جدوى للإستثمار
Jadwa Investment

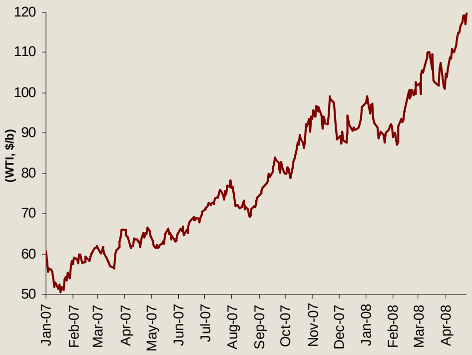
May 2008

Monthly Bulletin

Feature: Oil's surge: what's behind it and what it means for Saudi Arabia

Oil prices have hit a series of all-time highs and touched $120 per barrel in late April despite clear signs that the global economy is slowing. Demand and supply fundamentals have supported much of the run-up in prices in recent years, but the recent upward movement has been the result of investors using oil (and other commodities denominated in US dollars) as a hedge against the falling value of the dollar. Higher prices have not had too great an impact on economic growth so far because most consumers have been sheltered from the rise. Retail prices of fuel in emerging markets are generally fixed at low prices, those in Western Europe are heavily taxed, while in the US refiners have been absorbing some of the higher fuel costs with reduced profit margins.

Oil prices at another all-time high



Given the momentum within the market there is no reason why prices can not go on rising over the near term. However, we think that prices are now well beyond those justified by the fundamentals and as the dollar stabilizes we think oil prices will end the year near $70 per barrel. Nonetheless, with WTI averaging over $100 per barrel over the first four months of the year we are revising up our oil price forecasts. We now expect WTI to average $90 per barrel this year, $76 per barrel in 2009 and $85 per barrel in 2010.

Saudi Arabia's economic performance will benefit from high oil prices. This year we expect the current account surplus to hit an all-time high and nominal GDP growth and the budget surplus to be exceptionally robust. Lower oil prices over the following two years will make some of the headline numbers look less impressive, but the underlying momentum within the economy will strengthen, with inflation remaining a problem.

Economy in brief: Domestic pressure for a revaluation of the riyal against the US dollar is likely to increase over the summer. Inflation may well hit double digits and the effect of the decline in the riyal will be visible to Saudis on summer vacations abroad. Adjusting the exchange rate peg would not address the underlying causes of inflation and would have significant adverse impacts elsewhere in the economy, but it is probably the most effective way of reducing inflation in the short term. While we have stated forcefully in past reports that no change will be forthcoming, we are less certain now, given the severity of inflation and the weakening of the dollar.

Stock market in brief: The stock market has responded well to a generally healthy set of first quarter earnings reports. Earnings growth was strongest in the construction sector, while the banks generally underperformed, with some recording a decline in earnings compared to the first quarter of last year.

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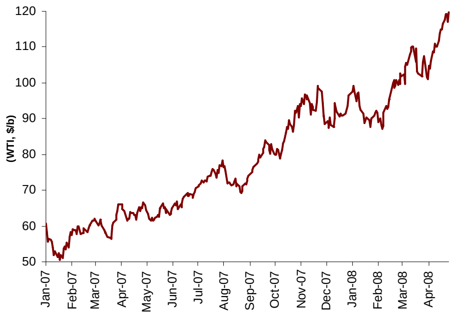
Oil's surge: what's behind it and what it means

Oil prices at another all-time high



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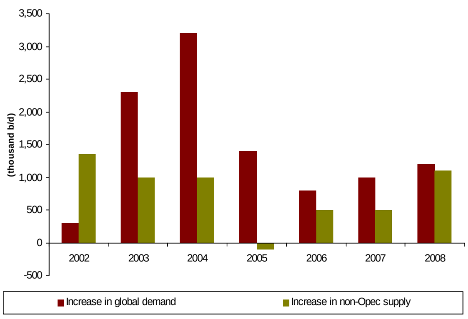
Why the oil price is going up

Demand has consistently outpaced supply

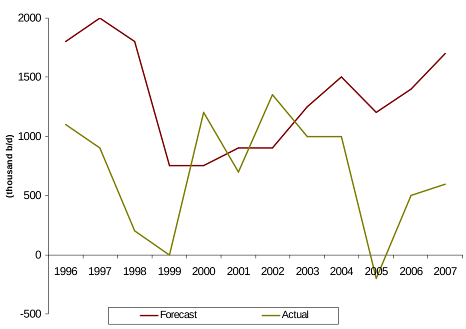


Oil prices have risen dramatically over the last six years. West Texas Intermediate (WTI) touched $120 per barrel in late April, compared to just $19.9 per barrel at the end of 2001, an increase of around 500 percent. Growth in demand for oil outpacing growth in supply has been the fundamental reason that oil prices have risen. The chart to the left shows that in each year since 2003 global demand has grown faster than non-Opec supply, putting pressure on Opec to expand output.

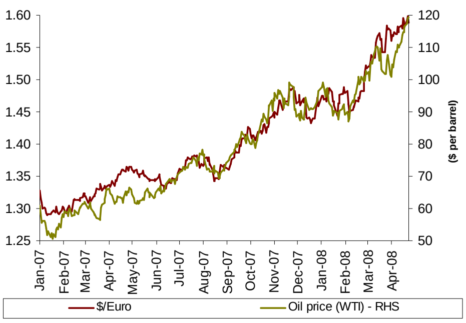
Over the five years to 2007 global oil demand increased by 8.1 million barrels per day (b/d), whereas in the five years to 2002 global oil demand was up by only 4.1 million b/d. China has been the main source of this new demand. Chinese oil consumption rose by 2.5 million b/d (50 percent) between 2002 and 2007, as the country's industrialization entered a more energy dependent phase and the number of vehicles on the roads has surged. The second largest source of new oil demand over this period has been the Middle East, where consumption growth of 1.2 million b/d has been supported by rapid economic growth and low fixed prices. Consumption growth in the US, the world's largest oil consumer, also expanded by 1.2 million b/d.

While demand has surged, non-Opec supply has failed to keep up. The chart at the top of the following page shows that non-Opec supply has consistently fallen below the benchmark forecasts of the International Energy Agency. Regular disappointment over new

Disappointment over new non-Opec supply



Oil used as hedge against dollar weakness



supply has helped push up prices. After many years of underinvestment, shortages of technology and expertise have rapidly pushed up the costs and slowed the process of locating new oilfields and bringing their production on-stream. This is currently hindered by the global credit crunch, which has raised the cost of securing the necessary finance.

Furthermore, the climate for investment in oil and gas in Russia (which has been the main source of new oil supply over the past decade) has worsened owing to greater political interference in the sector. After rising for each of the past nine years, Russian crude oil production fell by 1 percent in the first quarter of this year. Lower expectations of future non-Opec supply growth are becoming entrenched in the market and any threats to or actual disruption of supply is putting upward pressure on prices.

Opec production has increased over the last five years. Formal production quotas have been raised from 21.7 million b/d in January 2002 to 27.25 million b/d currently (excluding new entrants Angola and Ecuador) and current output is running around 200,000 b/d above this. Opec producers also have very little spare capacity. Only Saudi Arabia has sustainable spare capacity, of around 2 million b/d. However, the bulk of this is heavy sour crude that requires complex and expensive refining that not all refineries are configured to carry out. As a result, this type of crude trades at around a 15 percent discount to WTI.

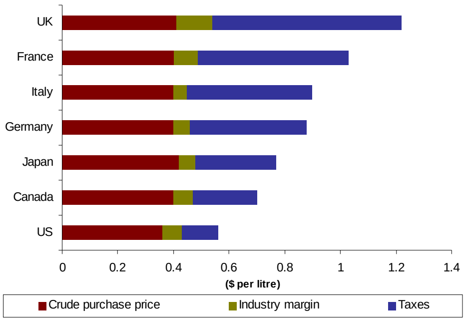
In this environment of limited surplus capacity, the effects of disruptions to supply on oil prices are more pronounced. Troubles in Nigeria, Iraq, Iran, Venezuela and Russia in recent years have all contributed to higher prices.

Inflows of capital from investment funds have also become an important factor pushing up oil prices. Oil is being used as a hedge against the US dollar and the run up in oil prices in recent months has corresponded very strongly with a persistent weakening of the dollar. The rationale for this is that oil prices are a dollar denominated investment that is maintaining, if not gaining, value against other currencies even though the dollar itself is falling. In addition, with global stock markets and interest rates falling, oil, and commodities in general, are considered relatively attractive investments.

We think it would take clear evidence of a slowdown in demand for oil for prices to retreat. Higher oil prices are hurting the global economy, but not by as much as analysts had expected. A benchmark study by the International Energy Agency (in conjunction with the IMF and OECD) in 2004 concluded that a 40 percent increase in oil prices takes around 1 percent off global GDP. Since the end of 2002, oil prices have risen by nearly 500 percent, yet global growth last year was 4.9 percent and even with recession looming in the US, it is expected to be around 3.7 percent this year, above its 20-year average.

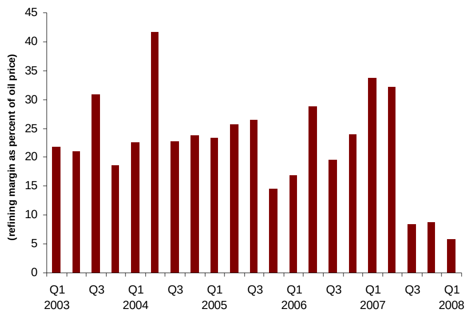
In part, the resilience of the global economy to the ongoing run-up in oil prices is because the price rise is the result of a shift in demand rather than a shock to supply (as was the case with the price surges in the mid-1970s and the early 1980s). In addition, the full extent of the prices rises has not been passed on to the consumer for the following reasons:

Taxes reduce impact of higher crude prices
Breakdown of retail price of fuel (2007)



Source: Opec

US refining margins are being squeezed



Source: BP

- In many emerging markets gasoline is sold at a fixed price that is not adjusted in line with movements in the global oil price. In China, for example, the retail price for gasoline has been increased by 95 percent since the end of 2002. In most Middle Eastern countries, prices have not been changed at all and in some cases they have been cut (Jordan is a notable exception; it removed all oil subsidies in February).

- In Western Europe fuel is heavily taxed. In the UK, for example, tax accounts for 55 percent of the retail price of gasoline. As crude oil prices account for less than half of the final retail price (refining, transportation and other costs make up around 10 percent of the total) the impact of the run-up in oil prices on final prices is less pronounced. Since the end of 2002, the retail price of gasoline in the UK has climbed by only 80 percent.

- The weakness of the dollar against most leading currencies over the last five years has offset some of the rise in international oil prices, which are denominated in dollars. For example, in euros the oil price has increased by just less than half of the increase in dollar terms.

- In the US, taxes are much lower than in Western Europe (they account for around 26 percent of the gasoline price) and there not been a beneficial exchange rate impact. Nonetheless, the retail price of gasoline is up by only 140 percent, as refiners have absorbed much the higher costs. Margins for US West Coast refiners have plunged since the middle of last year, from over $22 per barrel to less than $6 per barrel. As a percent of the oil price the decline is even more marked (see chart to the left).

Analysts assumed that higher crude prices would pass more directly to final consumers and this would cause inflation, leading central banks to raise interest rates and ultimately slowing economic growth. It is the lack of impact on inflation to date that explains why high crude prices have not significantly slowed global GDP growth.

A slowing global economy should put downward pressure on prices, but so far the opposite has happened. The fixed fuel prices that shelter consumers in the regions where demand is growing rapidly are unlikely to be adjusted by too much as governments try to contain inflation in the face of rising food prices. However, the rise in US gasoline prices has gained momentum in recent weeks and US oil consumption will decline this year. We also think that the dollar will stabilize as expectations of the size and number of future interest rate cuts are reduced and other leading global economies slow, reducing the flows from investors using oil as a dollar hedge.

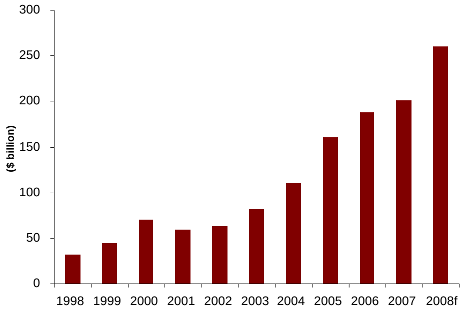
Given the momentum within the market there is no reason why prices can not go on rising over the near term. However, based on our assessment of the fundamentals we think that prices are too high and as the dollar stabilizes we think that WTI will end the year near $70 per barrel. Nonetheless, with WTI averaging over $100 per barrel over the first four months of the year we are revising up our oil price forecasts. We now believe that WTI will average $90 per barrel this year (equivalent to $85 per barrel for Saudi crude).

We are concerned about the global economic outlook for 2009, as the impact of the fiscal stimulus and lower interest rates in the US will have warn off, but the effects of the deterioration in the housing market on employment, consumer spending and corporate balance sheets will linger. Growth in Western Europe and Japan is also likely to slow next year according to the IMF. We therefore forecast that WTI will average $76 per barrel in 2009 ($72 per barrel for Saudi crude). With the global economy recovering and the fundamental tightness between demand and supply remaining, we expect WTI to jump up to an average of $85 per barrel in 2010 ($79.5 per barrel for Saudi crude).

Implications for the Saudi economy

The upward revision to our oil price forecasts has a positive impact on our outlook for the Saudi economy. The current account surplus will be at an all-time high this year and economic growth and the budget surplus will also be exceptionally strong. The lower oil prices we are expecting in 2009 and 2010 mean that some of the headline numbers will not look as good, but the underlying picture will remain very healthy and in real terms we expect economic growth to be stronger. (A full breakdown of our forecasts together with historical data is on page 10.)

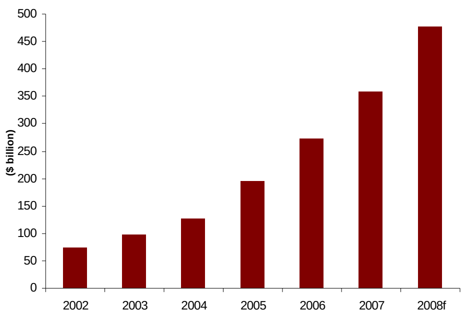
Oil exports will surge to new record...



We now expect oil export revenue to reach $260 billion in 2008. This compares with an average of just $43 billion per year throughout the 1990s and is equivalent to around $700 million per day (we estimate that Saudi Arabia earns $1 billion in oil revenues every day that WTI is above $115 per barrel). Non-oil export growth may slow modestly in response to lower global petrochemical prices. Nonetheless, total exports are now projected at $290 billion, compared with just $39 billion in 1998.

We have also revised up our forecast for imports owing to the spiraling cost of food imports (food accounts for around 12 percent of total imports). Higher global prices meant that the food import bill for January of this year was 44 percent higher than that for one year earlier (see In brief: Economy). Prices of many foodstuffs have subsequently moved even higher. In total, we expect imports to grow by 30 percent this year. However, this will be outweighed by the jump in oil revenues and we forecast that the current account surplus will reach an all-time high of $127 billion in 2008 (though as a percentage of GDP it will be lower than in 2005 and 2006).

...as will official foreign exchange reserves



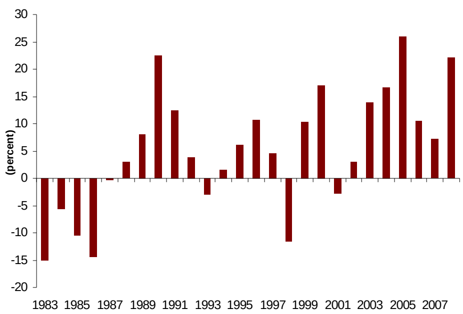
The current account surplus will be reflected in a further jump in foreign assets. SAMA's holdings of foreign assets have climbed by over $10 billion per month in each of the six months to February (the latest data that is available). We expect total foreign assets (those held by SAMA and the government pension funds) to exceed $475 billion at the end of this year, up from just $73 billion at end-2002.

Higher oil revenues will also raise the budget surplus. We now forecast that the budget surplus will be SR260 billion ($69 billion) in 2008, the second largest ever. Soaring oil prices and worsening inflation are putting popular pressure on the government to increase spending. In addition to a package of measures to alleviate the impact of inflation, including a public sector pay rise, announced in January (see our February *Monthly Bulletin*), at the end of March the government said that it would finance a cut in the tariffs that importers pay on 180 foodstuffs, building materials and other consumer goods.

We assume that further such targeted measures are likely over the remainder of the year. Costs for the large array of capital projects the government is undertaking are also rising rapidly, but we think that the high oil prices will encourage the government to push ahead with its spending plans. Based on our revised spending assumptions, Saudi oil prices would need to average below $53 per barrel this year for the budget to fall into deficit.

By adding to money supply growth and tightening various supply bottlenecks within the economy, higher government spending will feed into inflation, which is continuing to rise at an alarming pace. Inflation hit 9.6 percent in March, up from just 3.1 percent in June of last year. Rents and food prices remain the main sources of inflation, but the price rises are now spreading. In year-on-year terms inflation picked up in each of the eight subcomponents of the cost of living index in February. This spread of inflation will complicate policy to contain it and further fuel the public's inflation expectations. We have again revised up our forecast for inflation for this year; we now expect it to average 8.2 percent.

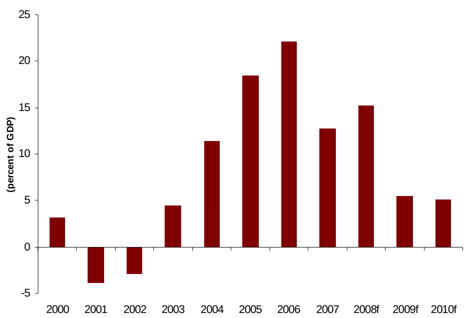
Strong nominal growth in 2008



We do not think that inflation will have too much of a negative impact on economic performance as it is the dynamism within the non-oil sector that is responsible for much of the run-up in prices. Our forecast for real GDP growth remains unchanged at 5.5 percent owing to strong growth in the manufacturing, construction, transport and communications sectors (for more detail on our growth forecast for 2008, see our January *Monthly Bulletin*). Higher oil revenues will allow greater government spending but the effects of this will be offset by the delays in many new projects and the impact of inflation on consumer spending.

In nominal terms, we now forecast GDP to grow by 22.1 percent this year, the second fastest rate since 1990 (higher oil prices lift nominal GDP). At $457 billion, the Saudi economy will be three times larger than it was in 1998.

Budget surplus to fall over next few years



The fall in oil prices we are expecting for 2009 will make economic performance look weaker compared with this year. In nominal terms the economy may not grow at all, while the current account and budget surpluses could shrink to five- and six-year lows, respectively. However, in real terms performance will improve owing to large new petrochemical facilities coming on-stream, a near doubling of cement capacity, higher oil production and the scaling up of work on various megaprojects around the Kingdom.

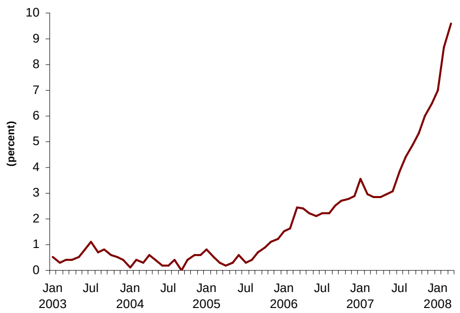
We expect 2010 to be another strong year for the economy as the momentum generated by the investment boom and ongoing liberalization will continue to support activity. Inflation will still be an issue, averaging 5 percent, and even though oil prices are expected to rise back to $85 per barrel, rapid growth in government spending will result in a budget surplus of only around 5 percent of GDP.

Economy watch

Saudi riyal: here we go again

Domestic pressure for a revaluation of the riyal against the US dollar is likely to increase over the summer. Inflation may well hit double digits in the next few months and the effect of the decline in the riyal will be clearly visible to the many Saudis that take their vacations in Europe. Adjusting the exchange rate peg would not address the underlying causes of inflation and would have significant adverse impacts elsewhere in the economy, but it is probably the most effective way of reducing inflation in the short term. While we have stated forcefully in past reports that no change will be forthcoming, we are less certain now, given the severity of inflation and the weakening of the dollar.

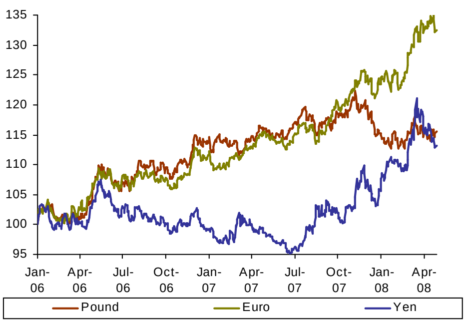
Inflation approaches double digits



Pressure on the exchange rate in the financial markets has eased in recent months following a series of clear and consistent official statements that the riyal's peg the dollar will remain. In addition, expectations of the size and amount of future interest rate cuts in the US (which SAMA is compelled to follow) have been scaled back and many analysts think that the dollar is unlikely to weaken much further. However, we think that domestic pressure for a revaluation will rise in the months ahead.

At 9.6 percent in March, inflation is now well above the 5 percent level of the public-sector pay rise awarded in January, meaning that disposable income is declining for the bulk of Saudi households. Inflation is currently concentrated in rents and food prices (both are up by around 15 percent year-on-year), which is having a disproportionate effect on low income Saudis. Recent rises in global food prices and the inadequacy of local property supply means that in the near term the prices of these will go up further.

Riyal has slipped against major currencies



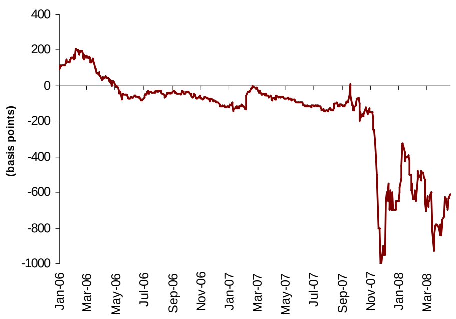
All Saudis are being hit by the fall in the riyal, as most consumer goods are imported. Since the end of 2005, the riyal has fallen by 35 percent against the euro and 15 percent against the pound and the yen. Local wholesalers and retailers are not fully passing on these costs (wholesale price inflation has consistently exceeded consumer price inflation), but there is no shelter for Saudis from the exchange rate impact on their spending while on summer vacations. Many high-income Saudis travel to Europe during the summer and they will find that prices will have gone up by around 20 percent in riyal terms since last summer because of currency depreciation.

With all sectors of the population suffering from inflation and the weak exchange rate there will be pressure on the government to respond. To date, the policies aimed at controlling inflation have had little impact. Government subsidies and reductions in import tariffs and port fees are apparently being absorbed by wholesalers and retailers. Higher reserve requirements for the banks have failed to curb lending growth and measures to speed up the supply of accommodation will take time to produce results.

In contrast, revaluation of the riyal (by 15 percent or more) would have a clear and immediate impact on inflation and would provide some breathing space while supply bottlenecks gradually unwind. It would not tackle the underlying causes of inflation and have adverse impacts elsewhere in the economy (see our August 2007 report, *The riyal's peg to the dollar*), so we therefore maintain our view that the exchange rate will not be adjusted. However, an adjustment simply to ease the pain of high inflation is beginning to make sense.

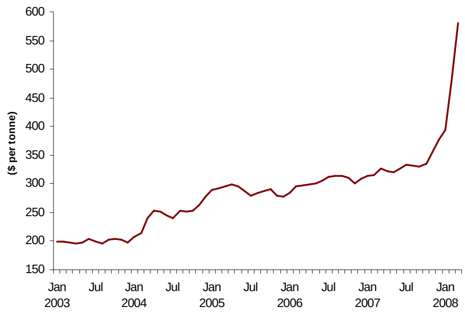
In brief: Economy

Pressure on riyal has eased a little



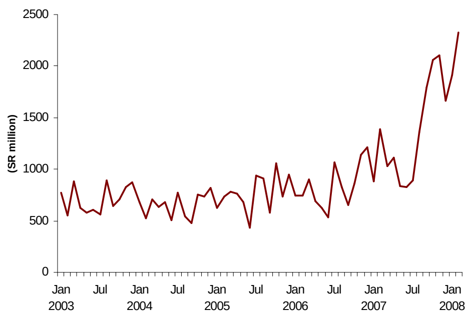
Regional central bank governors have injected some urgency into plans for the GCC single currency, which is formally targeted for launch in 2010. At a meeting in early April in Doha, the governors agreed to meet again in June to “complete the legislation and matters relating to monetary union”. There are many barriers to the introduction of a formal GCC single currency—not least that Kuwait has a different exchange rate arrangement to the rest of the region and Oman has said it will not be ready to join in 2010—however, the Saudi government is strongly committed to the project. The coordinated statements that followed the meeting have taken some pressure off the region's currencies; one-year Saudi riyal forwards have fallen to SR3.69:$ from SR3.67:$ at the start of the month and the GCC’s other dollar-pegged currencies have experienced similar moves.

Rice price has surged



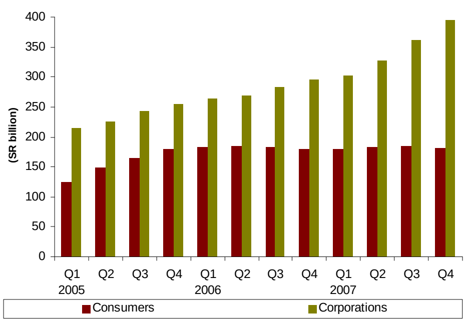
Global prices of some foodstuffs have shot up over the past month, with rice being the most prominent example. Rice prices are up by around 70 percent since January as key producers such as India, China, Vietnam and Egypt limit exports in response to strong demand and dwindling global stocks (stocks are currently half the level of 2000). Food prices have been one of the main contributory factors to inflation in Saudi Arabia and the current surge in prices, combined with continued rises in rents and broader price pressures, mean that inflation of above 10 percent is a real possibility over the next few months.

Letters of credit for food imports up sharply



Rising food prices are having a big impact on the import bill. Data for January show that food imports are up by 44 percent compared with the same month of 2007. Letters of credit opened for food purchases have also increased sharply and over the first two months of this year were 86 percent higher than in the same period of last year. It is not just food prices that are pushing up imports. Total imports climbed by around 20 percent in January, with construction materials and equipment also rising strongly, as work commences on an increasing number of the megaprojects within the Kingdom.

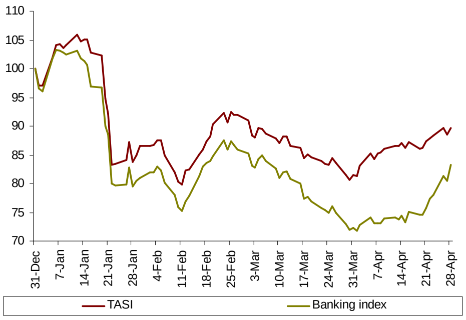
Corporate borrowing continue to rise



Year-on-year growth in lending to the private sector climbed to just below a two-year high of 28.5 percent in February, from 26.6 percent in January. Corporations accounted for virtually the entire growth in private sector borrowing, as has been the case since end-2005. Over the last two years bank claims on corporations have climbed by SR140 billion (55 percent) while those on consumers are up by just SR1.7 billion (1 percent). There remains a strong relationship between private sector credit growth and the stock market as some corporate borrowing finds it way into the market. However, we think that corporate investment spending is now providing an important impetus to new lending. The stagnation of consumer borrowing suggests that consumers with strong credit ratings reached their credit limits during the stock market boom and points to the limited sensitivity of consumers to changes in interest rates.

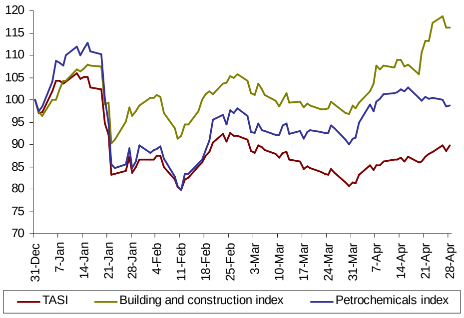
In brief: Stock market

Poor bank performance not a surprise
(31 December 2007 = 100)



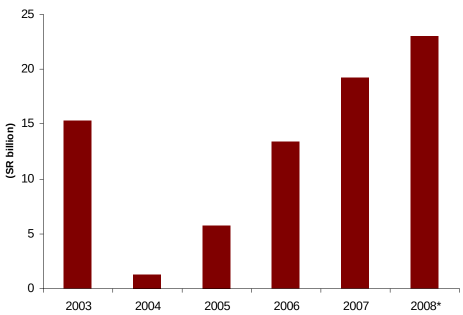
The Tadawul all-share index (TASI) performed strongly during April owing to a generally good set of first quarter results. By April 28, the TASI was up by around 8 percent from its level at the end of March. On average, earnings grew by around 15 percent compared with the first quarter of 2007, supported by the booming macroeconomic conditions. The banks were the main exception. Stripping out Bank al-Bilad, where earnings growth came from a very low base, bank earnings grew by an average of 7 percent and several banks saw their earnings decline. This was due to slow growth in fees from brokerage and asset management and losses due to exposure to products affected by the global credit crunch. Poor results had generally been expected and the banking sector has significantly underperformed the rest of the market so far this year.

Construction and petrochemicals outperform
(31 December 2007 = 100)



We estimate that earnings growth was fastest in the building and construction sector. This is not surprising given the building boom that is taking place throughout the Kingdom. Strong demand is generally allowing constructors to pass on higher costs to their clients. The building and construction sector has outperformed the TASI by 26 percent so far this year. Sabic disappointed some analysts with earnings growth of 10 percent owing to a 70 percent increase in costs. Unlike in January, when the market plunged after Sabic's figures came in below expectations, this time the results had little effect on the TASI.

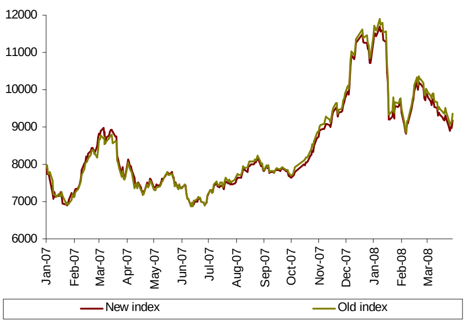
A bumper year of IPOs



* To end April

The Alinma Bank IPO closed 1.74 times oversubscribed on April 16. It raised SR10.5 billion ($2.8 billion), making it the largest IPO since Saudi Telecoms in 2003. Over 8.8 million people (around two-thirds of the adult population) participated in the offering. Alinma Bank was the first IPO in which a majority, in this case 70 percent, of the company was sold to the public. Just over SR23 billion has been raised by IPOs so far this year, compared with SR19.2 billion for the whole of 2007.

Reweighted TASI



The launch of the reweighted stock market index and revised sub-indices on April 5 passed off smoothly. The new index is weighted by freely floating shares rather than total issued shares. The companies whose weights in the index have been affected the most are those with small free floats; for example, only 5 percent of Kingdom Holdings' shares are currently freely floating. With information on the new market weighting available well in advance, investors were able to adjust their positions over time. The historical performance of the reweighted index is very close to that of the old index.

Key data

	2002	2003	2004	2005	2006	2007E	2008F	2009F	2010F
Nominal GDP									
(SR billion)	707.1	804.6	938.8	1182.5	1318.0	1414.0	1712.2	1712.7	1863.1
($ billion)	188.6	214.6	250.3	315.3	351.5	377.1	456.6	456.7	496.8
(% change)	3.0	13.8	16.7	26.0	11.5	7.3	22.1	0.0	8.8
Real GDP (% change)									
Oil	-7.5	17.2	6.7	7.8	0.2	-1.5	4.0	5.0	1.0
Non-oil private sector	4.1	3.9	5.3	5.8	6.4	5.9	7.6	8.0	7.8
Government	2.9	3.1	3.1	4.0	6.1	4.3	5.0	5.0	4.5
Total	0.1	7.7	5.3	6.1	4.3	3.5	5.5	6.4	5.0
Oil indicators (average)									
WTI ($/b)	26.2	31.1	41.5	56.7	66.1	72.3	90.0	76.0	85.0
Saudi ($/b)	23.7	26.9	34.7	49.5	60.5	68.1	85.0	72.0	79.5
Production (million b/d)	7.5	8.8	9.0	9.5	9.2	8.8	9.2	9.5	9.6
Budgetary indicators (SR billion)									
Government revenue	213	293	392	564	674	622	792	706	780
Government expenditure	234	257	285	346	393	443	532	611	685
Budget balance	-21	36	107	218	280	179	260	95	95
(% GDP)	-2.9	4.5	11.4	18.4	21.3	12.6	15.2	5.5	5.1
Domestic debt	660	660	614	475	366	267	250	230	240
(% GDP)	93.3	82.0	65.4	40.2	27.8	18.9	14.6	13.4	12.9
Monetary indicators (average)									
Inflation (% change)	0.2	0.6	0.3	0.7	2.3	4.1	8.2	6.2	5.0
SAMA base lending rate (%, year	2.00	1.75	2.50	4.75	5.20	5.50	5.50	5.50	5.50
External trade indicators ($ billion)									
Oil export revenues	63.6	82.0	110.4	161.1	187.7	201.2	260.5	227.8	257.1
Total export revenues	72.3	93.0	125.7	180.1	210.5	229.7	290.2	261.0	292.9
Imports	29.6	33.9	41.1	54.6	63.8	81.5	106.0	129.3	153.9
Trade balance	42.6	59.1	84.6	125.5	146.6	148.2	184.2	131.7	139.0
Current account balance	11.9	28.0	51.9	90.0	98.9	91.8	126.7	79.2	93.5
(% GDP)	6.3	13.1	20.7	28.5	28.1	24.3	27.8	17.3	18.8
Official foreign assets	73.3	97.1	127.9	195.5	273.4	359.8	477.7	553.7	644.2
Social and demographic									
Population (million)	21.5	22.0	22.5	23.1	23.7	24.5	25.3	26.1	26.9
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	14843	15394	18039	17483	18451

Sources: Jadwa forecasts for 2007 to 2010. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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