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Monthly Bulletin

US and EU policy shifts to impact Kingdom

Conditions on global financial markets remain volatile. Investors are focusing on economic data suggesting the likelihood of a return to recession is increasing and adjusting their expectations to account for lower global economic growth. There have also been shifts in economic policy that are of medium-term significance for Saudi Arabia. A pledge by the US central bank to hold interest rates very low for two more years could prove inflationary, while the recognition of institutional failures in the Eurozone is probably pushing the adoption of a GCC single currency even further back.

10-year US government bond yield

After a brief recovery from the sharp falls in early August, global financial markets suffered further stresses in recent days. Another round of weak economic data from across the world, with a large drop in manufacturing activity in part of the US the most concerning number, and more tensions around the health of Eurozone banks pulled down stock markets and oil prices and caused large inflows into assets considered safe havens. In addition to gold, the Swiss franc and Japanese yen, strong demand for US government debt pulled the yield on 10-year US government bonds below 2 percent for the first time since 1950, despite the recent credit rating downgrade.

The new economic data is consistent with our view that a global recession will be avoided and that the global economy is set for a period of slow growth. High government spending should enable the Kingdom's economy to prosper despite this weakness. We do not foresee oil prices declining to a level that would jeopardize government spending. We estimate it will take an oil price of $84 per barrel (Saudi export crude) for a budget surplus this year and $79 per barrel in 2012; even if prices fall below this level, spending can be financed by drawing down government reserves.

In the short term, the volatility on global stock markets will hit investor and business confidence in the Kingdom. The TASI moves fairly closely in line with global markets and has fallen by 7.4 percent so far this month. Although the TASI now looks attractively valued, more volatility on global markets is likely. New data releases will be monitored closely and investors remain concerned about the willingness and ability of policymakers to tackle the economic issues they are facing.

In the Eurozone these focus on the support the economically stronger nations provide to the weaker ones. A series of stop-gap measures over several years have bought some time, but have proved unable to draw a line under the problems in Greece or to prevent them from spreading. In the US, political wrangling places more pressure on the Federal Reserve to support the economy. As part of this process, after its most recent meeting the Fed announced that it planned to keep interest rates unchanged for two more years.

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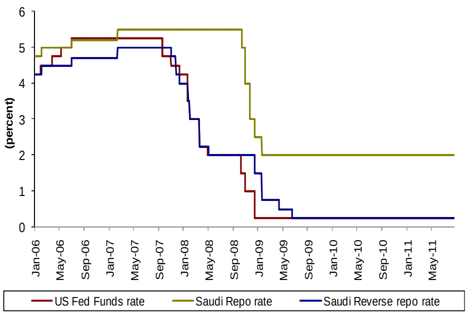
Interest rates



Trade-weighted US dollar index

This move has important implications for Saud Arabia, owing to the riyal's peg to the US dollar. The peg means that interest rates in the Kingdom are closely aligned with those in the US. As there are no controls on the movement of capital into or out of the Kingdom, should any significant differential open between Saudi and US interest rates, this would likely trigger a flow of funds, into the Kingdom if local rates were much higher than those in the US and vice versa.

The benchmark US interest rate, the Fed funds rate, has been at 0.25 percent since December 2008 and the Fed's latest statement suggests it will be at this exceptionally low level for a total of nearly five years. For much of this time very low interest rates have been appropriate for Saudi Arabia, with inflationary pressure low and little growth in bank lending. However, the case for keeping interest rates very low in the Kingdom for another two years is less compelling.

Although we think it likely that inflation will ease from the end of this year, the source of inflation will shift from international forces (primarily higher prices of foods and other commodities) to local ones, as government spending and bank lending accelerate. Higher interest rates are more effective at tackling inflation caused by local economic conditions. There are other policy tools that could be used, such as price controls, adjustments to bank reserve requirements or debt sales and purchases to manage liquidity, but these tend to be less effective than interest rates.

Inflationary pressures would be worsened by a weakening of the dollar. On a trade-weighted basis the dollar has been little changed this month, as dollar assets have retained their safe haven status, though there have been large moves against some currencies. Once confidence in the health of the global economy revives, it is likely that the dollar will fall. Furthermore, if the Fed decides to adopt another round of quantitative easing (probably by buying long-term government debt), this could also potentially add to dollar weakness. A weak dollar and very low interest rates, combined with inflationary pressures and healthy economic growth within the Kingdom could lead to pressure on the exchange rate peg.

Eurozone tensions are likely to impact on the progress toward a single currency within the GCC, as the model used by the EU is the basis for the GCC's approach. An increasing number of Eurozone countries are requiring support to meet debt repayments at the same time as all member economies are slowing. With austerity measures introduced across the region, voters are questioning why they should make cutbacks to help other member countries. Recent developments highlight the need for greater financial burden sharing. One approach, the issuance of bonds underwritten by all member countries, was recently dismissed by the French and German leaders. Nonetheless, it is likely that there will eventually be more cooperation on fiscal policy that leads to a formal system of budgetary transfers into a central revenue pool.

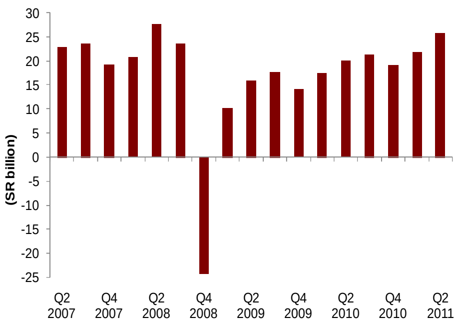
Such an institutional arrangement appears essential for the effective functioning of a regional single currency, but we do not think the GCC will be any more inclined to adopt it than Eurozone members. GCC countries have struggled to agree to a formula to distribute customs revenues since the introduction of a customs union in 2003 and argued the hosting of the regional central bank, which does not augur well for the need for greater financial cooperation.

Stock market watch

Strong second quarter results

Listed companies generally recorded strong profits during the second quarter. Performance was helped by the high level of consumer spending and broader boost to confidence resulting from the supplemental spending packages announced towards the end of the first quarter, in addition to higher oil prices. Even though profits for most of the large companies, primarily banks and petrochemicals, were above expectations, share prices declined. This was the result of falls in global markets, sales to fund subscriptions for an IPO and a seasonal pattern that sees share prices decline before and during much of Ramadan.

Quarterly earnings of listed companies



Profits of listed companies totaled SR25.8 billion in the second quarter. This was the highest since the second quarter of 2008, the quarter immediately before the dramatic intensification of the global financial crisis, though there are 18 more listed companies than three years ago. In year-on-year terms, profits were up by 28.6 percent, faster than the increase in the first quarter. The quarterly growth in profits was 18.6 percent, the largest since the first quarter of 2010.

Compared to the second quarter of last year, earnings growth was fastest for petrochemicals, which contributed 41 percent of total profits. Greater production, stemming from higher global demand and the ramp-up of output from facilities that have recently opened, together with higher product prices, were the main factors behind the growth in profits. In quarterly terms, petrochemicals profits were down, but this was due to a two-month closure of PetroRabigh for maintenance during the quarter.

Quarterly results by sector

	Percent change	
	Q2 2010	Q1 2011
Banks	15.1	9.1
Petrochemicals	48.9	-3.6
Cement	20.4	10.2
Retail	32.3	0.9
Energy & utilities	25.8	279.3
Agriculture	13.2	36.8
Telecoms	32.4	49.9
Insurance	-77.7	-53.0
Multi investment	22.4	80.1
Industrial inv.	12.9	20.7
Building & const.	-16.9	15.2
Real estate	29.5	17.3
Transport	-13.7	305.9
Media & publishing	-26.3	62.1
Hotel & tourism	38.1	-0.4
TASI	**28.6**	**18.6**

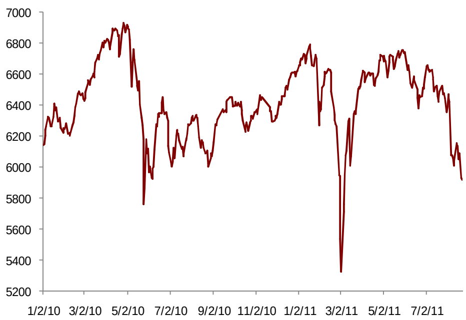
Profits for all but one of the 11 listed banks were up in both annual and quarterly terms; in the case of some smaller banks the gains were very large. Lending and deposit growth increased as banks and borrowers became more confident about the economic outlook. In addition, provisions for non-performing loans continued to fall; provisions were SR821 million in the second quarter, the lowest for two years and less than half of the corresponding quarter of 2010.

Of the other main sectors, telecoms recorded the highest earnings growth. Losses at the two new players continued to decline and profits at the other two were boosted by the expansion of data and broadband operations and higher income from overseas operations. The jump in quarterly earnings was also influenced by the two-month salary bonus that the telecoms companies paid staff in the first quarter. Transport recorded the largest quarterly rise in profits, reflecting one-time losses that were booked in the first quarter.

Retail recorded a healthy gain, helped by increased spending stimulated by the bonus for public-sector employees. Real estate benefitted from higher sales and Emaar Economic City, developer of the King Abdullah Economic City, recorded its first ever quarterly profit. Cement earnings posted their fastest year-on-year growth for three years as sales volumes rose. Four sectors recorded lower earnings than in the second quarter of 2010, with insurance the only one down in quarterly terms as well. Leading insurance company Tawuniya was hit by provisions for doubtful debt, higher claims and lower investment income. Nonetheless, a record number of the 31 listed insurance companies were profitable in the second quarter.

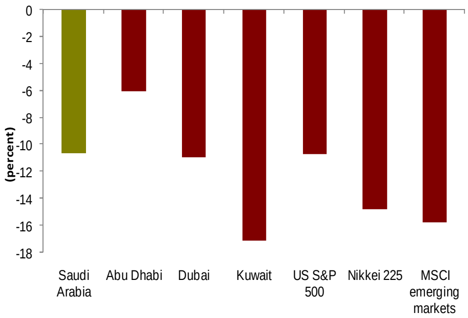
In brief: Stock market

TASI



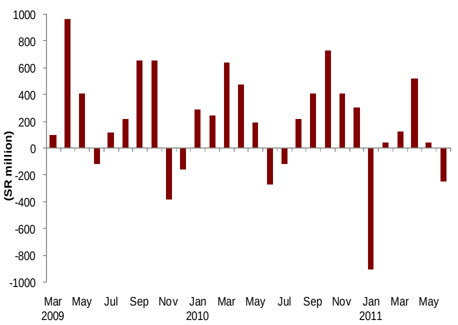
The TASI has followed global markets down. It has dropped by 7.4 percent so far in August and is 10.6 percent below where it began the year. This puts the market on a price-to-earnings ratio of just over 12, the lowest since the first quarter of 2009, when the TASI was trading below 5,000. The falls are largest in multi-investment and petrochemicals, the two sectors that are most exposed to the global economy. Although the fall broadly fits in with the usual pattern over Ramadan (share prices tend to fall in the first three weeks before rising in the last week), this is coincidence, as global rather than local factors have clearly been the primary driver.

Comparative stock market performance
(since December 31 2010)



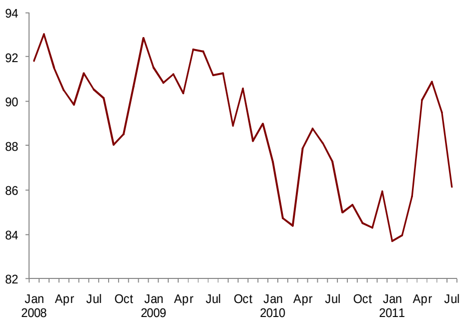
Despite the huge additional spending announced this year and good results from listed companies, the performance of the TASI is not noticeably better than that of other regional markets or of leading global markets so far this year. The Abu Dhabi and Qatar stock markets have fallen by less than the TASI and Dubai is on a par. The performance of the TASI is in line with that of major US markets despite the better position of the Kingdom’s economy, though it is stronger than that of emerging markets as a whole. The TASI has underperformed the healthy economic fundamentals for several years, largely because of the caution of the large retail investor base.

Net purchases through the swap agreement



Foreign investors stepped up their purchases of Saudi shares in July. Total net purchases made by foreigners through the swap agreement were SR103 million, following net sales of SR251 million the previous month. In absolute terms, the value of shares purchased was at a three-month high of SR1.02 trillion. This occurred despite the falls in global markets at the end of the month; generally, foreigners reduce their holdings in the Saudi market when there are tensions in global markets as part of a general reduction of risk. While Saudi Arabia does not face the debt problems of many large economies, it is not immune from events in global markets, so the net buying during the month appears to be a positive indication of foreign investors’ sentiment towards the Kingdom.

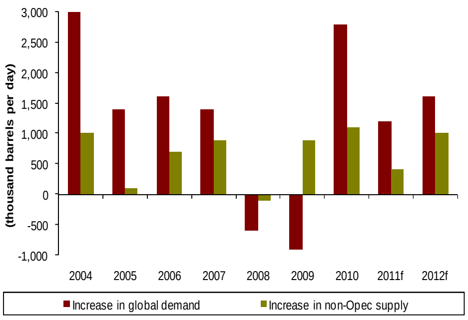
Saudi investors share of total trading



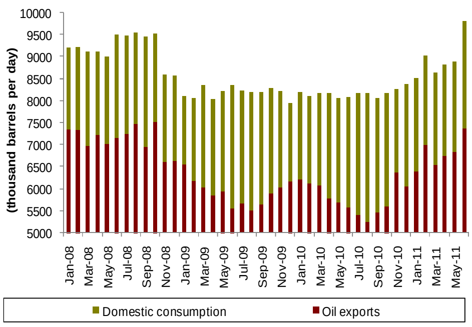
The value of trading by Saudi individual investors has fallen sharply in the past few months. Some of the bonus awarded to public sector workers was used for stock market trading, particularly in April and May, but as with the burst of consumer spending, this has faded quickly. The value of shares bought and sold by local individual investors in July was half the total in May. The fall was also influenced by seasonal factors, as July was the peak of the holiday season this year and it is therefore encouraging that the value of transactions was 20.5 percent above the level of July 2010 and above the monthly average for whole of last year. Saudi individuals accounted for 86.2 percent of the total value of transactions in July, down from a recent peak of 90.9 percent in May.

Oil prices

Global oil demand and non-Opec supply



Saudi oil production



Oil market watch

Fundamentals support comfortable oil prices

Oil prices have held up after their abrupt falls in early August, but have been volatile in line with conditions on global financial markets. While many leading forecasters have downgraded their outlook for global economic growth and therefore oil demand, the picture is still robust and should support fairly high prices over the next few years.

Mounting tensions in the Eurozone, the US credit rating downgrade and a succession of weak economic data pulled oil prices, together with most stock markets, down in late July and early August. Brent fell by 13 percent, dipping below $100 per barrel for the first time since February, and WTI plunged by almost 20 percent to its lowest level this year. After a brief recovery, stock markets have fallen back to their recent lows in recent days, but oil prices are still above their levels of early August.

Nonetheless, the need to tackle high debts in the US and much of Europe points to economic difficulties ahead and as a result projections for global oil demand have been cut back. The International Energy Agency (IEA), Opec and the US Energy Information Administration have all revised down their projections for oil demand growth for 2011 in the past month. The cuts are fairly modest, at between 60,000 and 150,000 barrels per day.

There has been little impact on 2012 forecasts yet. Across the three forecasters average oil demand growth is put at 1.5 million barrels per day. This is strong given concerns about the global economy and compares to an average of 1.1 million barrels per day between 2000 and 2010. However, the IEA has calculated that if global economic growth fell to 3 percent, from its present forecast of around 4 percent, global oil demand would be 600,000 barrels per day lower.

It is too early to determine if any cuts have been made to oil production this month to adjust for the weaker demand environment. Independent estimates for July put Opec output close to a three-year high. Official data from the Joint Oil Data Initiative put the Kingdom’s production at 9.8 million barrels per day in June, which may well be an all-time high. Domestic consumption rose, as is normal during the summer months owing to increased power demand resulting from air conditioning use, but at 2.4 million barrels per day, still left exports at 7.4 million barrels per day, the highest since August 2008.

There is unlikely to be a rapid resumption of Libyan output owing to damage to oil infrastructure during the fighting. It appears that some capacity could be brought back on stream fairly quickly, but that it might take several years for output to return to the pre-conflict level. We expect the Kingdom to lower production as Libyan output rises.

For some time our oil prices forecasts have been below consensus owing to concerns about the economic outlook. We have therefore kept our forecasts for Brent and WTI unchanged. However, we have made some adjustments to the relationship between Saudi export crude and these prices. We base our budget and current account forecasts on Saudi export crude and as a result our forecasts for both indicators have slightly risen. With demand growth still expected to outpace that of supply in 2012, we do not expect oil prices to fall too sharply next year, though they will be lower than this year.

Key data

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F
Nominal GDP									
(SR billion)	938.8	1182.5	1335.6	1442.6	1786.1	1397.5	1630.0	1988.4	2003.3
($ billion)	250.3	315.3	356.2	384.7	476.3	372.7	434.7	530.2	534.2
(% change)	16.7	26.0	12.9	8.0	23.8	-21.8	16.6	22.0	0.7
Real GDP (% change)									
Oil	6.7	6.2	-0.8	-3.6	4.2	-7.6	2.1	8.9	-0.2
Non-oil private sector	5.3	5.8	6.1	5.5	4.6	2.7	3.7	4.2	5.0
Government	3.1	4.0	3.1	3.0	3.7	5.2	5.9	5.0	5.0
Total	5.3	5.6	3.2	2.0	4.2	0.2	3.8	5.6	3.5
Oil indicators (average)									
WTI ($/b)	41.5	56.6	66.1	72.3	99.7	62.0	79.5	93.0	89.0
Saudi ($/b)	34.7	49.5	60.5	68.1	93.4	60.5	77.7	99.3	93.8
Production (million b/d)	9.0	9.5	9.2	8.7	9.2	8.1	8.2	8.8	8.7
Budgetary indicators (SR billion)									
Government revenue	392	564	674	643	1101	510	735	948	874
Government expenditure	285	346	393	466	520	596	627	821	777
Budget balance	107	218	280	177	581	-87	109	127	97
(% GDP)	11.4	18.4	21.0	12.2	32.5	-6.2	6.7	6.4	4.8
Domestic debt	614	475	366	267	237	225	167	160	160
(% GDP)	65.4	40.2	27.4	18.5	13.3	16.1	10.2	8.0	8.0
Monetary indicators (average)									
Inflation (% change)	0.3	0.7	2.3	4.1	9.9	5.1	5.3	5.5	4.5
SAMA base lending rate (%, year	2.50	4.75	5.20	5.50	2.50	2.00	2.00	2.00	3.00
External trade indicators ($ billion)									
Oil export revenues	110.4	161.6	188.2	205.3	281.0	163.1	214.9	278.4	238.9
Total export revenues	125.7	180.4	210.9	233.1	313.4	192.2	251.0	319.9	284.6
Imports	41.1	53.8	63.0	81.5	100.6	86.4	96.7	108.3	121.2
Trade balance	84.6	126.6	147.8	151.6	212.7	105.8	154.3	211.7	163.4
Current account balance	51.9	90.0	98.9	93.3	132.3	22.8	66.8	130.2	83.3
(% GDP)	20.7	28.5	27.8	24.3	27.8	6.1	15.4	24.6	15.6
Official foreign assets	127.9	195.5	273.4	359.8	502.0	474.2	520.3	614.3	675.6
Social and demographic indicators									
Population (million)	22.7	23.4	24.1	24.8	25.5	26.3	27.1	27.9	28.8
Unemployment (male, 15+, %)	11.0	11.5	12.0	11.0	9.8	10.5	10.2	11.0	10.5
GDP per capita ($)	11039	13503	14806	15523	18651	14158	16017	18983	18548

Sources: Jadwa forecasts for 2011 and 2012. 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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