlier expected and in line with...
our cautious expectations in improvement in the non-oil economy in the coming quarters. We expect that a fuller credit recovery to unfold in 2011 as private sector appetite becomes more robust. Private sector claims next year are likely to rise almost 13%.

The Dubai debt situation has not had a meaningful impact on banks and we regard their direct exposure to be limited. The Saudi Arabian Monetary Agency (SAMA) has aggressively maintained low tolerance on cross-border bilateral lending facilities. Private investors’ exposure to regional property markets, however, is not negligible and the direction of these markets will impact investment portfolios.

Interbank rates have remained steady in the past two months, with the three-month interbank offered rate at 0.77125% in early January – almost on par with its level in November and not far above a historic low breached last summer. SAMA is not likely to apply aggressive monetary constraints for most if not all of this year. Tighter monetary policy measures, including raising interest rate rises, could follow if inflationary pressures mount fast. We would expect action first on the repurchase rate, followed by the reverse repurchase rate, or deposit rate.

We do not expect any change to SAMA’s exchange rate policy in 2010. Policymakers have made it clear that maintaining the riyal’s peg to the U.S. dollar is in line with the kingdom’s national interests. The ‘hot money’ that poured into the region in 2007 and 2008 betting on possible revaluation of Gulf dollar pegs is not expected to return. Moreover, recent global liquidity conditions are likely to become more constrained, curtailing some of the asset exuberance in global markets.

Construction

Saudi Arabia’s construction sector grew 3.9% in real terms in 2009 – faster than growth of 2.2% registered a year earlier. This is partly a reflection of the knock-on affect of government infrastructure spending. In our view, a lot of work remains to address growing demand for housing which we estimate, given prevailing conditions, at 255,000 residential units per year for the next five years. The kingdom’s real estate sector is still suffering from a shortage of housing units, a fact that has shielded it from the sharp price corrections experienced in neighbouring countries, particularly the United Arab Emirates.

We expect demand for new housing will continue, steered by the indigenous population. Unlike neighbouring Gulf countries, Saudi Arabia has a substantial national population, underpinning the stability of domestic demand even during times of economic weakness. In most areas of the kingdom, a shortfall in the number of housing units available persists, which has placed upward pressure on consumer price inflation in the past two years. Besides residential demand, construction activity due to the government’s spending programme is visible around the country. At the site of Princess Noura University, estimated to cost SR 26 billion, more than 150 cranes dot the landscape. Meanwhile, development of the King Abdullah Financial Centre and reconstruction of King Abdullah Street, both in Riyadh, are progressing quickly.

During 2009, cement sales of Saudi cement companies rose 15% from the year earlier, according to data available up to November. We expect the construction sector to expand 4.5% at constant prices in 2010 as more real estate projects come on stream and are completed in an attempt to bridge a gap between supply and demand.
Manufacturing

In 2009, manufacturing sector GDP growth slowed sharply to 1.7% from almost 6% in 2008. This decline in output is understandable given the general deceleration in the domestic economy, in addition to a slowdown in demand for goods, particularly petrochemical products, globally. The value of petrochemical and plastics exports from Saudi Arabia, for instance, fell 21.5% between January and September of 2009, according to preliminary data of the Central Department of Statistics (CDSI). Saudi Basic Industries Corp (SABIC) in early 2009 decided to halt output at some plants, including temporarily suspending steel operations in Saudi Arabia, in order to weather the downturn.

The manufacturing sector is poised to benefit from a return in both domestic and global demand this year, particularly toward the second half of the year. However, any improvement will be gradual. Profits of SABIC have illustrated this optimistic trend. After reporting a loss in the first quarter of 2009, SABIC’s third-quarter profit more than doubled compared with the second quarter.

We anticipate the manufacturing sector’s output will rise to 4.1% in 2010 as petrochemical output increases on the back of higher oil prices and new production volumes reach fruition. High oil prices benefit the kingdom’s low-cost producers. For instance, oil prices would need to fall below $25 per barrel for international naphtha producers to begin to compete with Saudi producers.

Wholesale and retail trade

Wholesale and retail trade is likely to witness GDP growth rates of 3.6% this year, compared with 1.97% in 2009, according to our estimates. Consumer demand in Saudi Arabia, although much more price sensitive than in most Gulf countries, relies on a much larger national population. Robust population growth rates and a young population will support a continuation of consumer demand.

Saudi Arabia’s exports are highly dependent on the price of and demand for oil. Oil exports accounted for 85% of a total estimated $153 billion in 2009. Non-oil exports, primarily petrochemicals and derived products, have performed well over the past few years in line with global demand and the kingdom’s competitive advantage. However non-oil exports were not isolated from the global economic downturn, falling about 16% in 2009. Saudi Arabia’s non-oil exports are likely to follow the upward trajectory this year, while imports are likely to rise due to greater propensity among retailers and wholesalers to build up their inventories in anticipation of growing domestic demand.

State capital expansion plans will also promote a steady increase in imports. In November, issuances of new letters of credit surged 34% from the month earlier and registered...
a year-on-year gain following many consecutive months of annual declines between 25 - 40%. Letters of credit against the import of items such as food, automobiles and machinery are likely to track the performance of private sector expansion and private consumption. We expect imports, which fell 21% to $80.3 billion in 2009, to climb to $94.7 billion in 2010.

We anticipate that Saudi Arabia's current account surplus will rise to SR98.7 billion this year, or 6.2% of GDP, compared with SR76.7 billion last year on the back of higher oil income. In the near future, we do not foresee the current account surplus exceeding 28% of GDP as it did in 2005 and 2008, the highest rates in recent history.

Still, surpluses in the next two years provide comfort to the balance of payments.

A sharp 45.6% drop in oil export revenues last year was the primary drag on the surplus, which fell to 5.5% of GDP in 2009. We see this ratio rising to 6.2% this year as oil revenues climb, offsetting an anticipated leakage from current transfers, namely workers' remittances. Services payments are poised to witness a small increase this year and next, although not as high as happened in 2008. Payments for imported services should also improve in 2010 - 11 due to government services (defence outlays), other services (including royalties and business services), and construction and travel payments. Income from SAMA and private sector investments will support current account surpluses over the two years. An anticipated rise in oil prices will provide an adequate cushion even as the kingdom's propensity to import improves.

Electricity, gas and water

The electricity, gas and water sector grew 3.4% in 2009, down from an expansion at constant prices of 6.7% a year earlier, and we expect this sector to grow by a solid 4.3% this year. As demand for utilities rises in the coming years, greater government and private funds will be allocated to efforts to improve output and address growing demand. In 2008, electricity generation grew 5.7%, and domestic demand for utilities is growing by 8% per year.
Among the key drivers of growth in the utilities sector are high annual population growth rates, an increase in the number of smaller households, growing demand from industry, and precipitous fall in natural aquifers.

Transport, storage and communications

We expect the transport and communications sector to grow 4.8% this year, having been the fastest-growing sector last year, at 6%. The Saudi telecoms sector has expanded quickly with the introduction of two mobile phone operators to compete with the incumbent Saudi Telecom in recent years. Zain Saudi Arabia, the kingdom’s third mobile phone operator, reached 6 million subscribers in November, and total Saudi mobile phone subscriptions exceeded 41 million at the end of the third quarter.

On the transport side, a good proportion of the Saudi 2010 budget has been dedicated to building new roads and bridges, which will be a further catalyst to the sector’s growth. Transportation is a major concern as the absence of a public transport system throughout the kingdom is adding an enormous pressure on existing roads.

Agriculture

Agriculture GDP is likely to grow 0.5% in 2010 according to our estimates, up from growth of 0.2% last year. While the rate appears low at first glance, it is in line with the state’s policy of moving away from agricultural production toward importing key commodities, including wheat. Saudi Arabia is giving up a 30-year programme to grow its own wheat as part of a government strategy to change its water usage habits by phasing out water-intensive crop production.

Community, social and personal services

This sector, which relies heavily on the consumption appetite of private individuals in areas ranging from private education and healthcare to recreational and sporting facilities, is likely to grow 3.5%, on par with its expansion in 2009.

Inflation

After soaring to a record 9.9% in 2008, inflationary pressures subsided in 2009 due to slower domestic demand, lower global commodity prices, a retreat in food prices and a decline in domestic rents. The circumstances created deflationary trends in some Gulf countries, particularly Qatar, although we do not foresee a substantial decline in inflation in Saudi Arabia this year.

We expect Saudi annual inflation to average 4.3% this year, compared with 5.1% in 2009. Greater economic activity, domestic demand, higher rental costs, higher food prices,
and an imported inflation component should place upward pressure on inflation. Additional market liquidity (broad money supply) could also add to price pressures but could eventuate toward the second half of the year.

In particular, housing costs remain steep, falling much less than the official inflation rate last year, a trend that will continue to keep price pressures at historically high levels in the kingdom. Rental inflation in November remained at a high 14.1%, on par with the month earlier.

Foreign assets

Saudi Arabia’s substantial foreign assets enable the country to apply a counter-cyclical fiscal policy that involves high levels of government spending. Net foreign assets of SAMA, which amounted to SR1.46 trillion at the end of November, represent more than 100% of GDP and we expect foreign assets to outpace the economy’s nominal growth in 2010, providing ample fiscal cushion.

Foreign assets fell for most of 2009 due to the simultaneous fiscal impact of declining oil revenues and an increase in government spending. We don’t foresee a change in SAMA’s management of the country’s foreign assets nor of its conservative but very liquid investment allocation strategy. It is this conservative asset allocation policy that preserved the country’s foreign assets to be used in revenue constrained times.

Foreign assets will continue to support the government’s expansionary spending programme, but with higher oil income during the course of the year, we expect SAMA’s net foreign assets to swell 14% this year to SR1.67 trillion. Besides the fiscal support they provide, foreign assets have played a role in supporting international financial institutions since the 1970s. There are certain areas, however, for which the government has not drawn on its foreign assets:

A) SAMA has not deployed foreign assets to redeem government debt, entirely held domestically by local banks and other institutions. This avenue would not be prudent given the leakage in the form of foreign deposits abroad, impacting net foreign assets in a cyclical manner;

B) The government does not derive local currency deposits held in local banks from its foreign assets, but from other government liquidity instruments. Dollar deposits would use foreign assets, but these form a minority of government deposits in the local banking system;

C) The rise in SDRs (Special Drawing Rights) since August 2009 from $748 million in July to $11.2 billion in November 2009 is part and parcel of SAMA’s foreign asset base, placed with the IMF, but do not constitute a contribution to the Fund. These are funds within the foreign asset pool of SAMA and classified as such.
Pinch in productivity

A pick up in global demand for energy, as well as petrochemicals, bodes well for the kingdom’s macro-economic fundamentals, which remain among the most robust in the Middle East region. Against the backdrop of these prime conditions for growth, policymakers should not lose sight of the productivity trends that have implications for real wealth creation and real per-capita increases.

Productivity in the government sector has been declining since 2004, with a particularly sharp drop in 2008 as a large increase in state employment numbers took place without a simultaneous gain in output of government services. The government added 69,726 civil service employees in 2008 – the biggest year-on-year climb in the workforce in more than two decades. The move coincided with a drop in the official Saudi unemployment rate to 9.8% that year from 11.1% in 2007.

The government’s addition of 66,851 Saudi employees in 2008 compared with a smaller 63,436 hired by the private sector. The increase in public employment can be partly explained by the state’s overall expansive role in the economy.

While new hiring of civil service employees has succeeded at easing employment bottlenecks, productivity levels in the public sector have declined in the recent past. During the 1990s up to 2003, fluctuations in the civil service workforce were on par with government services GDP growth. This was because government services GDP had been calculated based on public sector headcount rather than actual fluctuations in productivity. After 2004, however, government services GDP growth witnessed a sharp slowdown while the number of state employees surged – a trend that has hurt productivity.

Improving productivity has implications on a country’s GDP. While boosting employment numbers leads to a one-time
upward shift in GDP, it is per-unit labour improvements that have the potential to lead to higher salaries, retain higher profits and reduce costs. These surpluses are channelled back into the economy through higher consumer spending, exports and business investment – hence their broader contribution to improving overall economic output.

Private sector productivity challenge

While private sector GDP continues to grow, the sector’s productivity – real non-oil private sector GDP divided by the total number of employees in the private sector – has tapered off in recent years. Productivity of the private sector jumped 23% between 1999 and 2007, according to our calculations. But in 2008, it fell 2% from levels recorded in 2007.

Declines in private sector productivity are most evident in a few key sectors: 1) finance, insurance and real estate; 2) construction; and 3) agriculture. Productivity in the agriculture sector retreated 24.6% between 2006 and 2008, while over the same period, employee productivity in the construction sector declined by 12.5% and finance, insurance and real estate sector by 7.7%. In the mining and quarrying sector, which includes oil and gas, productivity eased by a smaller 3.9% over the three years.
Productivity levels in the manufacturing sector, on the other hand, advanced 7.3% over the same period, while electricity, gas and water sector productivity rose 13%, wholesale and retail trade by 15.9% and transport and communications by 8%.

The financial sector has been behind a good degree of the decline in private sector productivity. Banks in Saudi Arabia have struggled since profit growth levels peaked in 2005 at a sector-wide rate of 54%. While bank profits jumped another 35% in 2006, the sector’s overall profits have fallen more than 23% between 2007 and 2009, primarily due to a stock market crash that occurred in 2006 and the global financial crisis that began in mid-2008.

The graph below illustrates that GDP growth in the finance, insurance and real estate sector peaked in 2005 – also the year that profit growth among Saudi banks reached a high point. The subsequent drop in profit growth in 2006 and 2007 coincided with slower growth in GDP, although a rise in bank assets, as well as a huge number of new branch openings (65 in 2006 and 64 in 2007), enabled the sector to keep GDP growth rates from falling too quickly.

A decline in productivity in the construction sector since 2004 happened due to the fast expansion in the predominately expatriate labour force, without an equivalent addition in output. We expect that this gap could equalise in the next few years on delivery of ongoing construction projects. The construction sector is poised to continue experiencing high rates of single-digit growth. Waning agriculture productivity, meanwhile, has happened due to the sector’s declining output and high labour content. We do not regard this as a worrisome trend as it reflects underlying policy changes, namely state movement to new agriculture policies.

It is likely that overall private sector productivity in Saudi Arabia gained slightly in 2009 due to an anticipated slowdown in the growth of the private sector workforce resulting from the economic downturn. Between 2006 and 2008, the number of employees in private sector enterprises in the kingdom grew 16%, according to Ministry of Labour data. We expect the number of new employees in the private sector advanced by a much slower 1.2% in 2009, thus enabling a slight rise in overall productivity numbers. However, if the private sector workforce expanded by 2.6% or more last year, productivity levels in the private sector would have fallen again in 2009.

**Job creation onus falls on private sector**

One concern we have with lower productivity levels is what this could mean for job creation in the coming years. The private sector will be the kingdom’s predominant engine for Saudi employment generation in the years to come. When non-oil private sector growth loses steam,
fewer employment opportunities are created for nationals, especially the onslaught that will be looking for jobs over the next decade. The kingdom’s population of 25 million includes 11.38 million – 46% – youth (aged 15 - 39), and another 32% is children aged 0 to 14.

Private sector growth rates have fallen quickly since 2006, when the sector expanded 6.1%, the fastest pace of growth since 1982, the tail end of the previous oil boom. But since 2006, growth rates slipped to 5.5% in 2007, 4.8% in 2008 and 2.5% in 2009. Private sector expansion began falling before the global financial crisis came into full swing.

At the beginning of the decade, lower private sector growth rates correlated with higher unemployment rates among Saudi nationals. When private sector growth fell in the past two years, however, unemployment levels fell, too. We believe this was due to the pick up in civil service hiring discussed earlier. With the state unable to absorb a good deal of the expected onslaught of new job entrants, lower private sector growth rates between 2007 - 2009 could signal that unemployment rates may begin rising again in the coming years.

According to Central Department of Statistics labour force surveys in 2007 and 2008, clerical and service jobs witnessed the highest increase in annual additions – although it is difficult to ascertain the level of nationalisation in the private sector. Unemployment among men declined to 250,402 in 2008 from 295,473 in 2007, while female unemployment was virtually unchanged at 167,660. Most females who are unemployed held bachelors degrees, while most unemployed men held a secondary degree, followed by intermediate and primary degree holders.

Labour market limits to multiplier

The private sector productivity issue once again raises questions about how effective the multiplier effect of government spending has been. According to basic Keynesian multiplier theory, government spending should generate many cycles of spending that increase employment (income), consumption and savings. As the spending unfolds, different segments of the economy benefit. For instance, when SR30 billion is committed to infrastructure projects, such as building a university or a bridge, hundreds of millions of riyals goes towards pure labour costs, generating purchasing power among the workforce and promoting consumption.

Money sloshing around the economy also creates jobs, leading to a new round of spending. Job creation is a short-term multiplier and creating a well-rounded education system is a longer-term multiplier. In Saudi Arabia, it is the labour make up of the private sector that constrains the multiplier. The private sector is currently entangled in low-
wage equilibrium, meaning salaries paid to employees in this sector are relatively low. This limits the potential for a higher multiplier on employment and, consequently, on consumption and savings.

We think that improving the level of education by hiring better-trained teachers could lead to better long-term multiplier benefits than continuing a tradition of hiring additional foreign labour. If the national workforce is the dominant player in the private labour market, the trickle down affect of government spending would certainly be deepened. In our view, the most crucial impediment to fully realizing the potential of short- and long-term multipliers is the structure of the labour market.

Gross fixed capital formation is showing signs of continuous growth, which is positive for business activity. Gross fixed capital formation growth rates improve when investment improves, and thus it can be used as a measure of the potentiality of the economy.

As a percentage of GDP, however, gross fixed capital formation is lower than rates attained in other emerging markets during high-growth periods. Gross fixed capital formation to GDP rates in China, for example, were above 35% in the 1990s, and India has followed suit more recently. Both Japan in the 1960s and South Korea in the 1970s attained rates sustained above 30%.

By contrast, gross fixed capital formation in Saudi Arabia was 19.6% of GDP in 2008 — lower than its level in 2007 and even 1998. We expect the ratio to have risen to 24.8% in 2009 despite the actual decline in the overall level of capital formation, mainly due to the smaller size of the economy resulting from lower oil prices. Private sector gross fixed capital formation has gained 66% between 1998-2008, while government gross fixed capital formation surged almost nine-fold over the same period, underpinning the government's role as the most-active investor in the economy.

A high percentage of fixed investment into GDP is an indispensable precondition for rapid growth rates. It is a high level of investment in GDP, not a high rate of consumption, that is necessary for rapid GDP growth.
Drawing in foreign funds

Foreign Direct Investment (FDI) into Saudi Arabia in 2008 amounted to $38 billion – accounting for 42% of total FDI to west Asian countries, according to the 2009 World Investment Report released by the United Nations Conference on Trade and Development. The kingdom’s inward FDI flows surged by a substantial 57% in 2008 to $38.2 billion, with the petrochemical and refining industries accounting for most of the growth, up 57% to $12 billion. Inflows to the real estate sector, meanwhile, amounted to $7.9 billion, a four-fold gain.

Saudi Arabia, home to about 25 million people, attracted almost as much FDI as India, where inflows of $41.55 billion reached the country in 2008. Key emerging markets witnessed dramatic gains in foreign funds during 2008. FDI to China expanded 30% to $108.31 billion while Brazilian inward FDI climbed 30.3% to $45.06 billion.

FDI flows in other Gulf states, particularly Qatar, also witnessed massive gains in 2008. Qatar, which is developing liquefied natural gas (LNG), power and water, and telecommunications capacity, saw FDI inflows surge 43% in 2008. FDI to West Asia’s second and third-largest recipients, Turkey and the United Arab Emirates, declined in 2008.

Growth in FDI into Saudi Arabia was mainly driven by real estate, petrochemicals, refining, construction and trade during 2008, although fund flows cooled down in the latter part of the year as the global financial crisis intensified and oil prices fell precipitously. While the proliferation of mega development projects was still very much in place during 2009, the key driver of growth became state – rather than private – funds.

It was at the end of 2008 that Rio Tinto pulled out of a major aluminium project in the kingdom, while contract awards for new energy and power projects were sparse in the first half of 2009 as the government awaited downward revisions to contractor costs. “Seizure in global credit markets has had a severe impact on the financing of development projects, which is likely to cut FDI inflows in 2009,” UNCTAD said.

One factor behind the likely downturn is that FDI into Saudi Arabia has tended to mirror oil price movements, with higher prices lending confidence to investors and lower prices deterring them. Saudi Arabia’s oil revenues account for almost 90% of total state revenues, thus leaving them vulnerable to swings in the price of crude. FDI into Saudi Arabia only began to notably surge in 2005, when oil prices averaged above $55 a barrel, and inflows climbed almost 20-fold between 2004 and 2008 as a result.

FDI may not have fallen as sharply as might be expected in 2009 due to the Saudi government’s comfortable fiscal position. Sitting on a substantial cushion of foreign assets, Saudi Arabia’s low public debt levels make it an appealing investment case for foreign investors. In addition, the state pledged to invest $400 billion into infrastructure projects during its 2009 - 2013 economic plan, further boosting sentiment despite a dip in oil prices. The price of crude, meanwhile, did not fall dramatically despite the global economic slowdown that pushed many industrialised economies into recession. Crude prices in 2009 were still higher than 2005 levels.
2010 likely to see FDI comeback

The main deterrent of FDI into Saudi Arabia in 2009, then, was not oil prices but risk aversion among banks. “The number of international banks willing to lend to projects in GCC countries has shrunk sharply: only 12 banks were actively seeking project finance deals there at the end of 2008, down from 45 in 2006,” UNCTAD said.

Still, the Saudi government continued in 2009 a plan to raise oil production and refining capacity in order to cater to growing global demand from Asia anticipated a few years down the line. During the latter part of the year, Saudi Arabian Mining Co (Maaden) and U.S. firm Alcoa agreed to form a joint venture to build a $10.8 billion aluminium smelter. Exxon Mobil Chemical and SABIC also agreed to set up joint-venture plants to produce synthetic rubber, at an anticipated project cost of $5 billion, while Aramco awarded Halliburton a five-year oilfield service contract to develop wells at South Ghawar.

A real estate sector downturn in the Gulf region, particularly centred on the UAE emirate of Dubai, is also likely to have cut into foreign investments into Saudi real estate during 2009 as investors stood on the sidelines to watch for signs the price correction was bottoming out. Such investments...
are also likely to rise in Saudi Arabia’s undersupplied real estate market this year, however, much focus has turned to the kingdom as the region’s key domestic demand story.

With these developments, 2010 promises to witness a small comeback in FDI following a weaker 2009. FDI capital flows as a percentage of gross fixed capital formation was 46% in 2008 compared with 31.8% in 2007. Moreover, the ratio of FDI stock to GDP has risen from 9.3% in 2000 to 24.4% in 2008 – above the average ratio of 18% for Asia. This reflects the importance of such investment flows for economic growth.

The impact of FDI on local economies depends partly on the capacity of the state to develop links between investors and the domestic economy and the ability of local companies to forge ties with foreign companies. Delinking FDI with oil revenues in Saudi Arabia will not be an easy process. FDI has helped countries like China and India improve growth, but both boast higher thresholds of human capital than Saudi Arabia, producing hundreds of thousands of engineers each year, for instance. If the Saudi labour threshold is made available, technology transfers could be beneficial and properly deployed to have an affect on growth.
# Key Saudi Arabia Economic Indicators

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009e</th>
<th>2010f</th>
<th>2011f</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MACRO-ECONOMIC INDICATORS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal GDP (USD bn)</td>
<td>188.6</td>
<td>214.6</td>
<td>250.3</td>
<td>315.3</td>
<td>356.2</td>
<td>384.7</td>
<td>475.1</td>
<td>369.2</td>
<td>422.5</td>
<td>478.2</td>
</tr>
<tr>
<td>Nominal GDP (SR bn)</td>
<td>707.1</td>
<td>804.6</td>
<td>938.8</td>
<td>1182.5</td>
<td>1335.6</td>
<td>1442.6</td>
<td>1781.6</td>
<td>1344.4</td>
<td>1584.2</td>
<td>1783.3</td>
</tr>
<tr>
<td>YoY % change</td>
<td>3.0</td>
<td>13.8</td>
<td>16.7</td>
<td>26.0</td>
<td>12.9</td>
<td>8.0</td>
<td>23.5</td>
<td>-22.3</td>
<td>14.4</td>
<td>13.2</td>
</tr>
<tr>
<td>Real GDP growth rate, %</td>
<td>0.1</td>
<td>7.7</td>
<td>5.3</td>
<td>5.6</td>
<td>3.2</td>
<td>2.0</td>
<td>4.3</td>
<td>0.15</td>
<td>3.9</td>
<td>4.8</td>
</tr>
<tr>
<td>Non-oil private sector real GDP growth rate, %</td>
<td>4.1</td>
<td>3.9</td>
<td>5.3</td>
<td>5.8</td>
<td>6.1</td>
<td>5.5</td>
<td>4.8</td>
<td>2.5</td>
<td>3.7</td>
<td>4.6</td>
</tr>
<tr>
<td>Government real GDP growth rate, %</td>
<td>2.9</td>
<td>3.1</td>
<td>3.1</td>
<td>4.0</td>
<td>3.1</td>
<td>3.0</td>
<td>3.7</td>
<td>4.0</td>
<td>4.1</td>
<td>3.8</td>
</tr>
<tr>
<td>Oil sector real GDP growth rate, %</td>
<td>-7.5</td>
<td>17.2</td>
<td>6.7</td>
<td>6.2</td>
<td>-0.8</td>
<td>-3.6</td>
<td>4.2</td>
<td>-6.4</td>
<td>4.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Inflation, YoY % change</td>
<td>0.2</td>
<td>0.6</td>
<td>0.3</td>
<td>0.7</td>
<td>2.2</td>
<td>4.1</td>
<td>9.9</td>
<td>5.1</td>
<td>4.3</td>
<td>4.8</td>
</tr>
<tr>
<td>GDP per capita (USD)</td>
<td>8774</td>
<td>9744</td>
<td>11111</td>
<td>13645</td>
<td>15040</td>
<td>15870</td>
<td>19149</td>
<td>14880</td>
<td>17028</td>
<td>19275</td>
</tr>
</tbody>
</table>

| **BUDGETARY INDICATORS** | | | | | | | | | | |
| Total export revenues (SR bn) | 271.7 | 349.7 | 472.5 | 677.1 | 791.3 | 874.4 | 1175.4 | 691.6 | 820.9 | 896.85 |
| Oil export revenues (USD bn) | 63.6 | 82.0 | 110.4 | 161.6 | 188.2 | 205.3 | 281.0 | 152.9 | 202.4 | 218.16 |
| Total government revenue (SR bn) | 213.0 | 293.0 | 392.3 | 564.3 | 673.7 | 642.8 | 1101.0 | 505.0 | 689.2 | 762.33 |
| Total government expenditure (SR bn) | 233.5 | 257.0 | 285.2 | 346.5 | 393.3 | 466.2 | 520.1 | 550.0 | 621.3 | 694.5 |
| Deficit/surplus (SR bn) | -20.5 | 36.0 | 107.1 | 217.9 | 280.4 | 176.6 | 580.9 | -45.0 | 77.9 | 67.82 |
| Budget balance, % of GDP | -2.9 | 4.5 | 11.4 | 18.4 | 21.0 | 12.2 | 32.6 | -3.3 | 2.1 | 2.2 |
| Domestic debt (SR bn) | 558.0 | 660.0 | 610.6 | 459.6 | 364.6 | 268.8 | 235.0 | 225.0 | 209.0 | 186.0 |
| Domestic debt as % GDP | 78.9 | 82.0 | 65.0 | 38.9 | 27.3 | 18.5 | 13.4 | 16.3 | 13.2 | 10.4 |
| Total imports (USD bn) | 29.6 | 38.3 | 43.5 | 53.8 | 63.0 | 81.5 | 100.6 | 80.3 | 94.7 | 109.2 |
| Current account balance (SR bn) | 44.5 | 87.2 | 184.9 | 337.5 | 371.0 | 350.0 | 502.7 | 76.7 | 98.7 | 159.8 |
| Current account as % of GDP | 6.3 | 10.8 | 19.7 | 28.5 | 27.8 | 24.3 | 28.2 | 5.5 | 6.2 | 8.9 |

| **EXCHANGE RATE (=USD1)** | | | | | | | | | | |
| Saudi Riyal | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 |

| **BANKING INDICATORS** | | | | | | | | | | |
| Domestic credit growth, % | 10.8 | 13.6 | 20.9 | 21.6 | 6.5 | 19.7 | 28.6 | -5.4 | 9.5 | 13.2 |
| Bank claims on private sector, YoY % change | 10.0 | 11.0 | 37.4 | 38.9 | 9.2 | 21.4 | 27.1 | 2.1 | 8.1 | 12.7 |
| Broad money M3 (SR bn) | 14.7 | 6.9 | 18.8 | 11.6 | 19.3 | 19.6 | 17.6 | 12.4 | 13.9 | 12.1 |
| SAMA net foreign assets (USD bn) | 41.9 | 59.5 | 86.4 | 150.3 | 221.1 | 300.9 | 437.9 | 391.7 | 445.9 | 498.2 |
| Repurchase Rate (year-end) | 2.00 | 1.75 | 2.50 | 4.75 | 5.20 | 5.50 | 2.50 | 2.00 | 2.00 | 3.25 |

| **DEMOGRAPHIC INDICATORS** | | | | | | | | | | |
| Population (in millions) | 18.1 | 18.4 | 16.7 | 16.5 | 17.5 | 20.5 | 19.6 | 24.8 | 24.5 | 26.7 |
| Unemployment rate (%) Saudi | 2.6 | 2.9 | 3.2 | 4.6 | 4.4 | 6.4 | 6.2 | 15.2 | 13.8 | 14.1 |
| Non-Saudi | 13.8 | 12.9 | 11.6 | 10.0 | 9.7 | 6.6 | 8.3 | 10.2 | 10.7 | 12.6 |

| **OIL INDICATORS** | | | | | | | | | | |
| Argus Sour Crude Index (ASCI) | 59.4 | 66.4 | 93.8 | 60.4 | 76.0 | 82.0 |
| Average oil price (WTI) (USD/barrel) | 26.3 | 31.3 | 41.3 | 56.6 | 66.1 | 72.3 | 100.2 | 62.1 | 78.0 | 84.0 |
| Average Saudi oil price (USD/barrel) | 23.4 | 26.8 | 34.5 | 49.5 | 60.5 | 68.1 | 93.4 | 58.1 | 74.0 | 80.0 |
| Crude oil production (million bpd) | 7.1 | 8.4 | 8.9 | 9.4 | 9.2 | 8.8 | 9.2 | 8.2 | 8.5 | 9.1 |

* Source: Saudi Arabian Monetary Agency, other Saudi Arabian government authorities, Banque Saudi Fransi forecasts
Disclosure appendix

Analyst certification

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