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Report Series

December 2008

Saudi Arabia: the 2009 Budget and Macroeconomic Prospects

Executive Summary

- In drawing up Saudi Arabia's budget for 2009 the authorities have been mindful of the vastly more challenging global environment confronting the economy.
- ***Saudi Arabia's economic outlook has dimmed considerably in the face of the ongoing global financial crisis and deepening recession in the world economy.*** The repercussions of the global turmoil have been felt primarily through the dramatic fall of oil prices and the severe tightening of credit and liquidity in global markets.
- As a result of the global financial crisis, corporate finance costs have soared in the Gulf region, with the result that many projects have been put on hold or cancelled. Saudi Arabia has suffered less than some other states, but local banks are increasingly risk sensitive and ***private investment growth will be significantly lower in 2009***. Some recovery in investment is envisaged for 2010.
- Slumping private investment, combined with an expected 12 percent reduction in crude oil production and brittle confidence among private consumers, indicates that ***the Saudi economy is set to shrink by around 1.5 percent in real terms in 2009***. Growth should rebound to around 4.2 percent in 2010, as crude output is stepped up and investment growth begins to recover.
- The fiscal outlook has deteriorated with the softening of oil prices, but remains manageable. ***We expect a fiscal deficit*** equivalent to almost **6 percent of GDP** in 2009, with a rebound to a small surplus projected for 2010. Financing should be comfortably covered by domestic public resources. The current account is expected to record a small deficit this year (equivalent to around 5 percent of GDP) before moving back into surplus in 2010.
- So far, the banking system has weathered the global financial turmoil, and ***Saudi banks remain well-capitalized in comparison with their Gulf peers***. Nevertheless, deposit growth has slowed and lending to corporates has become far more selective than previously. Mortgages offer scope for a pick-up in personal lending going forward.
- ***The main stock market index has been driven sharply lower as a result of global uncertainty and poor domestic prospects.*** Investors have been especially unsettled by the deteriorating outlook for the petrochemicals and banking sectors.
- ***The overriding feature of the Saudi economy remains its resilience***. Stress testing indicates that the fiscal position would record a substantial deficit if oil prices fell to $25/barrel, even if spending growth slowed. However, any such deficit could readily be financed through a drawdown of public sector deposits with the central bank and/or stepped up domestic debt issues, for which there is ample demand.

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Table 1: Saudi Arabia: Key Economic Data and Forecasts

	2006	2007	2008	2009f	2010f
Real GDP (% change)	3.2	3.4	5.0	-1.6	4.2
Hydrocarbon GDP	-0.8	0.5	7.6	-10.0	7.0
Non-hydrocarbon GDP	5.1	4.7	3.8	2.3	3.0
Nominal GDP (US$ billion)	353.7	378.8	490.2	376.3	436.6
Nominal GDP (% change)	13.0	7.1	29.4	-23.2	16.0
Consumer prices (% change)	2.4	4.0	9.9	8.1	7.0
Crude oil production (mbd)	9.2	8.7	9.2	8.1	8.6
Oil exports ($ billion)	187.7	205.5	309.8	138.7	191.1
Current-account balance (US$ billion)	98.4	94.4	178.3	-17.0	24.0
(% GDP)	27.8	24.9	36.4	-4.5	5.5
External debt (US$ billion) [1]	40.8	72.6	75.3	76.1	77.6
Fiscal balance (SR billion)	281.0	176.6	363.7	-79.0	18.8
(% GDP)	21.2	12.4	19.8	-5.6	1.1
Memorandum					
Arab Light crude oil ($/b)	61.1	68.8	98.0	50.0	65.0

[1] Foreign liabilities of Saudi banks and non-financial enterprises; there is no sovereign debt

f = Samba forecast
Sources: SAMA; Ministry of Finance and National Economy; IMF; Samba.

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The 2009 budget projects a deficit

The 2009 Budget and the Global Economic Environment

On December 22 the government released its budget for fiscal year 2009 (31 Dec. 2008 – 30 Dec. 2009) and announced fiscal results for 2008. In projecting a deficit, the new budget shows that the government is keen to keep infrastructure spending on track, despite the weakening revenue outlook.

For 2009, a deficit of SR65 billion is projected by the authorities, based on revenue of SR 410 billion ($109 billion) and spending of SR 475 billion. The oil price on which this is based is not revealed, but assuming a 12 percent contraction in oil production in 2009, we estimate that an average price for Saudi crude of $43/barrel is at the heart of the government's calculations. This is 56 percent lower than the likely average of Saudi crude for 2008.

Table 2: Saudi Arabia: Fiscal Outturns and 2009 Budget

(SR billion)	Actual 2007	Estimate 2008	Budget 2009
Total revenue	642.8	1100.0	410.0
(% change)	-7.0	71.1	-62.7
(% of GDP)	45.3	59.9	29.1
Total expenditure	466.2	510.0	475.0
(% change)	18.6	9.4	-6.9
(% of GDP)	32.9	27.8	33.7
Balance	176.6	590.0	-65.0
(% of GDP)	12.4	32.1	-4.6
Memorandum:			
Net domestic debt[a]	-335.1	-1058.5	n/a
(% of GDP)	-23.6	-57.7	

a = Gross public sector domestic debt less public sector deposits with banking system.

Source: SAMA; Ministry of Finance and National Economy; Samba.

The authorities are rightly concerned by a worsening global economy

The revenue projection is less than the SR450 billion budgeted for 2008 and well below the actual SR1100 billion generated in 2008. As such, the revenue calculation is typically conservative, but not overly so given the worsening global economic climate.

Prospects for global growth have deteriorated in the past few months as deleveraging and tighter credit conditions weigh ever more heavily on

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economic activity. Signs of cutbacks in consumption and investment are increasingly evident as households and firms prepare for a protracted period of job cuts and shrinking profits. There are growing risks of deflationary conditions in mature economies, although momentum in this direction is not yet strong. Further fiscal and monetary stimuli seem likely, though the effectiveness of any monetary easing is unclear in light of the financial distress and deleveraging that continue to plague the global financial system, while fiscal injections may be of limited value given the desire of many households to rebuild their savings.

There are many areas of weakness, but a key barometer of confidence (and an indirect driver of private consumption) is the US housing market. This continues to languish and there is little hope that any sustainable recovery can take place before prices stabilize, which might not occur before the end of 2009. Both housing starts and permits fell to record lows in October. Construction starts on housing fell 4.5 percent to an annual rate of 791,000. This is the lowest start rate since records began in 1959. The pending home sales index also fell 4.6 percent to 89.2, indicating that the housing downturn might extend well into a fourth year.

Activity is set to weaken further in 2009

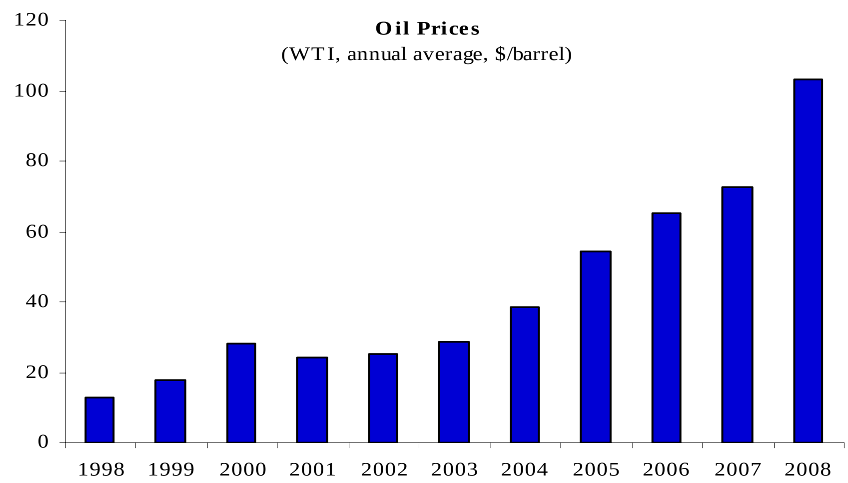
As investors and others look toward next year, we see a difficult terrain with an OECD recession likely to persist through the end of 2009, as adverse credit conditions and further deleveraging constrain activity of consumers and businesses alike. A gradual recovery in activity is in prospect for 2010 as financial markets return to something approaching equilibrium, and trade and investment pick up (this may in turn prompt some upward pressure on market interest rates as participants begin to make sense of the enormous increase in debt and contingent liabilities that have been taken on by governments across the globe). Nevertheless, such a recovery is by no means guaranteed, and a significant risk to the outlook stems from the possibility of increased protectionism, which would further undermine global economic confidence.

Table 3: Global Forecast	**2007**	**2008**	**2009**	**2010**
Real GDP growth (percent, annual)				
World	5.0	3.1	0.5	2.6
US	2.0	1.2	-2.0	1.3
Japan	2.1	0.2	-1.6	0.6
Euro area	2.6	0.9	-2.2	1.2
Emerging Markets	7.5	5.9	3.0	4.5
Official policy rate (end period)				
US	4.2	0.0	0.0	1.0
Japan	0.5	0.3	0.1	0.8
Euro area	4.0	2.5	0.75	1.5
Crude oil (WTI, $/b, average)	72.4	103.0	55.0	70.0

The authorities are rightly concerned by a worsening global economy

The impact of this slump in global economic demand on oil prices has been pronounced. By late December, the average price of the benchmark WTI had shed 70 percent since its peak in July. In its latest monthly report, the International Energy Agency (IEA) has again cut back its projections for world oil demand to reflect the darkening global outlook. There are a number of variables impacting oil prices, including OPEC's ability to abide by agreed supply cuts, the direction of financial and credit markets, the outlook for demand in China, and whether and when market participants might start to worry about long-term supply constraints again.

Despite these uncertainties, it seems likely that prices will continue to slide over the next six months, before beginning to firm again in the second half of 2009 as the global economy starts to recover. Thus, we project an average price for WTI of **$55/barrel** in 2009, and expect this to edge up to **$70/b** as the global recovery becomes more resolute.[1] Our 2009 forecast remains within the current range of global forecasts of $35/b - $65/b. Nevertheless, in acknowledgement of this uncertainty, Saudi Arabia's macroeconomic performance under a much worse oil price scenario is examined briefly at the end of this report.



We project higher revenue and spending than the authorities…

Our 2009 oil price forecast is some way higher than the price implicit in the Saudi authorities' budgetary calculations. Even when a likely 12 percent reduction in crude oil production (designed to support prices) is factored in, we still anticipate fiscal revenue of SR482 billion for 2009 (34 percent of GDP). This is a startling 56 percent lower than the actual level of revenue in 2008, but is still some 18 percent ahead of the budget projection. Our revenue projection is around 72 percent of the 2004-08 nominal average.

There is compelling evidence to suggest that government spending will continue to increase in 2009—and will most likely exceed the budgeted projection. The authorities are keenly aware of the need to provide the platform for future growth by expanding and improving basic infrastructure, such as roads, hospitals, schools and universities, particularly to less integrated parts of the country, such as the south west. Private investment

[1] The average price of Saudi crude generally trades at a $5 discount to WTI, though this is volatile.

growth has suffered from global liquidity dislocations, and it seems clear that public spending on infrastructure will have to continue at a reasonably high rate next year if the government's plans are to remain on track. Indeed, at a time of wavering private confidence, the government and other public sector institutions may need to increase their equity stakes in various projects to keep them viable. The authorities will be helped by rapidly easing construction costs, which should allow them to renegotiate better terms with contractors (an approach that Saudi Aramco has already adopted). This will help to soften the pace of nominal investment spending, but the overall trend in spending will be upwards.

On the recurrent spending front, softer inflation should help to ease pressure on the pace of subsidy spending. Yet with population growth continuing at around 3 percent and a weakened private sector unlikely to absorb many new job market entrants, upward pressure on current spending will remain considerable. Given these fundamentals, we anticipate overall spending of SR561 billion or 40 percent of GDP. This represents a 10 percent increase on last year's estimated figure, but again is well below budgeted projections.

Table 4: Saudi Arabia: Fiscal Outlook

(SR billion)	Actual 2007	Actual 2008	Budget 2009	Samba Projection 2009	Samba Projection 2010
Total revenue	642.8	1100.1	410	482.0	652.7
(% change)	-7.0	71.1	-62.7	-56.2	35.4
(% of GDP)	45.3	59.9	29.1	34.2	39.9
Total expenditure	466.2	510.0	475	561.0	633.9
(% change)	18.6	9.4	-6.9	10.0	13.0
(% of GDP)	32.9	27.8	33.7	39.8	38.8
Balance	176.6	590.0	-65	-79.0	18.8
(% of GDP)	12.4	32.1	-4.6	-5.6	1.1
Nonoil fiscal balance	-385.9	-256.9	n/a	-494.5	-553.8
(% of nonoil GDP)	-60.3	-35.2		-64.5	-68.8
Memorandum:					
Net domestic debt[a]	-335.1	-1058.5	n/a	-981.9	-1005.5
(% of GDP)	-23.6	-57.7		-69.7	-61.5

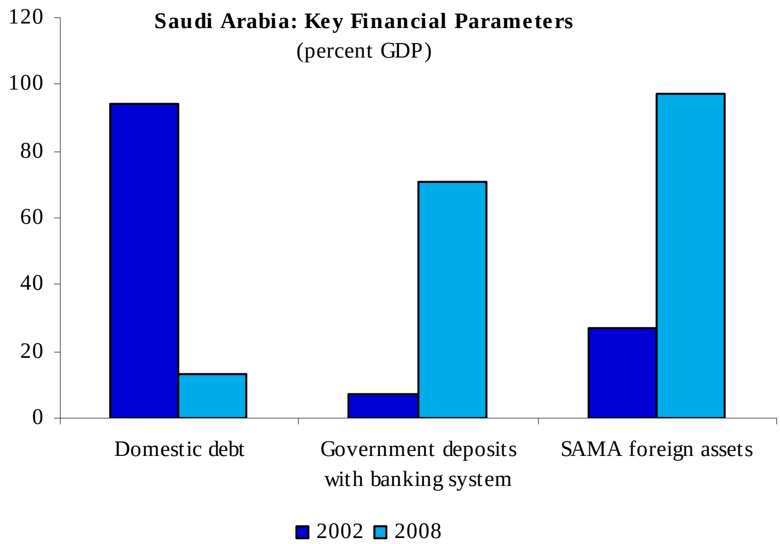
a = Gross public sector domestic debt less public sector deposits with banking system. Source: SAMA; Ministry of Finance and National Economy; Samba.

…and we think that a deficit of almost 6 percent of GDP is in prospect

These developments point to a fiscal deficit of SR79 billion or 5.6 percent of GDP, compared to a comfortable surplus of around 32 percent of GDP in 2008. This will be the government's first deficit since 2001, and its biggest since 1999. Nevertheless, the size of the projected shortfall needs to be put in

context: the deficit is equivalent to only around 9 percent of the SR850 billion that the government has deposited with the local banking system in net terms. The bulk of these funds is with the central bank (SAMA) and could be recalled at short notice.

Such a drawdown would represent a sizeable additional injection of liquidity, which would be helpful in the current cyclical conditions. Alternatively, the government has the option to finance some or all of the deficit by issuing debt. There is strong potential demand for such instruments: in October, outstanding t-bills and bonds accounted for around SR220 billion, equivalent to only 17 percent of commercial banks' total assets or 12 percent of GDP. Thus, unlike earlier in the decade, when domestic debt was in the region of 100 percent of GDP and government deposits with the banking system were worth a mere 7 percent of GDP, **the Saudi government has plenty of room for fiscal manoeuvre.**



The outlook for 2010 is hazy, but a gradual rebound in oil prices and a small gain in Saudi crude production should allow revenue to rise by around 35 percent. Spending will also be stepped up (by around 13 percent), but a return to a small **surplus** of SR19 billion, or **1 percent of GDP**, is in prospect.

The nonoil deficit is one measure of the importance of the public sector to the economy

The expansion of public sector activity in the economy and the corresponding weakness of private involvement are depicted in Table 4. This shows the nonoil fiscal deficit[2] expanding to 69 percent of nonoil GDP by 2010, a record.

[2] Although the overall fiscal position is in surplus, this does not carry the same weight as in diversified economies where domestic tax revenues counteract the liquidity caused by government spending. In oil exporting states, domestically sourced fiscal revenues tend to account for a very small proportion of total revenues, which overwhelmingly come from hydrocarbons exports. Hence, in the case of Saudi Arabia the correct measure of the impact of the budget on domestic liquidity is total fiscal spending less those revenues sourced domestically (i.e. the non-oil fiscal deficit).

The nonoil deficit has been increasing steadily since 2002, when it was a mere 26 percent of nonoil GDP. In and of itself the nonoil fiscal deficit is not a major problem if inflationary pressures are under control.[3] However, it does emphasize the growing importance of government spending in the Saudi economy over the past decade, notwithstanding the enhanced role that the private sector has assumed in certain sectors.

Saudi Arabia's Macroeconomic Performance

Table 5: Saudi Arabia: GDP and Inflation

(percent change, unless otherwise stated

	2006	2007	2008	2009f	2010f
Real GDP (at 1999 prices)	3.2	3.4	5.0	-1.6	4.2
Hydrocarbon	-0.8	0.5	7.6	-10.0	7.0
Non-hydrocarbon	5.1	4.7	3.8	2.3	3.0
Nominal GDP (at current prices)	13.0	7.1	29.4	-23.2	16.0
CPI inflation (average)	2.4	4.0	9.9	8.1	7.0
Memoranda:					
Nominal GDP (US$ bn)	353.7	378.8	490.2	376.3	436.6
Nominal GDP per capita (US$)	14404	14992	18855	14065	15860

f = Samba forecast.

Sources: SAMA; Samba.

Saudi Arabia's economic performance in 2008 can be divided into two phases

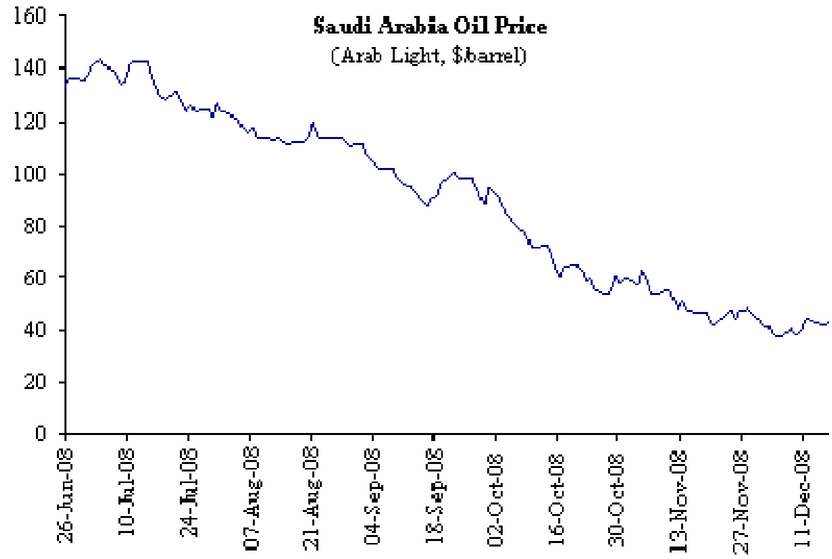
Growth and Prices

The economy's performance in 2008 can be divided into two phases. The first phase ran to around mid-year, and represented a continuation of a long period of industrial and infrastructure expansion that began in 2003. It was marked by robust increases in public sector spending (underpinned by high oil prices) and an energised, and liquid private sector that was channeling investment into a number of sectors, including hydrocarbons, utilities, manufacturing, mining, construction, transport, and financial services.

The picture changed markedly in the second half of the year, as two principal developments triggered a rapid and severe loss of private sector confidence. The first was the hardening of the global credit squeeze. The rapid withdrawal of foreign funds from the Saudi banking sector (and most other emerging markets) disrupted local credit markets and prompted a rapid run-up in spreads for private borrowing for investment. Second, oil prices, which had accelerated rapidly in the first half of 2008, fell away at an even greater pace in the second half of the year. Saudi Arabia does not produce quarterly GDP data, so the impact on growth has to be gleaned from other sources. However, one telling statistic is the $26 billion worth of infrastructure or

[3] Saudi Arabia's nonoil fiscal deficit has grown markedly in the past five years, helping to propel a sharp surge in broad money. This in turn contributed to the build-up in inflationary pressures up until mid-2008; inflationary pressures have since begun to subside, however.

industrial projects either on hold or cancelled in late December, according to MeedProjects, up from virtually nothing a year earlier.



Oil prices have fallen away and crude production is being sharply reined in

In mid-08, with global oil prices cresting $140/barrel, the Kingdom stepped up crude output significantly in a bid to rebalance the global market and bring down prices to levels more acceptable to both consumers and producers. This, and the unwinding of speculative positions (along with other developments) saw prices fall away rapidly. In late December, Arab Light (Saudi Arabia's benchmark crude) was trading at around $40/barrel.

This downward "overshoot" of prices led OPEC to make urgent efforts to rein in production. At three separate meetings in the second half of the year (the most recent taking place in mid-December), OPEC members pledged to remove a total of 4 million barrels a day from world markets, or 5 percent of total supply. Thus far, prices have not responded positively, though the full impact of the cuts has yet to be felt by oil traders. Given that hydrocarbons accounts for around 40 percent of real Saudi GDP, the impact of these cuts on overall economic output is likely to be pronounced (see Baseline Forecast).

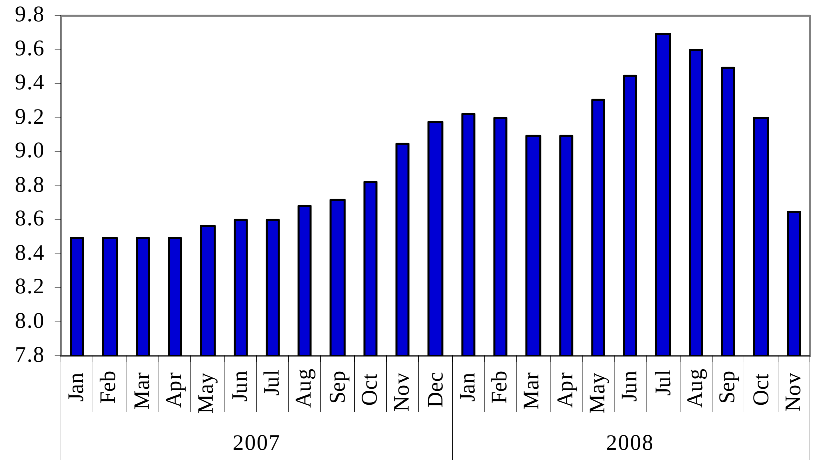
Hydrocarbons investment continues, but at a slower rate

Investment in the hydrocarbons sector also has a marked bearing on economic growth, both of itself, and as a means of generating future crude output. Saudi Aramco insists that the fluctuations in global oil prices have little impact on its spending plans (the firm's marginal cost of production is extremely small) and says it is sticking with plans to spend $129 billion on upstream, refining and petrochemicals projects in 2009-13. For upstream, the longstanding plan is to raise installed production capacity to 12.5 m b/d by end-2009. In addition, Saudi Aramco has recently identified five further projects at developed fields that could raise production capacity to 15 million b/d over the medium term, if global demand warrants it.

Nevertheless, some of Aramco's investment plans are being adjusted in order to take advantage of lower raw materials' costs. The firm says it is keen to renegotiate contracts for long-term capacity expansion that were signed at the

Saudi Arabia: Oil Production

(m b/d; sources MEES; Bloomberg)



height of the commodities' boom in early 2008. Aramco says it wants to secure cheaper deals that reflect the subsequent slump in construction costs. Among the contracts under review are those for the Manifa oilfield expansion. The review may delay the latest start up date of September 2011. The 900,000 barrels per day (bpd) expansion was to compensate for falling output elsewhere, and not to boost overall capacity. Manifa will feed two new 400,000 bpd export refineries, but contracts for those plants are also under review and start dates are likely to be pushed back from the latest estimates of late 2012 and 2013.

Projects near completion to boost Saudi capacity to 12.5 million bpd by the end of 2009 are not under review, but have been subject to delays. Saudi Aramco said in September it had started output from its 500,000 barrels per day Khursaniyah oilfield, some nine months behind schedule. The project was the largest single increment in global crude supplies for years. The Shaybah I and Nuayyim expansion projects have also been delayed to start up in the first half of 2009, from the initially scheduled December 2008.

All this means that Saudi Aramco's spending on investment is likely to be lower in 2009 than in 2008, reflecting both the impact of lower costs and the delays as Aramco waits to take advantage of these costs. This in turn should mean that the company is able to channel back to the finance ministry a slightly higher proportion of export revenue than it did in 2008; nevertheless, the nominal amount will be significantly reduced owing to lower oil prices.

The search for natural gas is also intensifying. Gas is the key feedstock for much of the Kingdom's industrialization, and its scarcity is a potentially significant constraint on the kingdom's economic growth. Demand from the power and petrochemicals sectors, as well as industry, is robust: dry gas demand is increasing at a rate of 6 percent a year and is expected to reach 590 million cm/d by 2030, from the current 155 million cm/d.

Saudi Aramco plans to raise gas reserves by more than 20 percent in the next five years and says it will drill 307 new development wells, including 67 exploratory wells, in its existing production areas between 2007 and 2011. Such is the demand that it is venturing into little-explored areas, such as the

Red Sea and the Nafud basin in the north. Foreign firms are continuing to explore in the Rub al-Khali (Empty Quarter), though so far with little success.

The nonoil investment climate has been broadly positive

While the hydrocarbons sector remains at the heart of the Saudi economy, the nonoil sector has witnessed significant growth in recent years.

Over the past five years, the investment environment has benefited from significant progress on structural reform, involving liberalization, greater transparency, and the reduction of red tape. The most recent “Doing Business in…” investment climate ranking by the World Bank again puts Saudi Arabia at the top of the MENA ranking. Moreover, its global rank is now a remarkably high 16, up from 23 in the previous year, putting Saudi Arabia—in the view of the World Bank—ahead of a number of Western European countries.

Table 6: Saudi Arabia: Ease of Doing Business

	2006	2007	2008	2009
Global Rank	35	38	23	16

Source: World Bank

Progress such as this has bolstered private confidence to the extent that in real terms, private nonoil sector growth has outpaced public nonoil growth for each of the past seven years. In addition, Saudi Arabia was the largest single recipient of FDI in the West Asia region in 2007, surpassing Turkey, according to UNCTAD. Moreover, appetite for reform has not been dimmed by the large gains in oil revenue, indicating that reform momentum can be sustained over the medium term.

Petrochemicals investment has been robust, but the outlook has clouded

Large-scale private investment is most visible in **manufacturing** (including petrochemicals and oil refining), and real estate. Petrochemicals and refining achieve significant economies of scale and scope when combined, and this is a template that is being pursued in the Kingdom. With an estimated total cost of at least $22 billion, the Ras Tanura combined refinery and petrochemicals project is one of the largest industrial projects ever undertaken in the Kingdom. It involves the upgrade of the existing 0.55 million b/d Ras Tanura refinery and the establishment of a grassroots petrochemicals plant, producing more than 300 different products.

Another major combined refinery and petrochemicals complex is nearing completion. The Petro-Rabigh complex is now due to be commissioned in the first quarter of 2009, delayed from the final quarter of 2008. Construction costs at the plant, which spreads over eight square miles and involves 38,000 workers, have doubled to $10 billion because of materials and labour shortages.

Nevertheless, as with its upstream oil projects, so Saudi Aramco is delaying some petrochemicals projects in order to encourage lower bids as global construction costs ease. Aramco and its partner Total of France said in November 2008 that they were delaying by three months the bidding process for their joint venture at the Jubail refining and petrochemicals complex. The two companies signed an agreement in June 2008 to build a refinery including plants with capacity for 700,000 tonnes a year (t/y) of paraxylene, 140,000 t/y of benzene and 200,000 t/y of propylene. Contractors will now make their submissions in February 2009, with the contract awards expected in the second quarter. Total says this will not affect the scheduled completion of the complex at the end of 2012.

Saudi Arabia still has a huge strategic advantage over most other global producers, owing to the heavily subsidised cost of ethylene feedstock. This should allow the country's plants to comfortably ride out any cyclical downturn in demand. Nevertheless, it is plain that the industry is entering just such a downturn. The slide into global recession has already led to significant retrenchment in industrial demand for chemicals of all types, particularly from the US and Europe (polymer demand slumped by 40 percent between September and December). The darkening horizon was illustrated by SABIC's third quarter results, which were 4 percent down quarter-on-quarter (though strongly up on a year-on-year basis). The vast majority of the industrial projects on hold or cancelled in early December were in the petrochemicals sector.

On the **real estate** front, Saudi Arabia is in the midst of a frenetic period of construction of private and commercial real estate in a bid to meet spiralling demand. Housing shortages within the low-to-middle income segments remain particularly pronounced, and this deficit could well be exacerbated as the pending mortgage law stirs demand among a wider section of Saudi society (see Monetary Developments and Financial Markets). Expatriate demand is also a key driver. These fundamentals should help shield Saudi Arabia from the full impact of the global downturn in real estate. This downturn has hit hard in those Gulf states where speculative foreign investment in property has been a key growth driver.

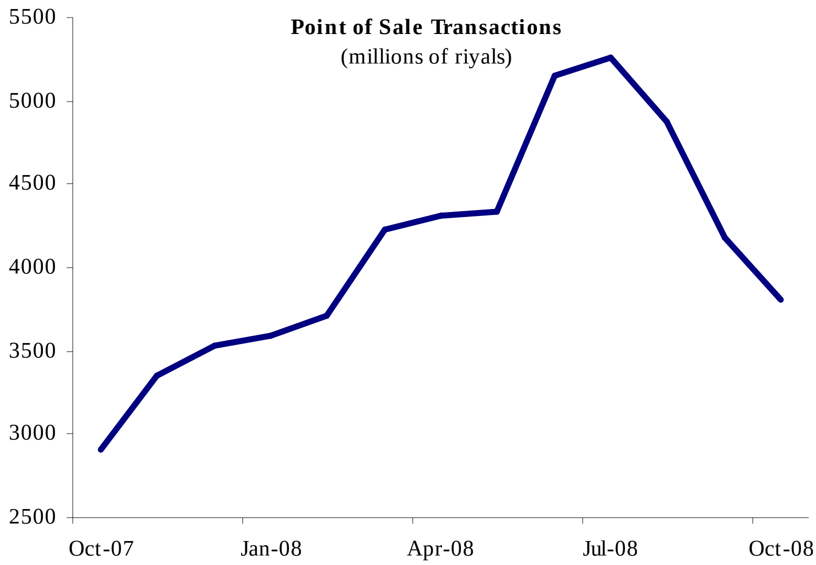
Slower progress on the economic cities

Slower progress is being made with the designated "Economic Cities". These are based on public-private partnership models, under which the public sector provides much basic infrastructure, with the private sector investing to create manufacturing, technological, educational and tourism capacity. However, the dislocations facing credit markets, allied to a general weakening of private confidence, has weighed heavily on the pace of construction in some of the cities. Given the basis of the PPP model, it is difficult for the public sector to "take up the slack" left by a more hesitant private sector.

The authorities view the cities as an important means of generating jobs in more remote areas of the country where unemployment rates are particularly high. Thus, the long term viability of the cities is underpinned by significant political will. Nevertheless, the current reticence of the private sector suggests that progress will continue to slow over the near term, and some of the more ambitious elements of the cities may be scaled back.

Private consumption is ebbing

Data on **private consumption** are limited, but a useful proxy is point of sale transactions. These mirror the fortunes of the broader economy, and demonstrated rapid growth in the first half of 2008, followed by an equally rapid cooling off in the second half. Point of sale values are exaggerated by inflationary pressures, which also rose significantly in the first half of the year before easing in the third quarter (see below). Stripping out the inflationary impact still leaves point of sale values in the first half of 2008 25 percent ahead of the same period of 2007. By the third quarter this had cooled to around 22 percent, and values had registered marked month-to-month falls (beyond typical seasonality).



Going forward, private consumption will continue to be heavily influenced by real disposable incomes and consumers' wealth perceptions. The former will be helped by continued gains in nominal public sector wages and moderating inflation, but the latter will be eroded by the weakness in the stock market, where values have declined by around 55 percent in the year to mid-December. With oil prices also set to stay flat, the outlook is for modest gains at best in private consumption growth in 2009.

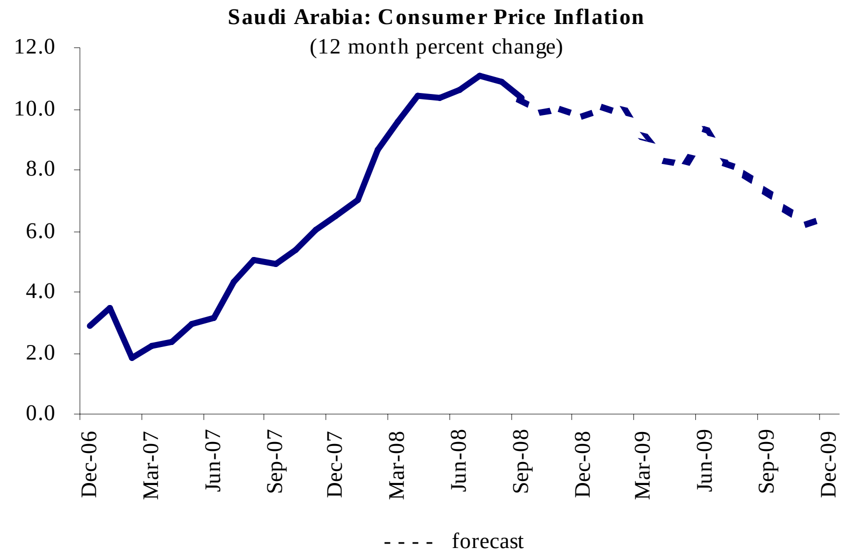
Overall, we anticipate real GDP growth of just over 5 percent in 2008. This is reasonably high by historical standards, but it should be emphasized that this mainly reflects buoyant economic conditions in the first half of the year. Private investment, consumption and net exports are all likely to have weakened sharply in the second half. For 2009, the Saudi economy seems likely to contract in real terms (see Samba's Baseline Forecast, below).

Inflationary pressures have been pronounced…

For much of 2008 **inflation** was a serious and pressing issue for Saudi Arabia. From an annual average of just 4 percent in 2007, 12 month consumer price growth accelerated to a peak of 11.1 percent in July 2008. Nevertheless, price growth has since eased—while remaining high—and the outlook is for moderating inflation in 2009 and 2010.

The pickup in inflation was generated by a number of factors:

- First, Saudi Arabia has suffered from acute **bottlenecks** in a number of sectors. These are especially pronounced in real estate, where residential housing demand remains robust. The rental element of the consumer price index surged 18.3 percent in the twelve months to September, and with a heavy weighting in the overall CPI, the impact on national inflation is marked.
- Second, for much of 2008 **shortages of skilled personnel** caused salaries to rise sharply in certain sectors. This was most notable in construction and finance, where a scarcity of skilled professionals—a Gulf-wide issue—was acute. Such shortages raise costs and contribute to second-round effects as higher salaries feed through into increased consumption and asset prices.



- Third, **global food prices** accelerated sharply in the first half of 2008. Prices of wheat and rice were forced up by the shift to biofuel production in some countries, restrictions placed by key producers on exports (in order to combat domestic shortages), and unusual global weather patterns.

- Finally, inflationary pressures in Saudi Arabia's **trading partners** (mainly OECD) were also transmitted into higher prices in the Kingdom. Until recently, the impact of this was amplified by the weakening US dollar, to which the riyal is pegged.

…but the inflationary outlook is less of a problem going forward

Some of these strains are now unwinding, and we believe that price pressures will continue to subside (albeit gradually) over the next two years. Specific factors that are helping to alleviate inflationary pressures include the following:

- A decline in global food prices should feed through into lower import prices over the next few months. The global price of rice (a Saudi staple) has already fallen 25 percent since its peak in August.

- Headline and core inflation is falling in OECD countries as commodity prices ease and domestic demand weakens. OECD counties should continue to witness decelerating rates of inflation over the next year as recession takes hold, helping to moderate Saudi inflation for a range of imported consumer and intermediate goods.

- Similarly, the price of imported construction inputs, such as steel, glass, etc, has eased markedly in recent months. This should work their way into lower rental costs with time.

- Both these processes should be helped by a stronger US dollar, which has firmed in line with a modest improvement in the US economic outlook relative to other areas.

- The slow-down in Saudi domestic demand will also help to moderate price growth going forward.

samba سامبا

- A less pressing inflationary environment has allowed SAMA to soften its monetary policy stance fairly dramatically in recent months. Up until mid-2008, SAMA was committed to limiting credit growth by instituting regular increases in commercial banks' reserve requirements and through stepped up auctions of government paper. However, as inflationary pressures have eased and local credit conditions have tightened, so the authorities have become more accommodating. Helped by US interest rate reductions, the Saudi repo rate has been cut, reserve requirements have been slashed, treasury bill yields have been reduced and the authorities have made direct injections of liquidity into the local banking system (see Monetary Developments and Financial Markets).

Balance of Payments

The current account recorded another substantial surplus in 2008, reflecting surging oil prices and output in the first half of the year. However, the climate has since changed, and the worsening oil price outlook suggests that Saudi Arabia's current account balance will drift into deficit in 2009.

The external position is set to deteriorate somewhat

Despite the rapid decline in oil prices in the second half of this year, the overall current account position for 2008 is likely to show a significant improvement on 2007 (which was itself a very strong year). We estimate that oil earnings increased by some 51 percent in 2008, reflecting both the 42 percent increase in average oil prices and the near 7 percent hike in crude oil output. Import spending has been rampant, growing by an average 23 percent in 2003-07, and is likely to climb by 22 percent this year, reflecting buoyant demand and surging construction costs in the first half the year. Remittances outflows are likely to have followed a similar pattern—soaring in the first half of the year, but cooling somewhat in the second half as demand for construction workers began to weaken and as competition from Gulf states for expatriate professionals sagged. Thus, we estimate that the Kingdom will have recorded a current account surplus of $178 billion, equivalent to 36 percent of GDP.

Import spending is likely to maintain reasonably strong growth in 2009 owing principally to still-firm public sector demand. With oil prices plummeting from their 2008 highs, this is likely to mean a current account deficit equivalent to around 5 percent of GDP. Nevertheless, financing can be easily accommodated by the huge foreign asset base (see below and Baseline Forecast).

FDI inflows have been surging…

Analysis of the capital account is hampered by incomplete data. Gross inward direct investment reached $24 billion in 2007, according to UNCTAD data, up from $18 billion in 2006. Particularly attractive sectors include gas, petrochemicals, construction and telecoms. UNCTAD puts outward FDI flows at $13.1 billion, though this is likely to be an underestimate. There are no data on portfolio flows, though these have the potential to pick up given the recent easing of restrictions on foreign investment in the Saudi stock market (see below). Nevertheless, this is unlikely to happen until the worst of the global credit dislocation is over.

Outward portfolio flows are certainly substantial, reflecting both the purchase of foreign equities by public sector entities and growing private investment in regional and global bourses. Egypt, Morocco and Jordan have been increasingly strong magnets for Saudi investors, and are expected to become more appealing as OECD stocks lose some of their lustre.

Table 7: Saudi Arabia: Current Account
(US$ billion)

	2006	2007	2008	2009f	2010f
Trade balance	146.7	150.9	242.6	55.1	97.9
Exports	210.5	233.4	343.3	163.8	217.5
Oil	187.7	205.5	309.8	138.7	191.1
Non-oil	22.8	27.9	33.5	25.1	26.4
Imports	-63.8	-82.5	-100.7	-108.7	-119.6
Services (net)	-33.3	-40.6	-51.1	-55.6	-61.7
Incomes (net)	0.6	0.2	3.7	0.7	5.9
Transfers (net)	-15.6	-16.1	-16.9	-17.2	-18.1
Current account balance	98.4	94.4	178.3	-17.0	24.0
(% GDP)	27.8	24.9	36.4	-4.5	5.5

f = Samba forecast.
Source: SAMA; Samba.

…and the foreign asset position is formidable

Data for official foreign exchange reserves fail to capture the buoyant external position. SAMA data show that official foreign reserves, excluding gold, rose to $35.6 billion in October 2008, equivalent to only 2.4 months of imports of goods, services and incomes. But the country's robust external position is more accurately reflected in SAMA's holdings of net foreign assets. By end-October these had risen to $430 billion (87 percent of GDP, or 29 months of import cover), up from $300 billion at end-2007. Holdings of foreign securities account for the bulk of SAMA's foreign assets but (in common with other central banks) there is no breakdown by asset class. Over the last few years, an increasing proportion has likely been channeled into emerging market securities, though the bulk of SAMA's assets is believed to be fairly liquid and denominated in "hard currencies" such as US dollars, euros and yen. The sharp deterioration in global financial markets in 2008 has likely led SAMA to re-emphasize a conservative approach.

Private foreign asset holdings are even more difficult to gauge, either by size or asset class. Traditionally, individual Saudis have tended to favour euro- or sterling-denominated assets, with a strong preference for real estate.

External debt has picked up, but remains low

We estimate that total external debt declined by around 3 percent to some $75 billion by the end of 2008. Loans from BIS-reporting banks to Saudi institutions surged by $8 billion in the first quarter of 2008 as expectations of a revaluation of the exchange rate mounted. These expectations ebbed in the second quarter, while the intensification of the global credit crunch in the third quarter (when global banks rapidly unwound their exposures to emerging markets) suggests that overall external debt is likely to have increased only

Liquidity surged in the first half of 2008, but has since tightened significantly

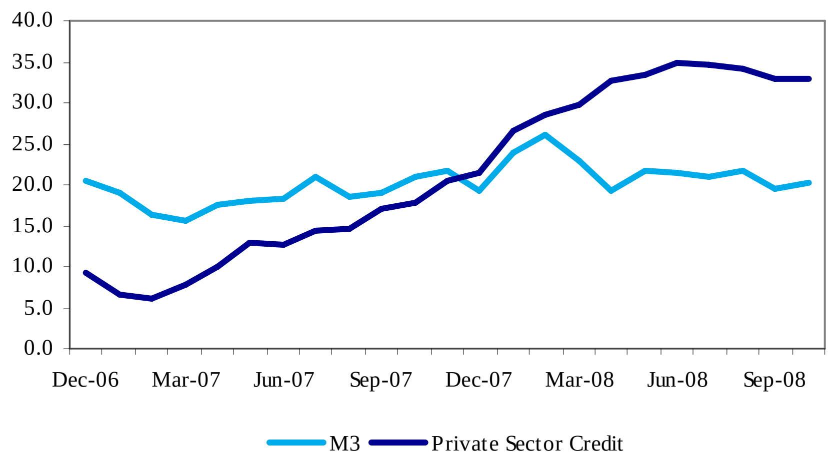
slightly during the course of the year. Rapid economic growth means that external debt is equivalent to only 15 percent of GDP. Moreover, given SAMA's buildup of foreign assets, net external debt is heavily negative and diminishing.

The bulk of the country's external debt is accounted for by commercial bank liabilities. The Kingdom has no sovereign debt, though state-owned companies do have external liabilities.

Monetary Developments and Financial Markets

For most of the past year or so, domestic liquidity growth has been rampant, reflecting buoyant aggregate demand and a banking sector with sizeable domestic deposits. However, developments in the second half of 2008 led to a slowing in credit growth as international banks withdrew from the Saudi market (and other emerging markets) and as local banks became far more discerning in their approach to corporate lending. The Saudi authorities have taken a number of steps to add liquidity to the market, but this has so far failed to reinvigorate lending to the corporate sector.

Saudi Arabia: Broad Money and Private Sector Credit
(12 month percent change)



The first part of 2008 saw a continuation of the rapid gains in credit growth registered during 2007. Local banks had been enjoying high levels of both Saudi riyal and foreign currency liquidity (the latter galvanized by expectations of an imminent revaluation of the riyal). At its peak in June, private sector credit was growing at almost 35 percent on a year-on-year basis. At that stage, the authorities were critically concerned about consumer price inflation, and had made strenuous efforts to contain credit growth by raising reserve requirements to 13 percent of deposits, from just 7 percent in November 2007 and by stepping up treasury bill issues. However, with the peg to the US dollar firmly intact, and SAMA consequently unable to raise interest rates, these efforts had little obvious impact.

The change in conditions from the third quarter onwards has been dramatic. The withdrawal of speculative positions from Saudi Arabia by international banks was exacerbated by the intensification of the global credit crunch in September and October. This saw a rapid unwinding of international banks' exposure to emerging (and other) markets, with the consequence that dollar liquidity became increasingly scarce, and local banks were under-resourced to take on all of the financing needs of the Saudi corporate sector (where industrial projects of $10 billion are commonplace). Separately, deposit growth slowed, meaning that local banks found themselves bumping up against the mandatory loan-deposit ratio limit of 85 percent. The response of local banks to all these trends was to cut back on lending, or at least to differentiate much more carefully between potential borrowers. Consequently, project costs soared, with a typical spread for a power or water project spiralling from around 40 basis points over US dollar Libor in late 2007 to 150 or even 200 bps over LIBOR by October 2008.

The authorities moved quickly to loosen their monetary stance

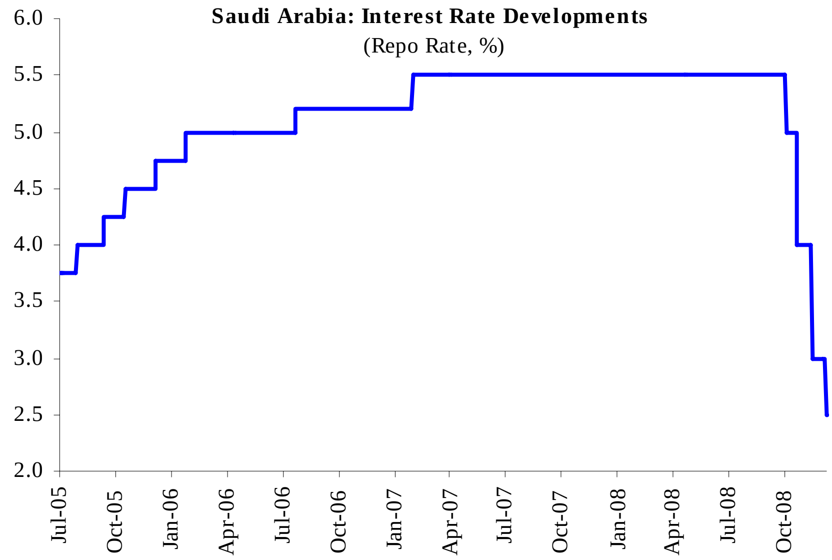
The authorities were quick to change tack and, helped by the softening of domestic inflationary pressures and the dramatic policy loosening undertaken by the US Federal Reserve, their stance has eased appreciably. Specifically, the following monetary measures have been taken:

- SAMA has cut its key lending rate four times since October 12. In mid-December the repo rate was cut by 50 basis points to 2.5 percent, down from 5.5 percent on October 12. The reverse repo rate (which guides deposit rates) was cut in December for the first time in five months and stood at 1.5 percent in mid-December.
- In November SAMA reduced commercial bank reserve requirements by 3 percentage points to 7 percent. This matched an earlier cut from 13 percent to 10 percent. The two reductions are expected to add about SR19 billion to commercial bank liquidity.
- Just as importantly, in November SAMA reduced the yield on treasury bills, and capped the aggregate amount available at auction. This has made t-bills less attractive to local banks, who had been heavy purchasers over the past year or so. In the months ahead significant quantities of t-bills will be redeemed that will not be rolled over. This could potentially free up around SR80 billion in additional liquidity.
- Also in November SAMA introduced unlimited swap arrangements for local banks, allowing them to exchange riyals for equivalent amounts of US dollars.

These efforts have certainly enhanced the liquidity of the local banking system, and interbank lending rates have fallen appreciably in recent weeks (though they remain high by historical standards). Nevertheless, this trend has not so far led to a significant revival in corporate lending and wide spreads persist. Banks remain cautious given weak deposit growth and the worsening global economic environment. Petrochemicals or refining projects that once appeared solid now look precarious given the reversal in oil prices and slumping demand for industrial chemicals. With this conservatism likely to abate only slowly, banks' profits from corporate lending in 2009 are set to be substantially lower than they have been for the past two or three years.

The banking system remains sound

In general terms—and notwithstanding the dislocations noted above—the banking system remains sound. Exposure of Saudi banks to sub-prime debt or structured investment vehicles is thought to be modest. Profitability and asset quality are likely to be impaired by the domestic and regional economic slowdown, but capitalization is high at an average 22 percent. More generally, risk management practices are deemed to be satisfactory and are improving. Overall, the regulatory environment is one of the best in the region.



Banks are refocusing on core activities

The weakness of the stock market (see below) has eroded brokerage income and led banks to refocus on core activities. As noted above, **corporate lending** has been constrained by growing risk aversion and weakened deposit growth. Banks are vying with each other to attract large corporate deposits, but the run-up in deposit rates will likely mean further upward pressure on corporate lending rates. As such, corporate lending growth looks likely to slow sharply (or even reverse) next year.

Retail lending has been dampened by specific curbs placed by SAMA on personal lending, and by uncertainties in the consumer sector stemming from the deteriorating oil price environment, still-high inflation, and a moribund stock market. Yet with a consumer debt-to-GDP ratio of just 14 percent, and bank claims on the private sector accounting for less than 40 percent of GDP (compared with 90 percent in the UAE), there is enormous scope for growth. Saudi banks have started segmenting their customer base, and are tailoring different products and services to each segment (e.g. premier banking for high net worth individuals, as well as youth, women's, and expatriate services).

Mortgage market offers great potential

One obvious area of untapped potential is **mortgage provision**. At 30 percent the ratio of home ownership in Saudi Arabia is the lowest in the GCC region. A long-awaited mortgage law is awaiting final approval. This should open the way for a significant new stream of personal lending, since mortgage finance is not subject to existing caps on other personal lending, and the banks are able to take payments directly from salaries.

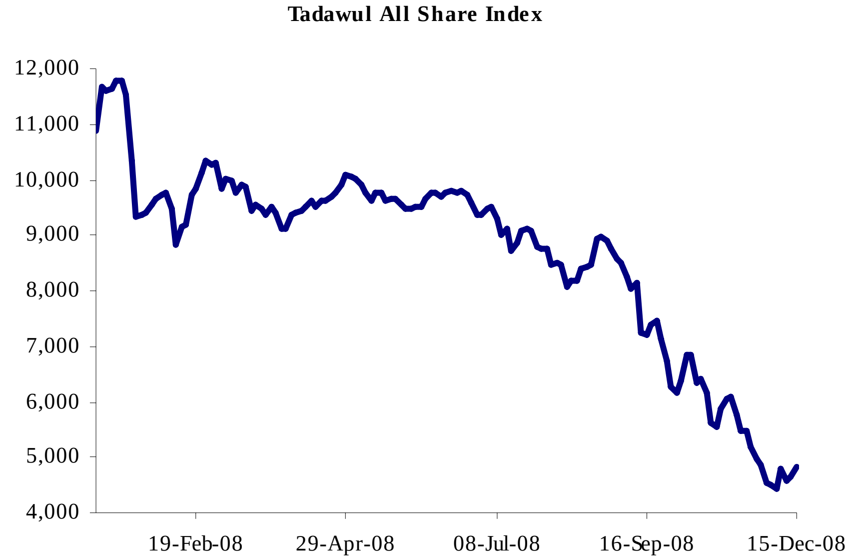
Islamic banking is also a key growth sector

Saudi banks have already realized strong growth in Islamic banking business. Moody's estimates that more than 80 percent of consumer lending in the Kingdom is now structured under Islamic terms. Demand for Islamic products in the Kingdom extends across the full gamut of financial services, including

The stock market has performed poorly this year…

project finance, and should be a strong source of asset growth in the medium term.

The **stock market** has endured a wretched run this year, with the Tadawul All Share Index (TASI) down 55 percent by mid-December. Market capitalization had slid to $250 billion by mid-December, less than half the peak of $552 billion registered on January 12.



Traders have been unsettled by a number of factors:

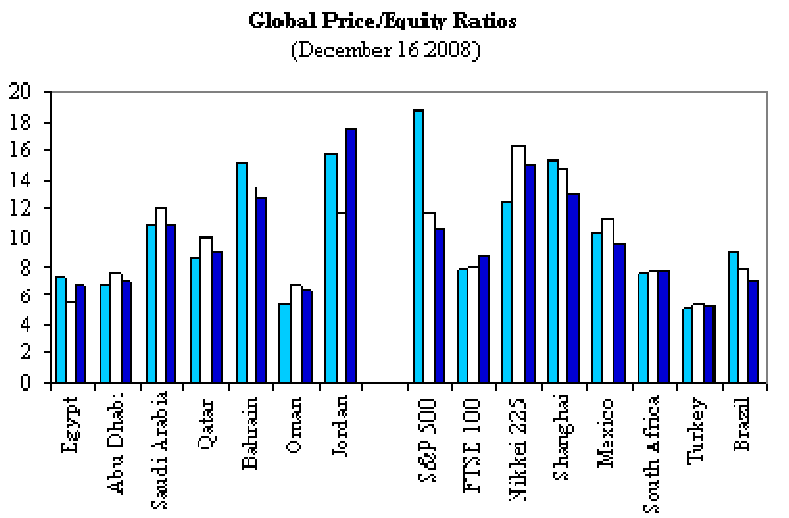
- First, **the sell-off in global equity markets** has been dramatic, and gathered pace in the final quarter of 2008 as fears of a global financial collapse stemming from the subprime mortgage crisis intensified. This has been quickly transmitted to the traditionally-volatile Saudi bourse, where retail investors account for 95 percent of trades.
- Second, traders are concerned about the impact of the **global credit squeeze** on the local banking sector and broader corporate investment growth.
- Third, market participants have reacted poorly to the decline in global **oil prices**, which have fallen by around 70 percent since hitting their peak in July. This has fuelled fears that the government will be forced to rein in spending on infrastructure and social programmes.
- Finally, the rapidly **deteriorating external environment** suggests to many that the petrochemicals sector (a bellweather for the bourse) is in for a challenging time.

The market's largest sectors by market cap are **banking** and **petrochemicals**, both of which are facing strong headwinds. We have noted the constraints facing the banking sector, particularly on the corporate lending side, and these are likely to weigh on profitability. In addition, the slide into global recession will involve significant retrenchment in industrial demand for chemicals of all types, particularly from the US and Europe.

…but the market is beginning to look good value

Yet despite the challenges facing these key sectors, the broader Saudi market is beginning to look good value, both in historical and global terms. The estimated average price/earnings ratio for 2008 is 12.1 (Bloomberg), which represents a 39 percent discount to its 15 year average of 19.8. The last time Saudi equities were so cheap was almost a decade ago, when oil prices were languishing at around $15/barrel and when Saudi structural reforms were in their infancy.

Moreover, today's Saudi economy is underpinned by a government committed to high levels of infrastructural investment, backed up by abundant financial resources. Official foreign assets reached $430 billion in October, equivalent to almost 90 percent of GDP, while domestic debt in net terms is a negative 48 percent of GDP. As such, although government spending growth might moderate somewhat in 2009, the nonoil economy will continue to expand. This contrasts with many emerging (and developed) markets where fiscal strains are becoming pronounced as commodity prices retreat and financing options become more expensive, leaving, in many cases, a bleak domestic growth outlook. Saudi Arabia's forward p/e of 11 is higher than most of its peers (see chart), but given the above it appears reasonable value.



The **medium term market outlook** is also more robust than current valuations suggest. The Capital Markets Authority has been making steady progress in its efforts to improve market transparency and enhance shareholders' rights, most notably by tightening corporate disclosure rules. The CMA's August decision to allow limited foreign participation in the bourse through swap agreements has so far failed to spark much interest, with foreign institutions continuing to shy away from the Saudi market (and emerging markets in general). Nevertheless, once foreign institutions have recovered their zest for higher yielding securities, so the Saudi market should come to be seen as an attractive long-term proposition. This in turn will add both liquidity and greater stability to the bourse.

Samba's Baseline Forecast

Weakening private investment and consumption suggests that government spending growth will remain reasonably robust as the authorities attempt to keep infrastructure expansion on track. However, with cuts to crude oil output and weaker oil prices, the economy is set to contract in both nominal and real terms in 2009. Assuming a gradual recovery in global economic activity, oil prices, production and investment spending should begin to pickup in 2010.

Our baseline sees the Saudi economy contracting in 2009

Our baseline forecast for Saudi Arabia is based on depressed global economic activity for most of 2009. Global deleveraging still has some way to go, and the associated dearth of credit will continue to weigh heavily on economic activity. The retrenchment in consumption and investment is now clearly visible in most OECD countries, and is expected to become more pronounced in 2009. Sagging OECD demand will mean weaker export growth for many emerging markets, while rapidly shrinking FDI will also weigh on EM growth prospects, creating financing difficulties for some. For 2010, a gradual recovery in activity is in prospect as financial markets begin to rebalance, and trade and investment pick up.

Table 8: Global Economy: Baseline Forecast

	2008	2009	2010
World (GDP %)	3.1	0.5	2.6
G7 (GDP %)	0.9	-1.9	1.2
United States (GDP %)	1.2	-2.0	1.3
CPI (yoy %)	4.1	-1.0	2.0
Unemployment (%)	6.9	8.5	7.7
Budget (% of GDP)	-3.4	-11.0	-6.0
Central Bank Rate (%)	0.0	0.0	1.0
Euroland (GDP %)	0.9	-2.2	1.2
CPI (yoy %)	3.3	1.2	1.4
Unemployment (%)	7.7	9.0	9.5
Budget (% of GDP)	-1.5	-4.0	-5.0
Central Bank Rate (%)	2.5	0.8	1.5
Japan (GDP %)	0.2	-1.6	0.6
CPI (yoy %)	1.5	0.0	-0.5
Unemployment (%)	4.0	4.9	5.5
Budget (% of GDP)	-1.9	-2.6	-2.4
Central Bank Rate (%)	0.3	0.1	0.8

The outlook for oil prices has darkened as global economic activity has deteriorated. In its latest monthly report, the International Energy Agency (IEA) has again cut its estimates for world oil demand to reflect new, more pessimistic, economic forecasts from the IMF. The principal driver of the weak demand outlook is the OECD, and in particular poor gasoline demand in the USA. The onset of recession will continue to eat into demand here and will offset expected demand increases in China and the Middle East. And even in these regions, concerns are growing over the impact of the global financial crisis and slowing world economy.

Projecting oil prices under current circumstances is difficult with much depending on how severe the global recession turns out to be, how successful OPEC is in abiding with agreed production cuts, what happens to financial and credit markets, and whether and when market participants start to worry about longer-term supply constraints again. Currently our working assumption is for the average price of WTI to fall from an average of $103/b in 2008 to **$55/b in 2009** (see footnote in Table 8), before recovering somewhat to **$70/b** in 2010. The average price of Saudi crude generally trades at a $5 discount to WTI, though this spread is volatile.

The main implications for Saudi Arabia's macroeconomic performance are as follows:

- Saudi Arabia's economy is set to contract in 2009 before staging a recovery in 2010.
- Private investment growth in Saudi Arabia has suffered from global liquidity dislocations: although liquidity is now adequate, greater risk aversion by commercial banks have generated dramatically wider spreads on corporate financing, and we see private investment growth continuing to weaken in 2009.
- There is therefore a strong impetus for the government to maintain spending growth, in order to "pick up the slack" left by private investors and keep important industrial and infrastructure projects on track. In addition, with the authorities also eager to limit the social impact of weaker growth, current spending is likely to remain firm.
- The main drag on GDP growth will be lower oil production (hydrocarbons contributes around 40 percent of GDP in real terms). We now expect a 12 percent cut to Saudi output as the authorities attempt to support global prices. Although the nonoil sector will expand by over 2 percent, this will be more than offset by the contraction in oil output and the economy is expected to shrink by just over **1.5 percent** in 2009, from estimated 5 percent growth in 2008. In nominal terms, GDP is expected to contract by 23 percent, reflecting the decline in average oil prices as well as the cut to crude production.
- By 2010 the world economy should have begun to recover from the pain of global financial deleveraging, and with US consumption likely to have turned the corner, oil prices should post a 27 percent gain. With Saudi crude production likely to edge up, public investment holding firm and private investment posting a hesitant recovery, nominal GDP should climb by around 16 percent to just under $440 billion. Real growth is also expected to post a respectable **4.2 percent**. This is above the 2005-2009 five year average of 3.1 percent.
- The fiscal balance is expected to move into deficit next year before rebounding in 2010. Revenue is expected to slump by around 56 percent as both oil prices and crude output fall. Despite the new oil price realities, public expenditure growth is expected to remain at around 10 percent given considerable pressure to maintain the pace of project delivery and public employment growth. This will likely mean a

deficit of around **6 percent of GDP in 2009**. The situation will be somewhat brighter in 2010 as revenue stages a 35 percent recovery. Despite spending growth gathering pace again to around 13 percent, a small surplus of **1 percent of GDP** is in prospect.

Table 9: Saudi Arabia: Baseline forecast

	2007	2008	2009	2010
Nominal GDP ($ bn)	378.8	490.2	376.3	436.6
GDP per capita ($ '000)	14992.3	18854.8	14065.3	15859.9
Real GDP (% change)	3.4	5.0	-1.6	4.2
Hydrocarbon GDP	0.5	7.6	-10.0	7.0
Non-hydrocarbon GDP	4.7	3.8	2.3	3.0
Nominal GDP (% change)	7.1	29.4	-23.2	16.0
Hydrocarbon GDP	8.0	42.1	-41.9	29.2
Non-hydrocarbon GDP	6.0	14.0	5.0	5.0
CPI inflation (% change, average)	4.0	9.9	8.1	7.0
Hydrocarbon exports ($ bn)	205.5	309.8	138.7	191.1
Current account balance ($ bn)	94.4	178.3	-17.0	24.0
(% GDP)	24.9	36.4	-4.5	5.5
External debt ($ bn) [1]	72.6	75.3	76.1	77.6
(% GDP)	19.2	15.4	20.2	17.8
(% current account receipts)	28.3	20.2	39.5	30.4
Fiscal revenue (SR bn)	642.8	1100.0	482.0	652.7
(% change)	-4.6	71.1	-56.2	35.4
Fiscal spending (SR bn)	466.2	510.0	561.0	633.9
(% change)	18.6	9.4	10.0	13.0
Fiscal balance (SR bn)	176.6	590.0	-79.0	18.8
(% GDP)	12.4	32.1	-5.6	1.1
Public sector gross domestic debt (SR bn)	181.6	241.5	-	-
(% GDP)	12.8	13.2	-	-
Public sector deposits with banking system (SR bn)	516.7	1300.0	-	-
(% GDP)	36.4	70.8	-	-
Public sector net domestic debt (SR bn)	-335.1	-1058.5	-981.9	-1005.5
(% GDP)	-23.6	-57.7	-69.7	-61.5
Memoranda:				
Oil price (WTI; $/barrel)	72.4	103.0	55.0	70.0
(Arab Light; $/b)	68.8	98.0	50.0	65.0
Crude oil production (m b/d)	8.7	9.2	8.1	8.6
Natural gas production (m boe/d)	1.3	1.4	1.5	1.6
Net Foreign Assets ($ bn)	312.7	491.0	474.0	498.0

[1] Foreign liabilities of Saudi banks and non-financial enterprises; there is no sovereign debt..

Sources: Ministry of Finance and National Economy; SAMA, IMF, Samba.

- The 2009 fiscal deficit could be comfortably financed by a draw-down of general government assets held with the banking system (the bulk of which are with the central bank). Such deposits amounted to SR1.1 trillion in October 2008, or SR850 billion in net terms. Alternatively, the authorities may decide to step up issues of domestic debt, for which there is strong potential demand. However, this might have the effect of drawing some bank liquidity away from the private sector, which, given the fragility of the corporate finance market, the authorities would probably seek to avoid.

- The current account is expected to slip into a moderate deficit in 2009, before returning to surplus in 2010. With lower oil exports and prices, hydrocarbons exports are expected to slump by around 52 percent next year, while exports of petrochemical products are set to contract given the outlook for global industrial demand. Against this, import spending growth will be pulled lower by cooling private demand, and reduced commodity prices. On the invisibles side, income inflows are likely to be slightly lower in 2009 than 2008, with depressed equity and property earnings offsetting the gains from a slightly larger foreign asset base. Meanwhile, outward remittances are likely to show only slight growth as domestic activity cools. In concert, these trends should produce **a current account deficit of 4.5 percent of GDP in 2009.**
- We anticipate a rebound in the current account position in 2010, mainly reflecting a projected 33 percent recovery in oil export earnings. This should help push the balance back into surplus at around **5.5 percent of GDP**. This will allow further additions to net foreign assets (official and commercial bank), which we expect to climb to $500 billion (115 percent of GDP) by end-2010.

A pessimistic scenario in which oil prices slump to $25/barrel bears consideration

Increasing uncertainty about the outlook for the global economy warrants some assessment of the Saudi authorities' policy options under a more pronounced oil price decline than that projected in our Baseline Forecast. If, for example, global oil prices were to fall to an average of $25/barrel in 2009, the authorities might well decide to enhance their counter-cyclical fiscal policy, in a bid to restore confidence to the local economy. Our assessment is that the authorities' formidable domestic asset position gives them a firm base from which to pursue an aggressive counter-cyclical policy.

Clearly, a counter-cyclical fiscal policy in a context of sharply reduced oil revenues would generate a large fiscal deficit. However, the Saudi authorities are well placed to run such a deficit. Financing could come from two principal sources: one would be a drawdown in public sector deposits held with SAMA which, as noted above, amount to around SR1.1 trillion, or 60 percent of GDP. Such a drawdown would represent a sizeable additional injection of liquidity, which would be helpful in the current cyclical conditions. Alternatively, the government has the option to finance some or all of the deficit by issuing debt. There is plenty of scope for new issues: in October 2008 outstanding domestic debt amounted to SR250 billion, or just 14 percent of GDP.

More likely, the authorities would opt for a combination of these policy options. Either way, the overriding message is that the authorities' firmly negative net domestic debt position offers ample scope for a sustained period of deficit financing should the need arise.

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