

SaudiEconomicReport

AMPLE ROOM FOR ANTI-CYCLICAL POLICIES OFFSETTING SLUGGISHNESS

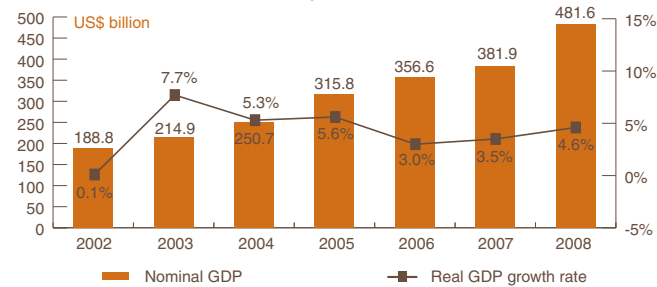
- ▶ Saudi Arabia is definitely not insulated from the global turmoil contagion woes that the whole region is suffering from. The Kingdom's real GDP growth, which had recorded 4.6% last year, is likely to witness its first negative figure since 1999, with the IMF recently projecting it at -0.9% for 2009 as a result of a number of unavoidable transmission channels.
- ▶ International oil definitely represents the most serious and challenging channel. Saudi Arabia's oil sector ended a five-year booming era, with oil prices slashed by half and output reduced as a result of OPEC's lower quotas for the last quarter of 2008 and early in 2009.
- ▶ At the current oil price level, fiscal and current account balances turn into deficits for the first time in almost a decade. After having recorded a huge fiscal surplus of 33% of GDP and a large current account surplus of 28% of GDP in 2008, the Kingdom is projected to report deficits of 7.6% and 1.8% of GDP respectively in its fiscal and current account balances this year.
- ▶ FDI inflows to the Kingdom are also adversely impacted by the global turmoil as a result of the wealth contractionary phenomenon around the Globe. Within this context, it is estimated that circa 20% of aggregate private sector projects in Saudi Arabia are being put on hold for the time being.
- ▶ Private project financing rises as a key hurdle in the Kingdom in this period of deleveraging and credit crunch reported around the Globe. It is obvious that global banks are restraining from getting engaged in new credit exposure, while Saudi banks have narrow financial flexibility with their loans to deposits ratios being close to regulatory ceiling and with their private funding growth rate falling from their recent highs.
- ▶ However, the Saudi government has both capacity and will to follow aggressive anti-cyclical policies. The huge fiscal reserve that was built during the oil boom gives the government very substantial room for stimulus fiscal policies to support growth. The Kingdom had accumulated foreign assets at SAMA of above US\$ 438 billion by end-2008, i.e close to the country's GDP.
- ▶ We believe the recently released 2009 IMF real growth forecasts (-0.9%) do reflect largely the cyclical strengths and weaknesses of the Kingdom's real economy today, while the 2010 preset forecasts (2.9%) would depend on uncertain variables such as the evolution of the global demand for oil which is itself linked to the relatively uncertain pace of global recovery in the year ahead.
- ▶ In a longer term, the structural growth trajectory depends on both economic and political challenges related to economic diversification, employment generation and the improvement of the skills of the Saudi Labor force in addition to domestic security conditions and regional geopolitical risks.

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Gross Domestic Product Performance



1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Oil Sector

Saudi Arabia's oil sector ended a five-year booming era, with oil prices slashed by half and output reduced as a result of OPEC's lower quotas for the last quarter of 2008 and early in 2009. The contraction in oil activity with its significant weight on overall economic performance that was further hampered by the global financial crisis' repercussions, remains manageable. Saudi Arabia's global role and its proper administration of oil windfalls in the past five years, place it, at present, in a good position to confront the challenges ahead.

Saudi Arabia is the largest oil producer and exporter globally with almost 266 billion barrels of proven oil reserves or one fifth of the world reserves and has substantial spare capacity that can be brought online quickly. In a recent declaration, the Minister of Petroleum stated that the Kingdom could be able to boost proven reserves by an additional 200 billion barrels. Five new oil fields and three new gas fields were actually discovered by the end of 2008.

The oil sector is the mainstay of the economy, accounting for around a third of GDP (at constant prices) and more than 60% of GDP at current prices in 2008, securing significant foreign currency receipts accounting for 90% of exports and 82% of government revenues. It registered a real growth rate of 3.2% in 2008.

In 2008, Saudi Arabia produced around 10.85 million barrels per day (b/d) of total oil which is a 4.2% increase from 2007, but this is estimated to contract to 10.65 million b/d in 2009, only to slightly recover to 10.8 million again in 2010 according to Business Monitor International (BMI). Over the first few months of 2009, production dwindled further not exceeding an estimated 8 million b/d. Oil exports that have also increased by 4.5% in 2008 to total 8.63 million b/d are foreseen to fall back 3% in 2009 as per BMI estimates.

Despite this slowdown, authorities are pressing ahead with

investments to expand upstream oil capacity. The Petroleum Minister suggested that the Kingdom is considering a second phase of upstream capacity expansions, after the first phase target of 12.5 million b/d is completed at end-2009. The vision is to take the capacity to 15 million b/d. In fact, by mid-2009, the Khurais field (300,000 b/d), and two smaller increments at Shaybah (250,000 b/d) and Nuayyim (100,000 b/d), will start producing. Such projects developments aim to prepare for a foreseen rebound in demand in the next couple of years and, at the same time, are part of the counter cyclical policies of government spending to stimulate overall economic activity.

Downstream projects (refineries and petrochemicals) are also ongoing but at a slower rate and with some delay, as these depend more on foreign borrowing and investment, whereas crude capacity expansion is to be financed by the state oil company. Refining capacity of the existing seven refineries was estimated at 2.1 million b/d by the end of 2008. Saudi Arabia has a US\$ 20 billion development plan of investment to increase domestic refining capacity to more than 3 million b/d and international holdings by at least 1 to 2 million b/d by 2011, particularly in an effort to meet the requirements of the fast growing Asian market. Among the most recent projects under way is the construction of a 250,000-400,000 b/d refinery in the country's south-western province of Jizan, announced in October 2008. The project is ongoing though the completion deadline for the refinery was postponed from 2013 to 2015.

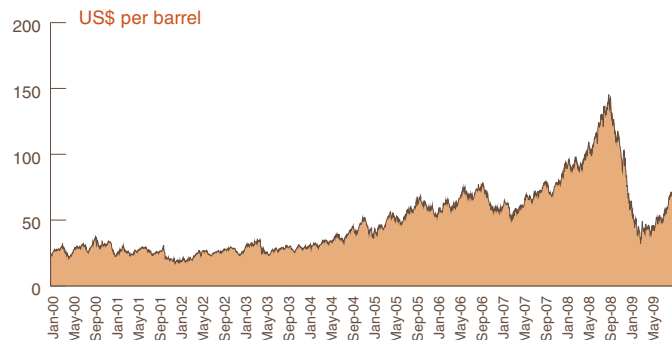
As to natural gas, Saudi Arabia's reserves are estimated at 7,300 billion cubic meter (bcm), ranking the country fourth in the world. Gas production has been estimated by BMI at a rate of 78.9 bcm in 2008, up 4% from 2007 with forecasts for 2009 suggesting another similar growth rate. Saudi Arabia is working currently to expand its production of non-associated gas to detach gas from oil production. However, this technique could be more costly and will erode Saudi Arabia's natural cost advantage in producing this feedstock. The increase in gas production is important for the Saudi petrochemical industry and other energy intensive industries that are subject of an economic diversification plan. In addition, the switch from oil to natural gas for domestic industries' use also aims to free up oil for exports.

The oil sector obviously remains of primary importance in Saudi Arabia, despite last year's crash and the OPEC's decision to support faltering prices. The increasing government spending to support non-oil growth, nonetheless, should somewhat offset the dampening effect of the oil driven downturn. In addition, the upward price corrections witnessed in the second quarter of 2009 should also return some liquidity to the country and boost the government expansionary stance to forge ahead with its multi-faceted investment program. Saudi Arabia had embarked and announced a US\$ 400 billion plan over the next five years to upgrade the productive base (including energy projects), social and physical infrastructure in areas like power, water, transportation, education and housing.

1.1.2. Non-Oil Sector

Saudi Arabia's non-oil sector has been gaining importance over the past five years and is expected to maintain a positive real growth rate, but with a slight deceleration. The IMF forecasts this expansion at above 3% in 2009, amidst the global downturn and the contraction in oil activity that used to fuel also non-oil industries. Last year's non-oil GDP real growth rate was estimated by the IMF at around 5.3%. Authorities want to boost the non-oil sector, within the context of worries

Crude Oil Prices



from a slowdown in private financing. Public spending under the 2009 expansionary budget should shore up the required funds to push ahead with economic diversification, crowd in private sector investments, and implement infrastructure upgrading. The non-oil sectors that are closest to this investment drive are mainly in construction, transport, and telecommunication, as well as the important petrochemical sectors.

Petrochemicals, an export oriented sector, enjoys a comparative advantage in Saudi Arabia and currently forms a cornerstone of the economic diversification plan. Petrochemicals were strongly hit by the recent downturn in the economy, due to the linkage with the oil industry and foreign markets. Some projects are expected to be delayed, as a result of weak demand and as the credit crunch limits the sizeable financing needed for such mega developments. Most petrochemical producers, such as the leading SABIC, reported sliding profits in 2008. By the first quarter of 2009, SABIC reported a net loss. However, the sector is still receiving significant attention and the government aims to make it a worldwide leader by 2015, notwithstanding the feedstock required for the planned projects.

The prospects for the sector remain favorable, especially if the refining capacity increases until 2011 to ensure adequate, cost-effective feedstock new projects. Saudi Arabia can easily reach its target of a worldwide leader in five years time, as it is well positioned to meet the worldwide demand as soon as it recovers. The Kingdom benefits from its infrastructure and cost advantage to attract investment into the sector. Indeed, more than US\$ 70 billion should be channeled into petrochemical projects by 2011 in the form of public private partnerships and/joint ventures with foreign petrochemicals firms.

Construction activity that accounts for 7% of GDP is another traditional and major driver of the Saudi economy. Investments in physical infrastructure and the creation of the mega economic cities have fuelled economic growth over the past five years and were a key recipient of the oil windfalls. After recording a real growth rate above 7% for two consecutive years, the sector expanded by 4.1% in 2008 (based on GDP at producers prices). However, this sector has been also hit by the recent downturn, mainly in the last quarter of 2008, but has been relatively picking up this year with the government fiscal stimulus program particularly targeting spending on physical infrastructure. A couple of mega projects were delayed, namely the twin towers planned to be the tallest around the world, but according to Meed Projects, the value of construction contracts awarded in the first quarter of 2009 bypasses the total awarded in 2008.

The Economic Cities' development continues with a total investment size of around US\$ 124 billion and completion dates within the next five years. The credit crunch and recessionary environment put these mega projects' financing in question, delaying some steps, but, as these developments constitute a key component of the authorities' economic vision, they are expected to receive additional public financing and support. The Saudi Industrial Development Fund has been providing long term loans with favorable terms to finance up to 50% of building costs. At the same time, construction activity should benefit from the recent decline of steel and cement prices reaching some 40%.

The transport sector is being revamped, with the 2009 budget allocating almost US\$ 5.2 billion to develop air, land and maritime infrastructure. The aviation industry will take a bit less than US\$ 1.4 billion to expand the King Abdel-Aziz International Airport, modernize other existing airports such as Prince Muhammad Bin Abdul Aziz Airport in Medina, Taif Airport, the King Khalid

International Airport and several domestic airports, and develop new airports.

The land network is another major overhaul project, with some US\$ 40 billion already placed in roads building between 2004 and 2009. The construction of new roads and highways and the expansion of existing ones are set to continue, with the Minister of Transport announcing US\$ 3 billion of funding for the country's roads in the fiscal year 2009/10. The rail network is also under expansion with a major contract signed at the beginning of 2009 to build the Mecca-Medina railway. The civil works contract is worth around US\$ 1.8 billion. Another expansion is set for the second Saudi railway called the Saudi Landbridge, linking the capital, the Red Sea port at Jeddah, the industrial city of Jubil and the oil port on the Gulf Coast.

The sea transport segment is likewise being refurbished and port-capacity is being increased, although it is quite adequate to meet the present needs, but Saudi Arabia aims to become a regional transport hub. A new terminal at Jeddah Islamic Port was inaugurated in February 2009, raising the container handling capacity by 1.5 million twenty foot equivalent units (TEUs). The Red Sea Gateway terminal is under work and is estimated to cost US\$ 450 million with an expected date of completion towards the end of 2009.

Another sector worth highlighting when considering non-oil activity in Saudi Arabia is communications. Saudi Arabia has been increasingly opening up its telecommunication sector over the past five years and this strategy has been paying off with strong growth in the mobile segment of the sector that is relatively more technology-driven than fixed line telephony. Mobile subscribers at the end of 2008 reached around 38.5 million, up by 35.5% year-on-year according to BMI estimates. The penetration rate exceeds by far the population, standing at 150%. This performance benefitted from the entry of a third mobile operator, Saudi Zain, in August 2008. The growth in mobile penetration has somewhat affected the fixed line segment through a substitution effect and the latter had a relatively low penetration rate not exceeding 17%.

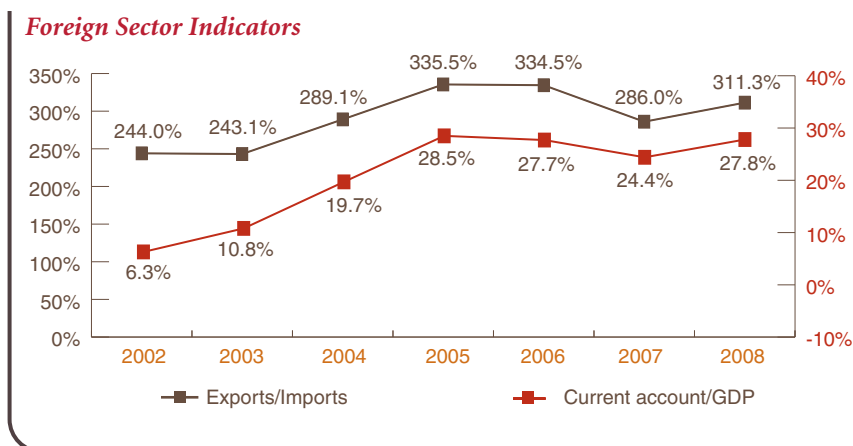
Along the same line, the information technology (IT) sub sector is expanding, supported by a proactive government strategy. The authorities placed in June 2008 a draft national strategy for this sector to raise its GDP contribution to 20% by 2020. At the same time, the government has already started to implement e-government programs. Saudi Arabia is still pursuing its vision of transforming the country into a knowledge-based society and economy. The Kingdom is indeed the biggest IT market in the region, having an estimated value of US\$ 3.4 billion according to BMI's 2008 figures and is expected to grow to US\$ 5.6 billion in five years time, registering an annual average growth rate of 11%. The impact of the economic recession and the global difficult conditions definitely left traces on IT activity but the market would still offer good opportunities in the medium term, supported by a relatively more resilient sizeable consumer demand.

In conclusion, Saudi Arabia is determined to go on a development path and reduce its dependency on oil, notwithstanding the difficult local, regional and global economic conditions. Even though Saudi Arabia's economic growth is expected to turn negative this year with many sectors shrinking, yet the government economic stimulus program, based on spending on specific well-targeted sectors of high value added to the Kingdom, should allow the diversification process to go on and strengthen non-oil activity.

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1.2. EXTERNAL SECTOR

The external sector in 2008 had reported one of its most favorable historical performances, benefitting from the oil bonanza during most of the year and the regional economic prosperity, which reigned throughout the first three quarters of 2008. As a matter of fact, the Kingdom's external sector has been burgeoning for several previous years now, and reached its zenith in 2008, in spite of the deterioration it witnessed in the last quarter of the year, as the sector was hit hard by the global economic downturn, predominantly when it comes to dwindling oil prices and sluggish demand for oil.



The trade surplus increased by 40.3% to total US\$ 212.7 billion in 2008, a historical record high. This growth in the trade surplus is deemed especially high as it is two times the annual growth rates since the beginning of the decade that averaged around 20%. Similarly, the current account reached a historical peak US\$ 134.0 billion, surging by 43.6% from US\$ 93.3 billion in 2007. This growth comes in spite of the 39.2% expansion in the services and transfers' deficit, which amounted to US\$ 64.9 billion. It is worth noting that the latter is constantly growing on account of accelerated expansion and diversification of activity in the Kingdom. Nonetheless, in 2008 the Saudi economy was well buttressed by oil exports' receipts, benefitting from skyrocketing oil prices in the first three quarters of the year, that the value of the trade surplus was more than three times that of the services and transfers' deficit.

Imports amounted to US\$ 100.6 billion in 2008, rising by 23.5% year-on-year, versus an average growth of 16.3% since the beginning of the decade. The growth is due to the increase in industrial imports that make up more than half total imports, with Saudi Arabia firmly heading towards a non-oil economic expansion, based on construction, infrastructure development, and a growing oil-related manufacturing activity. Indeed, imports of machinery and electrical equipment that account for almost one third of imports have increased by 34% in 2008. Likewise, metals and base metals that account for 15% of total imports increased by 28%.

Total exports (including oil exports and excluding bunker oil) amounted to US\$ 313.3 billion in 2008, rising by 34.4% from 2007. Exports' growth in 2008 is more than three times the 10.9% expansion witnessed in 2007 and also significantly surpasses that of the previous years which registered an annual average growth of 19% since 2001. The said augmentation in exports was to the most part driven by a 36.9% yearly surge in oil exports, which comprised 89.7% of total exports in 2008. In fact, the main reason behind such a substantial growth in exports was the fact that over the first three quarters of the year, before the global economic meltdown and the

plummet in oil prices, the latter were on an upward trajectory, continuously attaining new crests. In parallel, non-mineral products exports also increased by a healthy 16.5% year-on-year, as a result of the intensive developments of the non-oil sector over the past few years. These exports have more than quadrupled since 2000.

The breakdown of exports by country of origin in 2008 shows that the United States was the country with the greater share of Saudi Arabia exports, taking up 16.6% of total Saudi exports. It was followed by Japan with 15.2% of the total, China with 8.9%, Taiwan with 3.9%, Singapore with 3.7%, Bahrain with 3.0%, and the United Arab Emirates with 2.6%. The top seven importers of Saudi Arabian products accounted for almost a half of total exports. The breakdown of imports by country of origin in 2008 shows that the United States accounted for 12.6% of total exports to Saudi Arabia, followed by China with 9.4%, Germany with 8.8%, and Japan with 8.1%. The top four exporters to the Kingdom accounted for more than a third of total imports.

However, it is worth recalling that the aforementioned favorable performance at the level of merchandise trade activity, which in turn resulted in the solid current account surplus, reigned up until end-September 2008, prior to the outburst of the global financial crisis. In the last quarter of the year, oil exports were slashed into less than half their value in

the previous quarter on account of tumbling oil prices as well as dawdling global demand for oil. Indeed, Saudi Arabia's exports are reported to have nosedived in the last quarter of the year. Imports, on the other hand, slowed down too, as a result of softened demand in the Kingdom, noting that the slowdown in private sector construction and project work resulting from the crisis reduced the need for capital goods, as well as lower commodity prices. The decline in imports in the last quarter of the year has contained the trade balance from falling into a deficit, despite its significant contraction during the said quarter.

Looking ahead in 2009, the trend witnessed in the last quarter of the year is expected to continue, as negative spillovers from the crisis will not fade out during the year. Revenue from oil exports and from the key non-oil export, petrochemicals, is expected to be lower than in 2008, but with lower world commodity prices helping to ease the cost of imports, the trade balance is expected to remain positive. However, this surplus is likely to be offset by continued deficits on the services, income and current transfers accounts, especially as extremely low US interest rates will hit interest income from overseas investment, leading to a current account deficit, the first since 1998 and the equivalent of 1.8% of GDP, as per IMF forecasts.

1.3. PUBLIC SECTOR

Saudi Arabia's fiscal policy appropriately faced the 2008 oil crash and credit crunch, and is currently confronting the 2009 recessionary environment. Having learned from its history of oil booms, the Saudi government managed well this decade's bonanza and saved most of its windfalls. It is thus considered among the few countries that have enough space to currently embark on an aggressive counter-cyclical strategy to soften the downturn. Yet, for the first time in six years, the Kingdom will incur a budget deficit. Central government expenditures are expected to outstrip revenues in 2009, if the year's average oil price hovers around US\$ 55. As

such, Saudi Arabia's public finance deficit is projected to reach 7.6% of GDP, after a 33% record high surplus in 2008 as per IMF estimates.

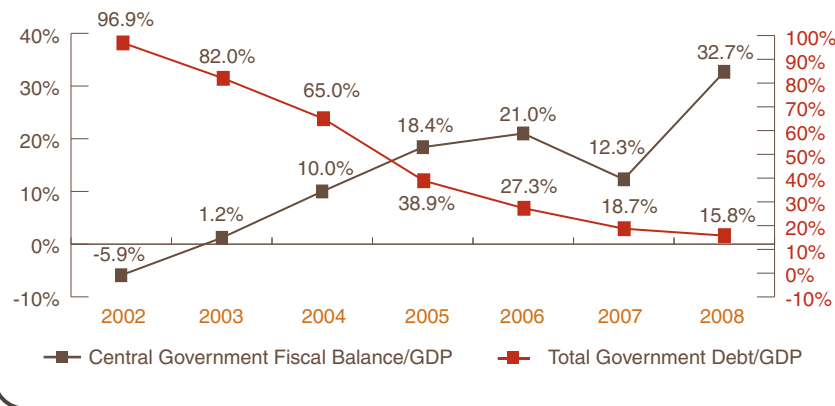
prospect. The 2009 revenues are forecasted at SR 410 billion (US\$ 109.3 billions) which are slightly more than a third of what was achieved last year. In contrast, expenditures are set at SR 475 billion (US\$ 26.7 billion), which is only 6.7% less than the realized figure of 2008. These consist mainly of capital expenditures that are targeted to increase by 36%, in line with the government's plan to boost infrastructure spending and stimulate economic activity, whereas current expenditure are increased by 2.2% only. Overall, the 2009 fiscal deficit is forecasted to reach circa SR 65 billion (US\$ 17.3 billion).

To sum up, Saudi Arabia, unlike other countries in the region hit by the global downturn and the oil boom bust, is not expected to find difficulties in financing its expansionary budget with its large reserves building up from the oil bonanza (SAMA's foreign assets almost doubled from end-2006 to reach US\$ 438 billion at end-2008).

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Saudi Arabia could also easily borrow having relatively low debt ratios and a large banking sector (second largest in the region, with a sizeable deposit base). Looking further ahead, the next couple of years should see a gradual readjustment in the fiscal situation. The major driver of the public finances is oil and its price fluctuation. With limited visibility on how these prices would move, it would be difficult to assess the public finance's outlook, but it can be easily said that Saudi Arabia's fiscal accounts have a very good chance of rising above the red in the next couple of years, on the back of a gradual rise in oil prices amidst steady expenditure growth.

Government Sector Indicators



According to the Ministry of Finance, revenues were estimated to reach SR 1,100 billion (US\$ 293.3 billion) in 2008 and expenditure to reach SR 510 billion (US\$ 136 billion), resulting in a surplus of SR 590 billion or US\$ 157.8 billion. Spending last year has increased, as a result of outlays to two major projects, namely the Two Holy Mosques and Mashair, as well as food subsidies, an increase in costs of living allowance, and increases in admission to universities and scholarship program. Despite the surge in expenditures, the 2008 fiscal surplus was substantial (double the 2006 surplus and more than triple the 2007 surplus) as the 2008 budget was built on half the actual average oil price registered in 2008. This follows a series of surpluses recorded since the beginning of this decade rising from an average of 0.9% of GDP in the 2000-2004 period to above 17% of GDP during the 2005-2007 period and culminating at 33% in 2008. Saudi Arabia saved more than three quarters of these surpluses over the past six years and managed to reduce the government debt position.

IMF data indeed indicates that public debt continued to slide to the equivalent of 15.8% of GDP in 2008 (around US\$ 76 billion or SR US\$ 285 billion), down from 18.7% the previous year and from above the 100% at the end of the nineties. The 2009 forecasts by the same source show a limited change, with government debt standing at 15.6% of GDP.

The 2009 budget focuses on infrastructure and social services, especially education, health, social affairs, science and technology related sectors, e-government as well as capital expenditures that will boost economic activities and enhance the economic growth

1.4. FINANCIAL SECTOR

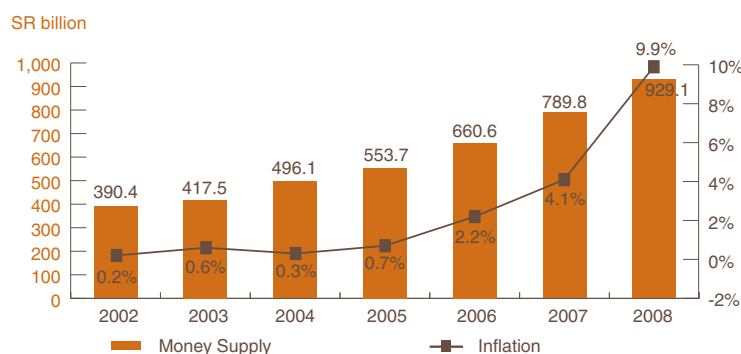
1.4.1. Monetary Situation

Though the eruption of the global financial crisis has put brakes to the inflationary pressures in Saudi Arabia and resulted in a squeeze in liquidity during the fourth quarter of the year, forcing SAMA to adopt loose monetary policy by slashing interest rates and reducing the reserve requirement, the year 2008 was all-in-all characterized by buoyant economic activity, strong domestic demand, significant expansion in money supply and high inflation rates.

In the aftermath of the global financial turmoil, food prices fell sharply, housing costs tumbled and the US Dollar appreciated, which contributed to driving Saudi Arabia's inflation rate down to 9.0% year-on-year in December, after peaking at 11.1% year-on-year in July 2008. All in all, inflation rate averaged 9.9% in 2008 versus 4.1% in 2007, and it is expected to drop to an average of 5.5% in 2009, according to the IMF, in view of slower domestic growth and global factors. It is worth recalling that the pick-up in average inflation rate in 2008 was attributed to several factors that were observed before the eruption of the global financial turmoil, namely soaring food prices, the run-up in housing costs, strong domestic demand and liquidity, in addition to exchange rate effects and imported inflation.

The squeeze in liquidity witnessed after the outburst of the global financial turmoil partly offset the booming activity observed during the first half of the year, resulting into moderate money supply growth rates year-on-year. In fact, the narrow measure of money supply (M1) ended the year with a growth of 10.9%, moving up from SR 384

Money Supply and inflation



billion at end-2007 to SR 426 billion at end-2008, while the broader money supply (M2) accelerated by 19.0%, moving up from SR 667 billion at end-2007 to SR 793 billion at end-2008. Money supply in its broadest sense (M3) widened by 17.6%, from SR 790 billion at end-2007 to SR 929 billion at end-2008. Most of the money supply growth is explained by demand for time and saving deposits, with the latter growing by 29.9% year-on-year.

Liquidity that tightened substantially after the eruption of the global financial crisis, forced Saudi Arabian Monetary Agency (SAMA) to adopt loose monetary policy during the fourth quarter of the year, trying to ease the strain in the financial sector and to encourage the banking sector to lend again. In fact, in view of continuous concerns for local liquidity and lending after September 2008, and in attempt to reinvigorate local credit markets, SAMA started to cut its repurchase rate (repo), which guides commercial lending rates, in mid-October for the first time since May 2004, following the concerted interest rate cuts by the G7 Central Banks early-October. After all, SAMA was forced to closely follow the Federal Reserve's interest rate policy, given the Riyal's fixed exchange rate against the US Dollar at SR/US\$ 3.75. Within this context, the repo rate was cut four times during the fourth quarter of 2008 for a total of 300 basis points to reach a four-year low level of 2.5%. SAMA simultaneously reduced the cash reserve requirement on demand deposits from 10% to 7%. These measures were taken against the backdrop of receding inflationary pressures and to ensure that adequate system liquidity is available to meet steady domestic demand.

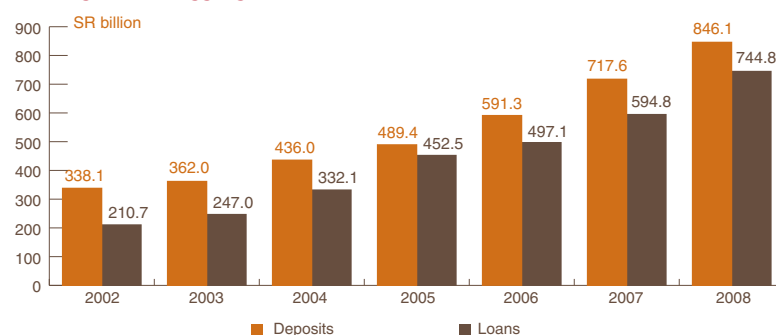
After several years of rapid growth, the pace of expansion of the broad money supply is expected to slow sharply in the coming period, owing to lower oil export earnings, slower government spending growth and the impact of the global liquidity squeeze on local financial

institutions. Within this context, and amid rising concerns about an economic slowdown and since global inflationary pressures are abating, SAMA's monetary policy would continue to focus on maintaining liquidity and keeping interest rates at relatively low levels.

1.4.2. Banking Activity

The Saudi banking sector has not been spared by the global financial crisis, with spillovers on balance sheet and bottom line growth starting to manifest towards the end of 2008, though it benefits from sufficiently healthy fundamentals and solid financial standing to weather the storm and counter the adverse effects of the ongoing crisis. In 2008, Saudi banks had enjoyed strong activity growth in the first three quarters, which offset the relatively weaker performance post crisis eruption. The sector's size, measured by total assets of operating banks, grew by 21.1% over 2008, moving from SR 1,075.2 billion at year-end 2007 to SR 1,302.3 billion at year-end 2008.

Banking Sector Aggregates



KSA Banking Sector Ratios

	2002	2003	2004	2005	2006	2007	2008
Banking sector dimension in economy							
Assets/GDP	71.9%	67.8%	69.8%	64.2%	64.5%	74.8%	74.3%
Deposits/GDP	46.4%	44.3%	46.4%	41.4%	44.3%	49.9%	48.3%
Loans to the private sector/GDP	28.1%	27.5%	32.3%	35.6%	34.6%	38.8%	40.6%
Loans to the public sector/GDP	1.7%	3.2%	3.1%	2.7%	2.6%	2.6%	1.8%
Growth rates							
Assets	7.6%	7.3%	20.2%	15.8%	13.4%	24.9%	21.1%
Loans	12.3%	17.2%	34.5%	36.2%	9.8%	19.7%	25.2%
Investments	8.0%	4.6%	0.6%	-8.6%	3.9%	32.1%	21.4%
Deposits	16.8%	8.5%	22.4%	12.3%	20.8%	21.4%	17.9%
Capital and reserves	8.0%	-0.6%	11.1%	27.5%	20.0%	32.6%	24.3%
Profits	5.0%	15.2%	36.3%	54.5%	35.4%	-12.7%	-1.1%
Liquidity							
Primary liquidity/Deposits	22.0%	16.6%	17.1%	15.7%	20.5%	22.3%	19.6%
Liquid assets/Deposits	82.2%	74.6%	64.8%	54.6%	54.0%	58.7%	57.1%
Loans to the private sector/Deposits	60.5%	62.1%	69.5%	86.0%	78.2%	77.7%	84.2%
Loans to the public sector/Deposits	3.6%	7.3%	6.7%	6.5%	5.9%	5.2%	3.8%
Total loans/Deposits	64.2%	69.3%	76.2%	92.5%	84.1%	82.9%	88.0%
Capitalization							
BIS ratio	21.3%	19.4%	17.8%	17.8%	21.9%	20.6%	-
Capital accounts/Assets	11.4%	10.9%	10.5%	12.1%	13.3%	12.7%	12.4%
Profitability							
ROAA	2.15%	2.31%	2.76%	3.62%	4.28%	3.13%	2.52%
ROAE	18.90%	20.78%	25.90%	31.81%	33.52%	24.12%	20.08%
Asset quality							
NPLs/Total loans	8.8%	5.4%	2.8%	1.9%	2.0%	2.1%	-
Provisions/NPLs	110.4%	128.2%	175.4%	202.8%	182.3%	142.9%	-

The sector's major activity drivers, total deposits and loans extended to economic agents, proved to be supportive of the banks' overall performance, but were not left unscathed following the outburst of the crisis. Deposits proved rather resilient, partly owing to efficient and timely policies of local authorities, while lending activity slowed down markedly. Accounting for two thirds of total assets, deposits did manage to progress by a sound 17.9% last year, from SR 717.6 billion at year-end 2007 to SR 846.1 billion at year-end 2008. Funding indeed does not seem to be an issue for local banks, as the sector has seemingly benefited from the conservative nature of the local regulator, which fostered relative stability in such a challenging period.

Authorities have been successful at maintaining depositor confidence by guaranteeing bank deposits in the Kingdom, which supported the private sector depositor base, and the SAMA and public sector institutions have injected considerable liquidity into the banks, notably in the form of long-term deposits, thus relatively sparing them from a tight liquidity squeeze. Accordingly, the outburst of the crisis did not quite hamper deposit growth, with monthly deposit statistics showing a quasi-continuous increase in banks' core funding all throughout year-end 2008, and even well into this year.

What has also been helping local banks weather the spillovers of the global financial crisis is the authorities' close monitoring of players' risk standing. Bank balance sheets remain unlevered and funding largely stemming from total deposits, exposure to real estate ventures and investments is low, and activity seems to be largely focused within the Kingdom.

Speaking of banks' exposure to economic agents, bank loans, in spite of having progressed by a yearly 25.2% in 2008 within the context of the liquidity boom tied to the oil bonanza and the growing financing needs of economic agents at large during most of 2008, bared the brunt of the tightening of liquidity conditions in the last few months of the year 2008 and the first months of 2009, with the crisis taking its toll on lending activity.

The Central Bank has thus taken a series of measures to encourage institutions to continue lending, after having introduced curbs on banks earlier throughout 2008 in the face of excess liquidity and inflation. The SAMA had increased reserve requirements on demand deposits for commercial banks on several occasions, and raised those on time and saving deposits as well. Following the outbreak of the crisis, the SAMA softened its stance by cutting reserve requirements for commercial banks on demand deposits and cut benchmark lending rates, while authorities have announced a multi-billion dollar interest-free loan scheme for low income Saudis to be distributed via local credit banks.

The tightening of liquidity conditions and financial markets turmoil at large pressured banks' interest and non-interest income, and the provisioning on investment books and lower asset valuations weakened the performance of Saudi banks in the last few

months of the year, leading overall 2008 net profits of the Saudi banking sector to stagnate when compared to those registered in the previous year. Net profits of the second half of 2008 were reportedly 28% lower than those of the first half of the year, pushing total yearly net profits down by 1% relative to those registered in the year 2007 to reach SR 29.9 billion.

Yet, profitability ratios remained largely satisfactory, with the broad sector's return on average assets (ROAA) standing at 2.5% and return on average equity (ROAE) at 20.1%, both ratios still comparing very favorably to international benchmarks, especially at a time when some of the world's largest banks were posting heavy net losses, hit directly by the crisis.

More generally, Saudi banks continue to enjoy overall good financial soundness indicators. Liquidity ratios remain healthy, with the banks' primary liquidity/deposits ratio sticking close to the 20% mark, and the liquid assets still accounting for nearly 60% of sector deposits. Saudi banks maintained good asset quality ratios throughout 2008, with the NPLs to total loans ratio averaging a sound 1.4%, and the coverage ratio remaining strong (at 169%), according to Fitch Ratings.

The main challenges Saudi banks face this year lie in ensuring business volume and profitability while maintaining adequate asset quality. With banks being increasingly cautious about lending within such adverse conditions, lower business volumes and additional loan and financial assets impairment charges are bound to pressure profitability. However, demand for loans stemming from the private corporate sector and from the public sector would still manifest, albeit at a slower pace than in recent years, and might ensure core revenues for Saudi banks.

1.4.3. Equity and Bond Markets

The Saudi stock market tracked sharp declines in global equity markets after the eruption of the global financial crisis mid-September 2008, amid rising fears about a global economic recession and growing concerns about fast falling oil prices. Within this context, the Tadawul All Share Index (TASI) tumbled by 56.5% in 2008, moving down from 11,039 at end-December 2007 to 4,803 at end-December 2008, wiping out all the gains realized during the previous year.

The breakdown of the TASI by sector shows that the insurance sector witnessed the highest index drop with -73.7%, followed by the multi-investment sector with -67.0%, the petrochemical industries sector with -66.5%, the cement sector with -57.8%, the banking and financial services sector with -55.5%, and the media & publishing sector with -55.2%.

Following the market declines, valuations dropped substantially this year. The average price to earnings ratio stood at to 9.7 times in 2008, versus 23.2 times in 2007. Similarly, the price to book ratio

June
2009

Selected Stock Market Indicators

	2002	2003	2004	2005	2006	2007	2008	Var. 03/02	Var. 04/03	Var. 05/04	Var. 06/05	Var. 07/06	Var. 08/07
Market capitalization (in US\$ billion)	74.9	157.3	306.4	650.1	326.9	519.0	246.5	110.0%	94.8%	112.2%	-49.7%	58.8%	-52.5%
Market capitalization/GDP	39.7%	73.2%	122.2%	205.9%	91.7%	135.9%	51.2%	33.5%	49.0%	83.7%	-114.2%	44.2%	-84.7%
Trading value (in US\$ billion)	35.7	159.1	473.0	1,103.7	1,403.2	682.1	523.5	345.9%	197.4%	133.3%	27.1%	-51.4%	-23.2%
Turnover ratio	47.6%	101.1%	154.4%	169.8%	429.2%	131.4%	212.4%	53.5%	53.3%	15.4%	259.5%	-297.8%	81.0%
Number of transactions	1,033,669	3,763,403	13,319,523	46,607,951	96,095,920	65,665,500	52,135,929	264.1%	253.9%	249.9%	106.2%	-31.7%	-20.6%
General share price index (base 1985=100)	2,518	4,438	8,206	16,713	7,933	11,039	4,803	76.2%	84.9%	103.7%	-52.5%	39.1%	-56.5%
Change in share price index	3.6%	76.2%	84.9%	103.7%	-52.5%	39.1%	-56.5%	72.6%	8.7%	18.7%	-156.2%	91.7%	-95.6%
Price/Earnings ratio	19.7	29.2	36.5	66.2	15.9	23.2	9.7	48.7%	24.9%	81.6%	-76.0%	46.1%	-58.1%
Price/Book value ratio	2.6	3.7	6.6	12.5	3.5	4.3	1.7	42.7%	75.7%	89.8%	-71.6%	20.9%	-61.4%

reached 1.7 times in 2008, against 4.3 times in 2007.

The normal stance of activity during the first eight months of the year triggered new listings in the Saudi stock market. The number of companies that offered parts of their shares to public through IPOs reached 13 in 2008, noting that since mid-September the CMA didn't give any approval to IPOs owing to the weak performance of the Tadawul and due to concerns that an IPO could drain liquidity from existing stocks. Within this context, the total number of listed companies stood at 127.

The increase in the number of listed companies in the Tadawul was more than offset by a sharp drop in prices in 2008, which resulted in an important fall in the market capitalization of 52.5%, moving down from US\$ 519.0 billion at end-2007 to US\$ 246.5 billion at end-2008. It is worth noting that the two largest sectors on the Tadawul stock exchange- the banks & financial services sector and the petrochemical industries sector- collectively represented 56.9% of the capitalization and they had a major impact on the overall market's performance.

On the backdrop of a decrease in the number of shares traded and a sharp drop in prices, the total trading value amounted to SR 1,962.95 billion (US\$ 523.5 billion) at end-2008, dropping by 23.2% relative to the previous year. The division of the total trading value by category showed that the petrochemical industries sector led the market with SR 637.7 billion (US\$ 170.0 billion), followed by the banks and financial services sector with SR 209.0 billion (US\$ 55.7 billion) and the real estate development sector with SR 163.7 billion (US\$ 43.7 billion). The number of executed transactions stood at 52.1 million, down by 20.6% as compared to 65.7 million for the previous year.

Looking ahead, the Saudi stock market's recovery shall be associated with the pace of increasing optimism about a global economic recovery and a rebound in oil prices. With liquidity deemed to be still available in the market partially hedging it from the worst effects of the global turmoil and with the Saudi bourse now showing attractive valuation ratios, investors may see that there was an overestimation of risk following the outbreak of the global financial crisis, and that the equity market has not been acting on real fundamentals.

2. CONCLUSION

During the tough economic times that the whole World is living nowadays, it is the ability of the states to follow anti-cyclical policies that determines the relative resistance of individual countries to crisis contagion factors emanating from the sluggish external environment. The Kingdom of Saudi Arabia rises among the countries with large potential to reduce the effects of such external spillovers, at least in the short to medium term, despite the obvious transmission channels through global oil demand, FDI flows and the global banks capacity for project financing.

Oil prices rise definitely as the most serious challenge. At the current oil price levels, Saudi Arabia is likely to report its first budget deficit since the year 2002. It is agreed upon that an average price of US\$ 55/barrel is required for Saudi Arabia to breakeven in its 2009 budget. We need yet to bear in mind that spending is likely to exceed budget figures (revenues too but at a lower pace than expenditures), which suggests that the actual breakeven point stands at even above that level for the year average, which is becoming increasingly difficult to register.

FDI inflows to the Kingdom are also adversely impacted by the

global turmoil as a result of the Wealth contractionary phenomenon around the Globe. This adds to the reduced capacity of Saudis themselves to finance private domestic investment as a result of the hit they were subject to in the aftermath of the collapse of regional and international markets at large. It is assumed that circa 20% of private sector projects were put on hold for the time being.

When talking about project financing rises a significant factor which is the global banks capacity and appetite to finance projects in the Kingdom in this period of deleveraging and credit crunch reported around the Globe. It is assumed that 60% of the Kingdom's private project financing lies on the shoulders of global banks, while close to 30% is accounted for by Saudi banks, leaving the remaining 10% for all other sources of private financing. It is obvious that global banks are restraining from getting engaged in new credit exposure, while Saudi banks have narrow financial flexibility with their loans to deposits ratios being close to regulatory ceiling.

Here comes the government role in trying to offset the sluggishness observed at the private sector investment level. The government has both capacity and will to follow aggressive anti-cyclical policies. The huge fiscal reserve that was built during the oil boom gives the government very substantial room for stimulus fiscal policies to support growth. This distinguishes Saudi Arabia's current position crucially from that in the 1970s and 1980s. Back then, most of the oil windfall was spent, leaving the country poorly prepared for the oil price slump that followed in the 1980s.

Indeed, the Kingdom has accumulated foreign assets at SAMA of above US\$ 438 billion by end-2008, i.e close to the country's GDP. With government gross debt at nearly 16% of GDP and with government deposits at SAMA reaching close to 58% of GDP, the net public sector debt is obviously negative, suggesting huge ability to intervene and support private sector investment. The growing support from government agencies like the PIF for instance which is relaxing lending criteria lies within the context of the government affording to take a bigger role in economic financing.

Mirroring all adverse factors coupled with existing opportunities to reduce spillovers, the International Monetary Fund forecasts by mid-April the Kingdom's real GDP growth for this year at -0.9% within the context of a 5.5% average inflation. For 2010, real growth was forecasted at 2.9% with inflation moderating at 4.5%. While we believe the 2009 forecasts do reflect largely the current cyclical strengths and weaknesses of the Kingdom's real economy today, the 2010 forecasts would depend on uncertain variables such as the global demand for oil which is itself linked to the pace of global recovery in the year ahead. It is likely that stronger oil prices at above US\$ 75 per barrel on average should result in outpacing those forecasts, while a worst case scenario where global sluggishness persists within a double-dip recessionary scenario translating into oil prices at below US\$ 45 per barrel might keep real output growth in the red for a second year.

In a longer term, the structural growth trajectory depends on both economic and political challenges. At the economic level, long term challenges include economic diversification, employment generation and the improvement of the skills of the Saudi Labor force. At the political level, long term challenges relate to domestic security regional geopolitical risks, or even the generational change that the Saudi leadership would have to undergo, with possible effects on the overall institutional framework and corollarily on the pace of economic development in the Kingdom.

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