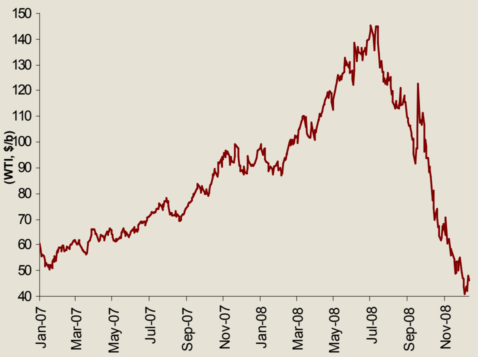
Jadwa Investment

December 2008

Monthly Bulletin

Saudi Arabia and the global financial crisis

Oil prices have plunged



The world is passing through an unprecedented financial crisis. Global financial conditions worsened to the point that the financial system almost ceased operating in early October. Conditions have since improved, but not without massive wealth destruction, as banks have been forced to write down hundreds of billions of dollars, huge financial institutions have been gone bankrupt or been bailed out by governments and stock markets have plunged.

The crisis occurred against the backdrop of a deteriorating global economy and appears to have pushed much of the world into recession. The IMF expects the developed economies to shrink for the first time since the 1940s next year. With demand disappearing, commodity prices have collapsed and exchange rates have been highly volatile as investors have sought safe havens.

No country in the world will be spared from the effects of the financial crisis and ensuing global recession. For Saudi Arabia, it has completely shifted the focus of economic policy from controlling inflation to restoring confidence in the financial sector. We see the following key implications for the Saudi economy:

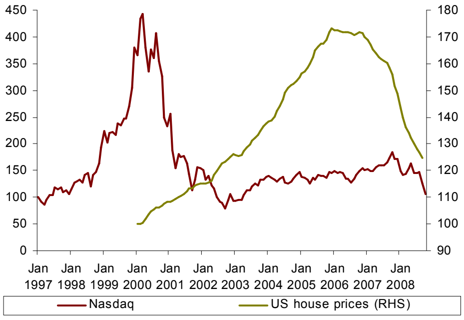
- Oil prices will be significantly lower than previously anticipated and reduced production will exacerbate the impact on oil revenues.
- Finance for local and foreign companies doing business in the Kingdom will be less easily available and more expensive.
- Economic growth will slow as problems accessing suitably priced financing and lower oil revenues hinder project implementation and hurt confidence.
- Lower oil revenues will mean the end to the huge budget and current account surpluses of recent years.
- Sharply lower commodity prices and a strengthening of the riyal will cause inflation to fall back rapidly over the next 12 months.

As a result, headline economic data will look very poor in 2009 in comparison with previous years. However, this does not mean that the economic boom is over. Dynamism within the domestic economy has been propelling the economy forward over the last few years and we think the healthy growth momentum within the non-oil sector will be maintained (albeit at a slower rate than we had previously forecast). The welcome slimming down of the project pipeline should prevent some marginal projects from being undertaken and spread the remainder over a longer period that will help alleviate some of the bottlenecks that have developed throughout the economy.

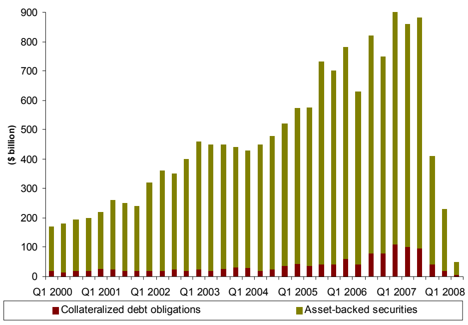
For comments and queries please contact:
Brad Bourland, CFA
Chief Economist
jadwaresearch@jadwa.com

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

The two bubbles
(Nasdaq, January 1997 = 100; Case-Shiller index, January 2000=100)



Mortgages securitized
(Global issuance of structured products)



Arrears on subprime mortgages

Source: Federal Reserve Bank of Chicago

What has happened?

The problems stem from the collapse of the dotcom boom in the early part of the decade and the subsequent period of low interest rates. From the end of 1982 to the end of 1999 the US stock market (S&P500) rose by an average of 14.7 percent per year. By early-2000 share prices (particularly of internet companies) had reached exceptionally high valuations and they soon began to fall (the S&P500 fell by 42 percent between August 2000 and October 2002; the NASDAQ index of technology stocks dropped by 78 percent from peak to trough). The end of the dotcom boom and the ensuing mild recession caused the US Federal Reserve to slash interest rates and hold them below 2 percent for nearly three years. Low interest rates and falling share prices encouraged huge investments in property. The total value of outstanding US residential mortgages rose from $6 trillion at the end of 2001 to $11.2 trillion at the end of 2006.

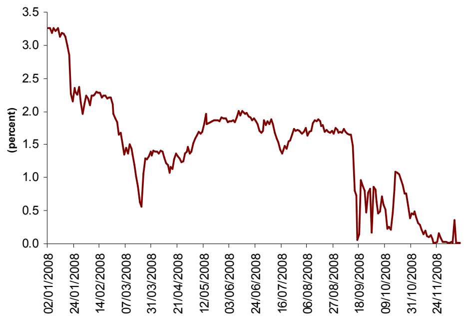
Low interest rates encouraged excessive lending and risk taking in the financial sector. In particular, there was a huge increase in mortgage financing to US borrowers with weak credit ratings and little regular income (loans to this category of borrower were known as “sub-prime”). Total sub-prime loans accounted for 15 percent of the mortgage market in 2006, compared to just 3 percent in 2003. Banks then repackaged their risks into complex financial products and sold these to other financial institutions. Most institutions borrowed to acquire these products and many did not have sufficient risk management controls in place to fully understand what they were buying.

As interest rates rose, an increasing number of borrowers defaulted on their mortgage repayments, raising concerns about the creditworthiness of associated financial products. Investors fled these and other products causing markets to dry up. With banks using mark-to-market accounting (where their assets are valued at prevailing market prices) they were forced to significantly write down the value of their assets for which there no buyers. As these write downs grew, confidence in some financial institutions dropped, triggering sharp falls in share prices.

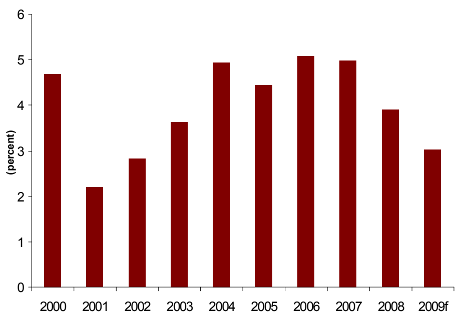
In April 2007, US sub-prime lender New Century Financial collapsed, making it the first casualty of what would evolve into the current crisis. September of last year saw the British government nationalize mortgage lender Northern Rock and in March 2008 investment bank Bear Stearns collapsed owing to subprime loans. In early September, US mortgage market giants Fannie Mae and Freddie Mac, whose role was to buy mortgages on the secondary market in order to repackage and resell to other financial institutions, were effectively nationalized due to huge losses caused by mortgage defaults. This was followed by the collapse of Lehman Brothers, then the fourth largest investment bank in the US, on September 14. Lehman had large holdings of troubled mortgage and mortgage-related securities.

The collapse of Lehman Brothers (the largest bankruptcy in US history) greatly intensified the financial crisis. Investors saw the value of their Lehman’s shares and bonds wiped out and were unable to liquidate trades in which Lehman was a counterparty. One large US money market fund with large holdings of Lehman bonds was unable to maintain the $1 per share value that is essential to the viability of these funds (a value of below $1 per share indicates that investors

Panic flight to quality
(Yield on US 3-month government T-bill)



Global real GDP growth



have lost money). This triggered large withdrawals ($56 billion was withdrawn from money market funds in September) and made money market funds reluctant to invest in the short-term debt that many banks and non-financial companies rely on to finance their day-to-day operations (commercial paper), quickly spreading the financial crisis into other sectors of the already weak economy.

By setting the precedent that no institution was too big to fail and reveling just how large and widespread exposures to Lehman were, this set off a period in which banks were solely concerned with protecting their own balance sheets and not prepared to lend. This deprived troubled banks of the capital they needed and put the share prices of banks with similar business models to Lehman's under extreme pressure. A rapid wave of mergers and government takeovers of financial institutions followed.

Government rescue plans have helped to slowly improve global financial conditions from exceptionally stressed levels. These typically involve massive central bank injections of liquidity into money markets, direct government purchases of stakes in financial firms and large cuts in interest rates. However, financial conditions remain very fragile and are unlikely to return to normal for some time.

The global economic outlook

The strains in the financial markets occurred against a backdrop of weakening growth in most of the world's leading developed economies and the global economic outlook is now bleak. Data for growth in the third quarter, which does not include the worst of the financial crisis, show that the US, Euro area, Japanese and UK economies shrunk. Subsequent economic data has been grim.

The IMF released revised global forecasts in November, cutting sharply the projections it issued only one month earlier. Total global economic growth has been revised down from 3.9 percent to 3.7 percent this year and from 3 percent to 2.2 percent next year. Growth in 2009 is now expected to be the lowest since 2001; a contraction of developed economies is expected for the first time since the 1940s.

The projection for growth in emerging economics has also been cut back, but at 5.1 percent next year it is still higher than in any year during the 1980s and 1990s. Many emerging markets are now being buffeted by collapsing commodity prices, sharp moves in exchange rates, rapid outflows of foreign capital and problems in the banking sector. These problems appear greatest for Eastern Europe. Even for those countries with healthy domestic fundamentals, export prospects are being hit. Nonetheless, emerging markets will provide the main dynamism in the global economy next year. In particular, growth in China is expected to be 8.5 percent and many other Asian countries seem relatively well positioned to weather the poor external conditions.

It is clear that it will take some time for global economic conditions to turn around. Continuing volatility makes it difficult to predict the length and depth of the recession; the consensus view is that the US economy will emerge from recession during the second half of next year and the EU should start to recover by the end of the year. Some forecasters expect a much more protracted scenario. One thing that is clear is that 2009 will be a very bad year for the global economy.

IMF economic growth projections
(percent)

	2007	2008	2009
World	5.0	3.7	2.2
US	2.0	1.4	-0.7
Japan	2.1	0.5	-0.2
EuroZone	2.6	1.2	-0.5
UK	3.0	0.8	-1.3
China	11.9	9.7	8.5
Emerging Markets	8.0	6.6	5.1
Middle East	6.0	6.1	5.3

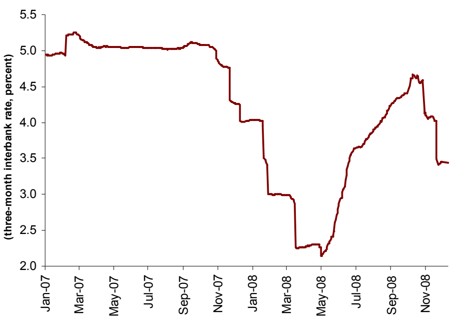
How has this affected Saudi Arabia?

The financial crisis and ensuing recession has significant implications for Saudi Arabia. Growth will be lower, projects delayed and the budget will fall into deficit. It also raises some longer-term policy issues concerning the role of the state in the banking sector, financial regulation and the introduction of a mortgage market that government will need to ponder. The fallout is not all bad; lower commodity will help reduce inflation and project costs. We believe that the economic reforms and investment boom of the last few years means that Saudi Arabia is well positioned to weather the extreme economic and financial conditions and that the underlying economic fundamentals remain strong. Below we examine the key issues arising from the turbulence of the last few months.

Tougher local financial conditions

Financial conditions have worsened in Saudi Arabia. The interest rates at which banks lend to one another (interbank rates) have moved sharply higher since the end of May, as lending between banks has dried up. The three-month riyal interbank rate rose from 2.14 percent on May 4 to a peak of 4.67 percent on October 12. Policy action by SAMA had helped lower the three-month riyal interbank rate to 3.45 percent on December 13. Nonetheless, the borrowing environment remains challenging.

Saudi three-month interbank rate



An indication of the tightness of lending conditions is the difference between the three-month riyal interbank rate (the rate that commercial banks pay for three-month deposits from other commercial banks) and SAMA's reverse repo rate (the rate the SAMA pays for deposits from commercial banks; effectively a risk-free rate). In the three months to end April this spread averaged 0.02 percentage points; it peaked on October 12 at 2.67 percentage points and was 1.45 percentage points on December 13.

While the run-up in Saudi interbank rates began well before the extreme stresses in global interbank markets, it is related to the global financial turmoil. Three main factors account for the rise in interbank rates:

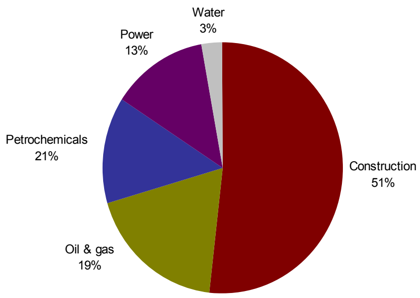
- A clampdown on credit growth by SAMA in order to contain inflation. The main tool for this was the commercial bank reserve requirement. Reserve requirements for current accounts were raised in a number of steps from 7 percent in November 2007 to 13 percent in May. Reserve requirements for time and savings deposits were doubled to 4 percent in May. The combined impact of these moves was the withdrawal of SR36.4 billion in liquidity from the banking sector between November and August.

- The exit of foreign funds that had entered the regional banking system in anticipation of exchange rate adjustments, as investors became more risk averse and GCC government's emphasized and solidified their commitment to the exchange rate pegs. All these funds were in US dollars, as that is the currency against which the riyal is pegged. The withdrawal of these funds therefore caused a shortage of dollars, which has aggravated problems securing project financing, as most large projects are financed in dollars.

- Some banks raising large amounts of local currency to buy up the assets underlying instruments they hold that were affected by the financial crisis.

Interbank rates are a key determinant of the rates banks charge to borrowers. For individual borrowers, commercial bank lending rates are generally not that responsive to adjustments in interbank rates, but for large corporate borrowers interbank rates are vital, as much lending is priced in relation to interbank rates. High interbank rates therefore directly increase the cost of borrowing for local corporations.

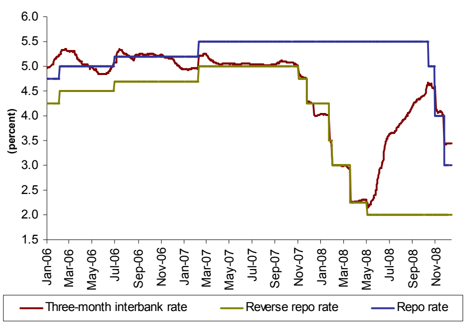
Investment by sector
(percent of $600 billion total)



One factor that has reassured us about the sustainability of the current economic boom is the heavy involvement of the private sector. Much of the $600 billion worth of projects currently under way or planned in the Kingdom are reliant on private sector funding. However, with the local banks less willing to lend, the cost of borrowing rising, a shortage of dollars and access to external finance greatly reduced, securing this financing was becoming a problem, hampering implementation of the project boom.

This is likely to have encouraged SAMA to act. On October 13 SAMA cut the repo rate to 5 percent from 5.5 percent (a few days earlier the US Fed cut by the same magnitude) and reduced the commercial bank reserve requirement for current accounts to 10 percent from 13 percent. The repo rate is the rate SAMA charges for lending to commercial banks, lowering it should cause increased bank borrowing, which will boost the amount of funds they have available to lend. Cutting the reserve requirement frees money that was previously held as reserves at SAMA for commercial banks to lend (we estimate the move made around SR10 billion available for lending). In addition, SAMA pumped $2-3 billion of liquidity into the banking sector (in the form of riyals and dollars).

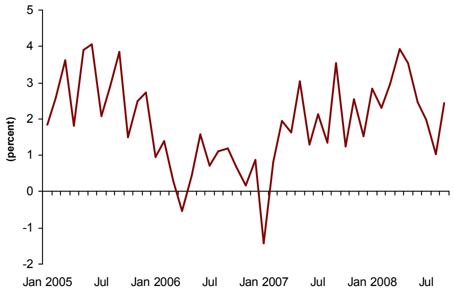
SAMA and interbank interest rates



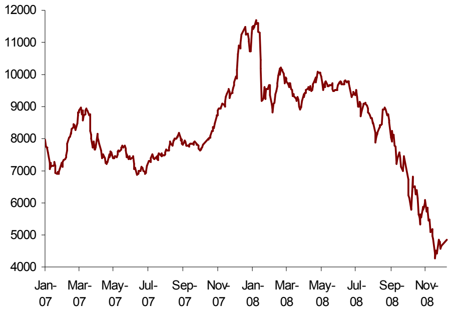
Following another cut in US interest rates, SAMA lowered the repo rate further on October 30; to 4 percent. The repo rate was cut again on November 23, to 3 percent. Simultaneously, the commercial bank reserve requirement for current accounts was lowered to 7 percent, bringing it back to where it was last November, before SAMA began tightening.

While SAMA can inject liquidity into banks and reduce the rates its sets for policy purposes, it has not been able to compel the banks to lend this money instead of using it to shore up their balance sheets. We are confident that no Saudi bank is seriously threatened by the currently financial and economic turmoil. Nonetheless, uncertainty about the health of their counterparties and a lack of transparency

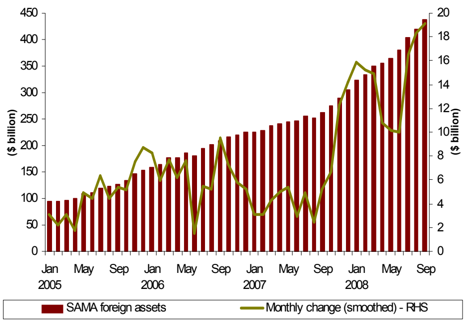
Growth in credit to the private sector
(monthly change)



TASI



SAMA net foreign assets



means that local banks will adopt a highly cautious policy toward lending for some time to come.

This does not mean that the banks have stopped lending entirely. Commercial bank loans to private sector corporations increased by SR38.9 billion (7.6 percent) over the third quarter. The bulk of this was short-term lending to the commerce sector, probably in the form of trade financing. Short-term financing for local corporations with strong relationships with their banks should still be readily available.

The tougher local and global financial conditions have effectively frozen the debt financing markets. There have been no new sukuk or major syndicated loan deals since the start of the summer. Given the heightened risk aversion of foreign investors, new sukuk issues will need to target local investors and will have to be priced much higher than before the crisis (making it more expensive for the borrower). The forthcoming Saudi Hollandi Bank sukuk will give a key guide to pricing in new environment

Raising finance through the equity market has lost its attractiveness. The Saudi stock market, along with many others in the world, has gone into freefall since the intensification of the crisis. The market is down by 48 since the end of June and hit its lowest point in almost five years on November 23. It is currently trading at a 12-month trailing price-to-earnings ratio of 9.3. This compares to an average of 20.6 in the first half of this year and 16.7 for 2007. While we believe this is attractive for investors (we examine the outlook for the stock market in a forthcoming report), there is little incentive for companies to try to raise capital through the market when shares are undervalued as they will not be able to raise as much funds as under normal market conditions. Approximately 80 Saudi have companies postponed their initial public offerings (IPOs); these have a collective value of $19 billion.

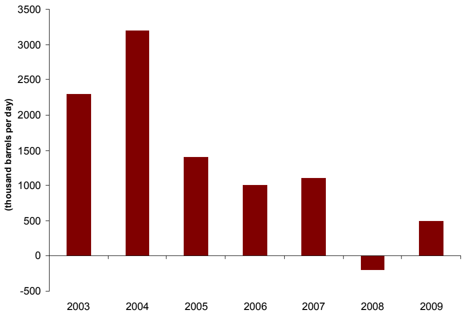
The outlook for those companies that need to raise finance is clearly bleak. However, many companies and investors in Saudi Arabia are cash-rich and therefore in the position to meet their funding requirements without borrowing. For these, conditions have improved, as collapsing raw material prices and the easing of global supply bottlenecks (see below) means that project costs have fallen notably. It is a similar position for the government. Lower oil revenues will impact on government spending. Nonetheless, government revenues will remain exceptionally large and are backed up by huge foreign assets held at SAMA (SAMA’s net foreign assets stood at $433 billion at the end of September). With these resources at its disposal the government is in the position not only to meet its own commitments but also to step in to underwrite the private sector in key strategic projects.

The huge stock of assets that the government can call on gives Saudi Arabia an advantage over most other countries in alleviating the impact of the extreme financing pressures. They mean it can push ahead with strategic projects such as key infrastructure, oil, power and water and support the private sector where necessary. Nonetheless, the reduced access and higher cost of financing will prevent the private sector growing as fast as we had previously forecast.

Plunging oil prices

The collapse in oil prices is one of the clearest and most immediate impacts of the financial crisis on the Saudi economy. WTI peaked at an all-time high just over $145 per barrel in early July but concerns about the health of the global economy and a reversal of financial investment in oil (partly related to the strengthening of the dollar) pulled it close to $40 per barrel in early December.

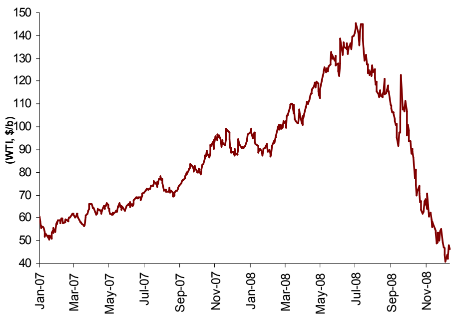
Oil demand growth
(IEA data)



Exceptionally high oil prices had already begun to slow demand growth and the onset of financial crisis and recession in much of the world will further dent demand. Since June the International Energy Agency has slashed its projections for global demand growth in 2008 (to a fall of 200,000 barrels per day from 800,000 barrels per day) and 2009 (to 500,000 barrels per day from 800,000 barrels per day). The decline is oil demand is most pronounced in the US, the world's largest oil consumer. US oil demand in October was 8 percent lower than in October 2007, a decline equivalent to 1.5 million barrels per day.

In an effort to stabilize prices Opec, members agreed to a 1.5 million barrel per day cut in production effective November 1. Under the new agreement Saudi Arabia's production quota was reduced by 466,000 barrels per day from 8.943 million barrels per day to 8.477 million barrels per day. Production has been persistently above quota over the last 12 months, though it was cut back sharply in October and indications are that a further cut in output was implemented in November.

Oil price



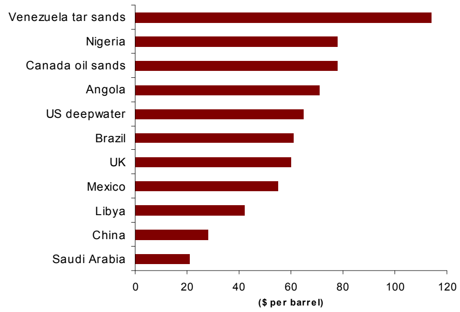
Pressure within Opec is mounting for it to announce another production cut at its next scheduled meeting in Algeria on December 17. We think that in the prevailing economic environment, most Opec producers would be content with prices of between $70 and $80 per barrel. Unless oil recovers to this level, Opec is expected to cut production further this year and during the first half of next year.

Lower production, combined with continuing (albeit modest) demand growth will eventually cause oil prices to stabilize above the current level. However in the near term further price declines can not be ruled out. Much as factors beyond demand and supply fundamentals pushed oil prices too high during the summer, we think that they have caused oil prices to fall far more quickly than is justified by the deterioration in the outlook for demand.

Despite the plunge in prices over the last few months, WTI is expected to average an all-time high of $100 per barrel this year, up 38 percent on the 2007 average, which was the record high. For 2009, we forecast that WTI will average $70 per barrel. While this is down on the 2008 level it is still the second highest ever. We expect oil prices to slowly rise over the subsequent few years as the global economy recovers and demand picks up.

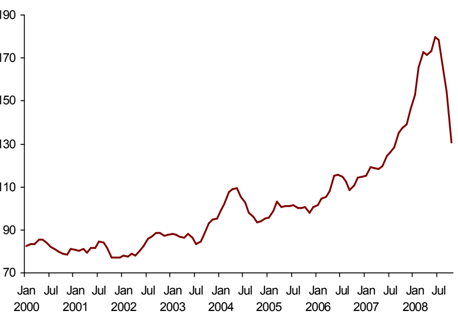
While the short term outlook for oil prices has worsened significantly, the medium term outlook may have improved. This is because the difficultly and higher cost of raising finance combined with lower oil prices have reduce the attractiveness of non-Opec supply and alternative energies. The bulk of new increments to non-Opec supply will come from the private sector, which is now facing problems in raising the necessary capital. In addition, lower oil prices undermine the financial viability of developing more costly source of supply.

Minimum WTI price needed for new projects



Reuters commodity price index

IMF food price index



According to estimates by Cambridge Energy Research Associates, the minimum WTI price needed for oil production offshore of West Africa is over $70 per barrel, for the Canadian oil sands the price rises to $78 per barrel and for the Venezuelan tar sands the price is $114 per barrel. The think tank estimates that nearly 45 percent of the potential growth in global production over the next five years is at risk.

State oil company Saudi Aramco does not need to borrow to finance its investment plans (Aramco is working on five capacity expansion projects to 2011 that are budgeted at $60 billion; see the September 2008 *Monthly Bulletin*). However, some Aramco contractors are reliant on borrowing to raise capital and may face problems in honoring their commitments. Aramco and other cash rich national oil companies will benefit from lower raw material and contractor costs owing to falling raw material prices and the inevitable postponement of similar work elsewhere. Some local projects have already been put on hold pending retendering to try to lock in lower costs; this is also likely to delay their implementation.

Commodity prices collapsing

While the collapse in oil prices has clear negative impacts on the Saudi economy, prices of other important commodities have fallen just as fast as concerns about demand have intensified. Since the end of June the Reuters commodity price index has dropped by 51 percent. The price falls are across the range of commodities, covering industrial raw materials, food products and precious metals.

Prices of most petrochemicals have fallen by two-thirds since July. Around $120 billion of investment in petrochemicals facilities is planned or under way throughout the GCC. Collapsing prices, much higher financing costs and falling demand raise questions over the viability of some of these projects and it has been reported that around $20 billion worth of petrochemical projects have been put on hold in the Kingdom.

Similarly, base metal prices are down substantially, which is hitting the vast projects being developed in the north of the Kingdom. An $11 billion aluminum joint venture between state mining company Ma'aden and Rio Tinto has been placed under review. With petrochemicals accounting for over 30 percent of non-oil exports, base metals nearly 10 percent and plastics (whose prices can be heavily influenced by the cost of petrochemicals) a further 22 percent, non-oil exports are likely to fall next year for the first time in a decade.

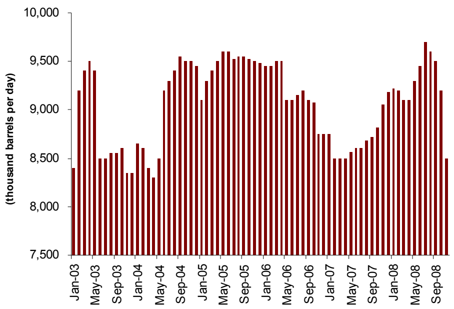
However, lower prices will provide some important benefits for the economy. For example, the prices of copper and steel, key construction materials, have plunged by 57 and 36 percent, respectively, since the end of June. Surging raw material prices had undermined the financial viability of some construction projects and these price falls mean considerable savings for those constructors that have financing in place. They also improve the affordability of building homes (more than 90 percent of homes are built by individuals) and are likely to take some pressure off the rental market, currently the main source of inflation.

Food prices have also fallen markedly. The surge in food prices in the first few months of this year has been reversed and the IMF's global food price index is now at its lowest level since August 2007. Prices of basmati rice have fallen by 45 percent since the end of June and are down by 31 percent in the last two months alone.

Slower economic growth

We have revised down our economic growth forecast for 2008 to 5.7 percent and slashed our 2009 forecast to 1.5 percent. Real GDP growth next year will be the lowest since 2002 and in nominal terms the economy will shrink by 17.4 percent, the first annual decline since 2001. In total the economy is forecast to contract by SR325 billion next year; a sum equivalent to the entire Qatari economy.

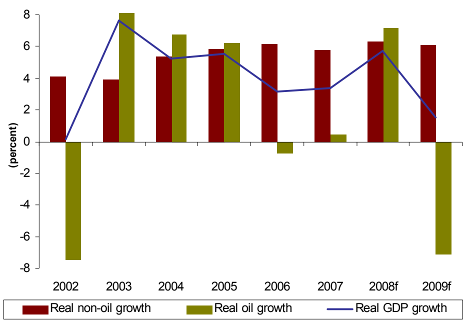
Oil production



The slowdown next year will be most prominent in the oil sector. Average output is expected to be 7.1 percent lower in 2009 than this year as a result of the Opec production cuts. Saudi production peaked at 9.7 million barrels per day in July and has since been brought down and is expected to average 9.2 million barrels per day this year. With one more production cut expected to be announced this year and a further one during 2009, we forecast that oil production will average 8.4 million barrels per day next year.

Non-oil sectors have been the main driver of economic growth in recent years as they have benefitted from economic reform and an investment boom. We think the outlook for all non-oil sectors has deteriorated owing to reduced consumer confidence resulting from the plunging oil prices and stock market. While there was little discernable impact on the economy from the 2006 stock market crash, this happened at a time when oil prices were rising. With the private sector experiencing wealth destruction and public sector revenues falling, the impact on confidence is likely to be more pronounced this time around.

Breakdown of GDP growth



The outlook has worsened most for those sectors exposed to the global economy or reliant on acquiring new financing, particularly manufacturing, which tends to be export-oriented (though we still expect healthy manufacturing growth owing to the amount of new capacity coming on stream). In contrast, domestically focused sectors such as retail and telecoms will be less affected. We expect telecoms to be the fastest growing sector next year as the new fixed line providers begin operation and the full impact of the third mobile provider is felt.

The impact of the adverse conditions will extend well beyond next year. It takes years to plan and fully implement many projects (up to 20 years in the case of the economic cities). To date, work has only started on only around one-quarter of the $600 billion of announced projects. We think that the bulk of projects that are already under way will be completed, as it is not easy or cost effective to stop a complex project part way through, though some are likely to be scaled down. For example, developer Emaar is delaying work on some non-priority parts of the King Abdullah Economic City. For those yet to commence, difficulties in raising finance and a deterioration in export markets and many product prices may cause sponsors to downscale, postpone or scrap plans, with a longer term impact on economic growth.

Slimming down the project pipeline is not all bad for the economy as it should prevent some marginal projects from being undertaken and will alleviate raw material and skill bottlenecks. For example, construction activity had stalled this year due to a rapid run up in raw material prices. Now that prices of steel, copper and cement have fallen, we think that project implementation will speed up for investors that have their financing in place. In addition, some projects are being retendered so that sponsors can lock in lower costs.

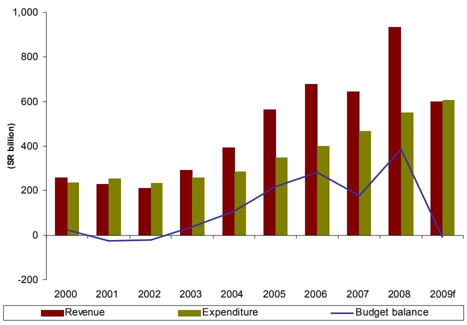
Engineering, procurement and construction (EPC) costs have not fallen as far as raw materials and still remain at elevated levels. But with project implementation in most other parts of the world likely to slow, which will reduce competition for these resources, lower EPC costs are likely. Furthermore, the relative health of the Saudi economy could encourage the entrance of more skilled expatriates to the labor force.

Although the outlook for economic growth for the next few years has worsened, we still think that it will be strong on an historical basis. The non-oil private sector should grow at around 6 percent over the years to 2010, slightly quicker than the average for the three years to 2007 and well above the average of just 2.6 percent for the whole of the 1990s. This is because many projects under way will come on stream and the ongoing domestic economic liberalization and easing of business regulations will continue to yield benefits.

Pressure on the government budget

With oil revenues accounting for around 85 percent of total revenues, the collapse in prices and lower production will have significant implications for the government budget. Nonetheless, we think that the government will continue to increase spending in 2009 even though this is likely to result in a small budget deficit. The deficit can be comfortably financed by the drawing down of foreign assets.

Budget data



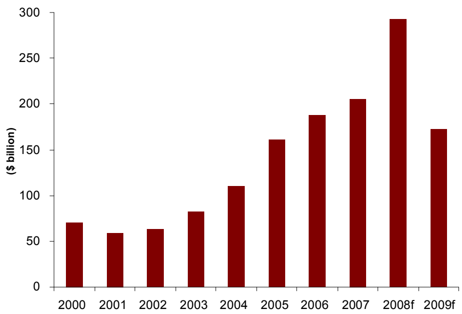
Although oil revenues are expected to be about 40 percent lower in 2009 than this year, this will not compel the government to cut back spending, as oil revenues have been far in excess of what the government has spent. Over the first nine months of this year we estimate that the government has spent only around 60 percent of the oil revenue it has earned. We think the government will increase spending by 10 percent next year.

The government has made clear its commitment to press ahead with its infrastructure spending plans and lower project costs and raw material prices will make these more affordable. The government could also step in to support the private sector in key projects (though this may take the form of loans from various quasi-government bodies, rather than direct spending). Enhancing physical and social infrastructure remains the key goal of government spending. In addition, the government wage bill will rise owing to a 5 percent pay rise that will be implemented at the start of the year as part of a multi-year package announced in January 2008 (see the February 2008 *Monthly Bulletin*). (We will publish a detailed report on the budget when it is released later this month.)

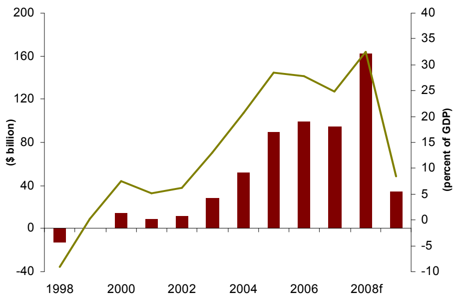
Reduced external surplus

Lower oil export revenues will cause a large fall in the current account surplus, though it will still be healthy, ensuring that the Kingdom's stock of foreign assets will continue to rise. Lower oil prices and production and an increase in domestic consumption will cause oil export revenues to fall to $172 billion next year. This is

Oil export revenues



Current account balance



Trade-weighted US dollar index

down by 41 percent from the 2008 figure, but still double the level of 2003.

Sharply lower prices of petrochemicals, metals and plastics are expected to cause the value of non-oil exports to decline for the first time in a decade in 2009. Although import prices have also fallen, continuing project implementation by the government and those in the private sector not constrained by financing will result in another year of double digit import growth. As a result, the trade surplus is expected to narrow to $90 billion in 2009 from $225 billion this year.

Trends in other foreign payments and receipts should be little changed. Returns on foreign assets held by SAMA are the leading source of revenue. We think that SAMA has adhered to a very conservative investment policy, meaning that the value of its investments has not been greatly affected the crashes on global markets. Nonetheless, very low global interest rates mean that the returns on its investments are likely to be down next year. The slowdown in project activity will reduce the payments to foreign contractors; these account for the largest service payment.

Overall, we expect that the current account surplus will plunge to 8.4 percent of GDP in 2009 from 32.6 percent of GDP this year. This is still healthy on a historical basis; the current account was in deficit for the bulk of the 1990s and the surplus did reach double digits as a percent of GDP until 2003. Net foreign assets held by SAMA are expected to rise further, but at a far slower pace than in the previous four years.

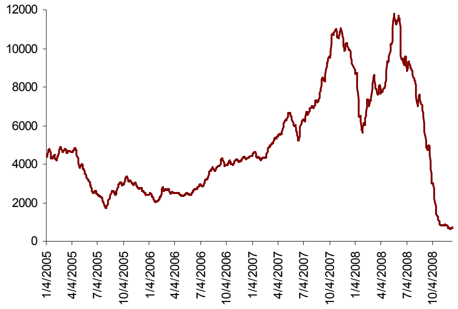
Lower inflation

Until the sharp intensification of the financial crisis in September, controlling inflation was the main short term objective for economic policymakers. Inflation had surged over 10 percent this year compared to an average over the decade to end-2006 of just 0.1 percent. Steps to encourage bank lending will, if successful, add to inflationary pressures. However, the collapse in commodity prices and a sharp appreciation of the riyal mean that inflation is likely to fall back fairly rapidly over the coming 12 months. The dampening of inflation is the main positive effect of the crisis on Saudi Arabia.

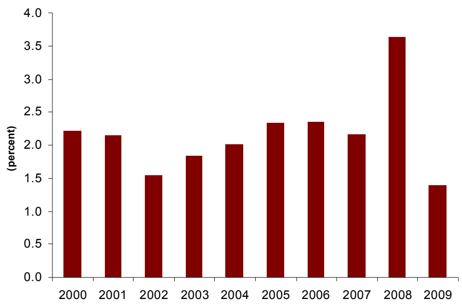
As noted above, commodity prices have dropped markedly. The beneficial effects of lower prices are being compounded by the strength of the dollar (and therefore the riyal). Since the end of July the dollar has appreciated by 14 percent against a basket of the currencies of its leading trading partner and is around a two-year high on a trade-weighted basis. The table below shows the movement of the riyal against the currencies of Saudi Arabia's main trading partners.

Country	Share of imports (percent)	Change since end July versus riyal (percent)
Eurozone	27.1	-14.3
US	13.6	0.0
China	9.7	-0.2
Japan	8.7	15.5
South Korea	4.5	-35.3
UK	3.9	-24.6

Baltic dry freight index



Global inflation
(IMF projections)



The dollar has benefitted from its status as a safe haven and has seen large inflows from US hedge funds and other institutional investors that have liquidated foreign investments and moved into cash (US Treasury data from July and August shows that US investors sold $57 billion more foreign bonds and shares than they bought, the largest repatriation on record). It also benefits from market sentiment that interest rates need to fall much further outside the US than inside it and that as the first of the leading global economies to enter recession, the US may also be the first to emerge from it.

A further factor that should impact on the price of imported goods is lower transportation costs. The Baltic dry freight index; the leading measure of international shipping costs, has plunged by 94 percent from its peak of earlier this year, as fuel prices have fallen and demand for shipping has dropped. Over 90 percent of Saudi Arabia's imports by volume enter the Kingdom through its ports. Furthermore, lower fuel prices in the countries that produce the goods that Saudi Arabia imports will reduce the cost of transporting goods to and from their ports.

In addition, inflation in the Kingdom's major trading partners will be much lower next year. A study by the IMF earlier this year found that inflation in trading partners was the key determinant of inflation in Saudi Arabia. The dramatic weakening of the global economy and the collapse in commodity prices means that global inflation is expected to significantly weaken next year. The IMF expects average inflation among advanced economies to fall to 1.4 percent in 2009, from 3.6 percent this year.

Commodity prices and exchange rate movements were important factors in pushing up inflation in recent years. Over the next 12-months or so they will be the most important factors pulling inflation down. The sharp strengthening of the dollar should cut import prices for a wide range of goods and services throughout the economy. Lower commodity prices will have a more focused impact, specifically:

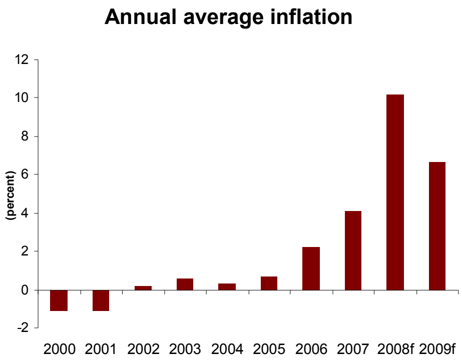
- Food price inflation, the largest component of the cost of living index, has been above 15 percent since April, but is expected to ease rapidly in the coming months. The IMF's food price index was 4.8 percent lower in October than one-year earlier, compared to an annual rise of 41 percent as recently as July. If food prices stay at their current level, global food price inflation will be minus 20 percent for seven of the first eight months of next year.

- Inflationary pressure from 'other goods and service' should also ease. This area is dominated by jewelry prices, which in turn are driven by gold prices. Inflation from this component of the cost of living index has been above 10 percent all year. However, gold prices are down by 12 percent since the end of June, despite gold traditionally being used as a store of value during volatile times

Domestically driven sources of inflation are not expected to ease as quickly. Lower prices of construction raw materials will encourage further building of residential property, which should help to tackle the rise in rents, which is the main source of inflation throughout the region. Nonetheless, there remains a fundamental shortage of real estate and we do not see any significant slackening of demand (though there may be a slightly lower rise in the population of expatriate workers).

Reductions in interest rates and commercial bank reserve requirements may also prove inflationary over the medium term. The growth in lending to the private sector shows that until the end of September, at least, commercial banks continued to provide largely short-term financing to local corporations. Lower interest rates are likely to lift demand for loans, while the relaxation of the reserve requirements will released more funds for the banks to lend; the ratio of private sector loans to deposits was at a multi-year high of 90.6 at the end of the third quarter.

We think that inflation peaked at 11.1 percent in July and will fall fairly rapidly into 2009; we expect it to average 6.7 percent next year. Nonetheless, real estate supply will remain inadequate and with non-oil growth remaining healthy the domestic inflation dynamics will remain in place. We therefore forecast that inflation will only fall back slowly in 2010, to an average of 6.1 percent, and that the Kingdom will continue to face inflation well above the historical norm.



Key data

	2002	2003	2004	2005	2006	2007	2008F	2009F	2010F
Nominal GDP									
(SR billion)	707.1	804.6	938.8	1182.5	1307.5	1430.5	1867.5	1542.8	1745.3
($ billion)	188.6	214.6	250.3	315.3	348.7	381.5	498.0	411.4	465.4
(% change)	3.0	13.8	16.7	26.0	10.6	9.4	30.5	-17.4	13.1
Real GDP (% change)									
Oil	-7.5	17.2	6.7	6.2	-0.8	0.5	7.1	-7.1	5.1
Non-oil private sector	4.1	3.9	5.3	5.8	6.1	5.8	6.3	6.1	6.1
Government	2.9	3.1	3.1	4.0	3.1	2.7	2.5	4.0	3.3
Total	0.1	7.7	5.3	5.6	3.2	3.4	5.7	1.5	5.2
Oil indicators (average)									
WTI ($/b)	26.2	31.1	41.5	56.6	66.1	72.3	100.0	70.0	80.0
Saudi ($/b)	23.7	26.9	34.7	49.5	60.5	68.1	95.0	65.8	74.0
Production (million b/d)	7.5	8.8	9.0	9.5	9.2	8.7	9.2	8.4	8.7
Budgetary indicators (SR billion)									
Government revenue	213	293	392	564	679	643	935	598	687
Government expenditure	234	257	285	346	398	466	550	605	666
Budget balance	-21	36	107	218	280	177	385	-8	21
(% GDP)	-2.9	4.5	11.4	18.4	21.4	12.3	20.6	-0.5	1.2
Domestic debt	660	660	614	475	366	267	250	230	240
(% GDP)	93.3	82.0	65.4	40.2	28.0	18.7	13.4	14.9	13.8
Monetary indicators (average)									
Inflation (% change)	0.2	0.6	0.3	0.7	2.3	4.1	10.2	6.7	6.1
SAMA base lending rate (%, year end)	2.00	1.75	2.50	4.75	5.20	5.50	3.50	4.00	5.00
External trade indicators ($ billion)									
Oil export revenues	63.6	82.0	110.4	161.1	187.7	205.5	292.7	172.5	199.8
Total export revenues	72.3	93.0	125.7	180.1	210.5	233.4	324.5	201.0	230.7
Imports	29.6	33.9	41.1	54.6	63.8	82.5	99.1	110.9	124.2
Trade balance	42.6	59.1	84.6	125.5	146.6	150.8	225.4	90.1	106.4
Current account balance	11.9	28.0	51.9	90.0	98.9	95.0	162.4	34.6	57.3
(% GDP)	6.3	13.1	20.7	28.5	28.4	24.9	32.6	8.4	12.3
Official foreign assets	73.3	97.1	127.9	195.5	273.4	359.8	509.6	544.7	602.9
Social and demographic indicators									
Population (million)	21.5	22.0	22.5	23.1	23.7	24.2	25.0	25.8	26.6
Unemployment (male, 15+, %)	7.6	8.2	8.5	8.8	9.1	9.0	8.8	8.5	8.2
GDP per capita ($)	8773	9745	11112	13640	14725	15736	19884	15919	17473

Sources: Jadwa forecasts for 2008 to 2010. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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