

Leveraging the Kingdom's Comparative Advantages

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- The year 2007 witnessed the government's continued commitment to administer counter-cyclical fiscal policies. Both the fiscal and current account surpluses fell from the previous year, amounting to SAR178.5 billion and SAR356 billion, respectively. If the global economic slowdown worsens, the Kingdom will be able to weather any possible negative external demand shocks.
- In 2008, Saudi crude oil prices are expected to average around USD100/BBL with oil revenues projected to register record levels of SAR 997 Billion. Through 2008 - 2010 we are bullish on investment expenditure as a key driver of growth. Investment expenditure is primarily triggered by: (1) capacity expansions in the oil & gas, petrochemical and aluminium sectors (2) building of infrastructure and expanding utilities and (3) establishment of economic cities.
- Inflation in Saudi Arabia has become a major challenge in 2008, rising considerably to 10.4% Y/Y in May 2008, mainly driven by rents and food prices. Meanwhile, monetary policy easing by SAMA following the US Federal Reserve have pushed interest rates sharply lower, leading to increasingly negative real interest rates at a time when the economy is already expanding.
- The Iranian US standoff remains a serious issue. While the prospect of war between Iran and US/Israel will push oil prices up and hence the Kingdom's oil revenues higher, rising risk will adversely affect private sector confidence. As government priorities shift to security issues and the private sector cuts back on its consumption/investment plans, domestic aggregate demand will likely fall sharply.

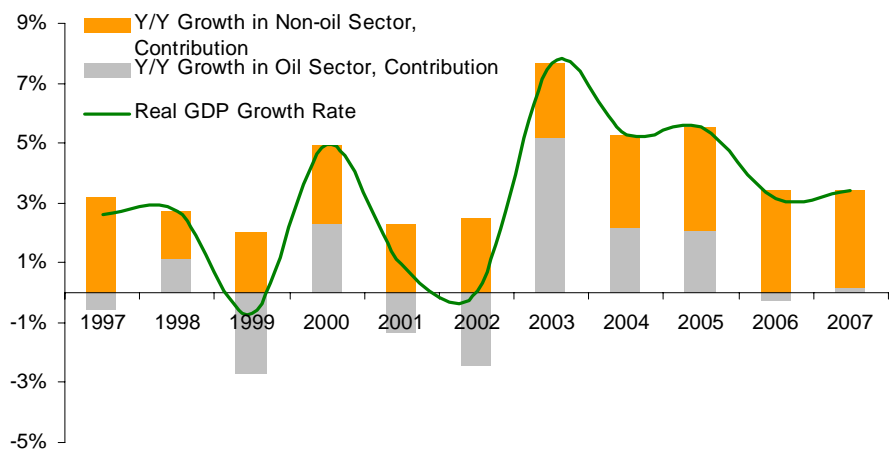
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Business Cycles in KSA*



* The chart above depicts the percentage contribution of the oil and non-oil sectors to overall real GDP growth from 1997 until 2007.

Sources: SAMA and NCB

I. 2008 Projections

Our macroeconomic projections are based on an average crude oil price (Arab Light) of USD100/BBL and an average daily crude oil production level of 9.3 MMBD (out of which 76% is exported) in 2008. Growth in the oil sector will be exceptionally strong in 2008 on the back of higher production and investment in productive capacity. Growth in non-oil sectors, particularly construction, financial services and government services, will also remain robust this year mainly due to strong private/public investment and consumption expenditures. Strengthening domestic demand is reflected in a rebound in private-sector credit expansion and double-digit growth in merchandise imports, despite accelerating rates of inflation. It should be noted, however, that the likelihood of shocks to our crude oil prices/production assumptions are on the upside, particularly if geopolitical risks concerning the US-Iranian standoff and political instability in Nigeria persist throughout 2008.

Key Macroeconomic Indicators

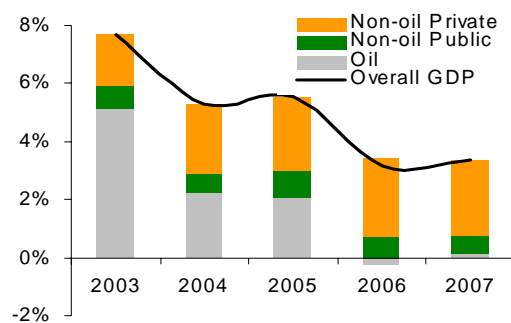
	2006	2007p	2008f	Latest	Date
Real Sector					
Average KSA Crude Spot Price, Arab Light, USD/BBL	60.3	68.5	100.0	101.3	5M08
Average Daily Crude Oil Production, MMBD	9.1	8.7	9.3	9.15	5M08
GDP at Current Market Prices, SAR billion	1,335.6	1,430.5	1,849.8	-	-
GDP at Current Market Prices, USD billion	356.2	381.5	493.3	-	-
Real GDP Growth Rate	3.1%	3.4%	5.1%	-	-
Oil Sector GDP Growth, Contribution	-0.3%	0.2%	1.8%	-	-
Non-oil Sector GDP Growth, Contribution	3.4%	3.2%	3.3%	-	-
Population, million	23.7	24.2	24.9	-	-
Population Growth Rate	2.5%	2.5%	2.5%	-	-
GDP/Capita, USD	15,041.1	15,735.9	19,836.1	-	-
CPI Inflation, Y/Y % Change, End of Period	2.9%	6.5%	12.0%	10.4%	May-08
External Sector					
Merchandise Trade Balance, USD billion	146.6	150.8	197.0	-	-
Oil Export, USD billion	187.7	205.5	259.2	-	-
Non-oil Exports, USD billion	22.8	27.9	30.2	-	-
Merchandise Imports, USD billion	(63.8)	(82.5)	(92.0)	-	-
Invisibles Trade Balance, USD billion	(47.7)	(55.8)	(64.0)	-	-
Net Factor Income, USD billion	10.4	15.0	18.0	-	-
Net Unilateral Transfers, USD billion	(15.6)	(16.1)	(19.0)	-	-
Current Account Balance, USD billion	98.9	95.0	138.0	-	-
Current Account Balance/GDP	27.8%	24.9%	28.0%	-	-
Net Foreign Assets in the Banking System, USD billion	239.9	312.3	420.0	364.8	May-08
Fiscal Sector (Central Government)					
Budgeted Expenditure, SAR billion	335.0	380.0	410.0	-	-
Actual Revenues, SAR billion	673.7	621.5	1,071.6	-	-
Actual Expenditures, SAR billion	393.3	443.0	506.5	-	-
Expenditure Overrun, %	17.4%	16.6%	23.5%	-	-
Total Revenues/GDP	50.4%	43.4%	57.9%	-	-
Total Expenditure/GDP	29.4%	31.0%	27.4%	-	-
Overall Budget Balance, SAR billion	280.4	178.5	565.1	-	-
Budget Balance/GDP	21.0%	12.5%	30.5%	-	-
Net Banking Sector Claims on the Government, SAR billion	-214.9	-372.5	-650.0	-560.0	May-08
Financial Sector					
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	Jun-08
Growth in Broad Money (M3)	19.3%	19.6%	22.0%	21.6%	May-08
Growth in Credit to the Private Sector	9.2%	21.4%	30.0%	33.4%	May-08
Average 3M SAR Deposit Rate	5.1%	4.9%	3.0%	2.9%	6M08
Average 3M USD Deposit Rate	5.2%	5.3%	3.1%	3.0%	6M08
Spread, in Basis Points	-6.4	-35.4	-10.0	-12.0	6M08

Sources: Reuters, SAMA and NCB forecasts, data has been updated to reflect revisions and updates

II. 2007 Macro Story

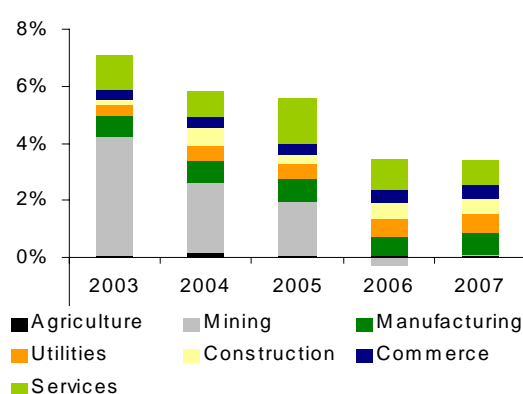
Saudi Arabia's slow-but-steady growth was largely driven by private domestic demand in 2007. Recently, official real GDP growth estimates in the preceding three years have been downwardly revised with a total of 1.7%, or an average of 0.6% per year, which would imply that growth was moderately reduced. Nevertheless, the economic growth cycle is moving ahead. Despite oil production cuts in late 2006 and early 2007, real GDP growth slightly increased to 3.4% in 2007 from 3.1% in the previous year. The average Saudi oil production was higher at 9.1 MMBD in 2006, compared with an average of 8.7 MMBD throughout all of 2007. But with the surge in oil prices in late 2007, the contribution of the oil sector, in nominal terms, turned positive last year. However, real GDP growth was largely driven by the expansion in the non-oil sectors, pushed by rising government spending, foreign capital inflows, and rapidly growing private-sector credit. Real non-oil private GDP has grown at annual rate of around 5.8% in 2007, slightly weaker than the 6.1% observed in 2006, but still solid. As figure 1 illustrates, the non-oil sector continued to provide an increasingly positive contribution to overall growth, particularly manufacturing, construction and services.

1. Real GDP Growth, Contribution



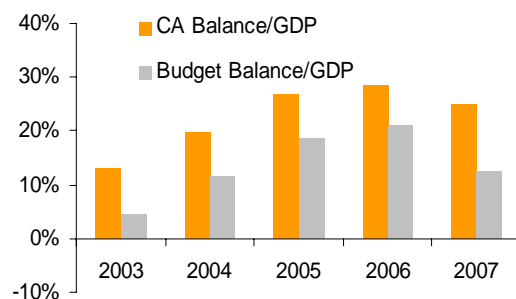
* At constant factor cost, Sources: SAMA and NCB

2. Real GDP Growth*, Contribution

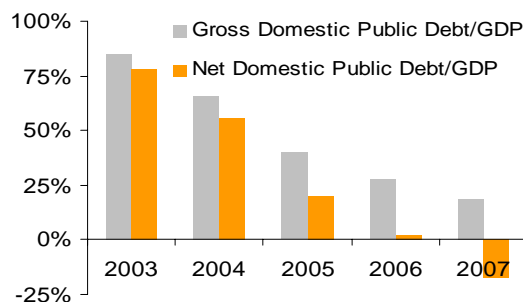


The year also witnessed the government's ability to administer counter-cyclical fiscal policies. Despite high oil prices, the build-up of government spending on infrastructure and social projects, as well as investment programs to expand oil production and refining capacity has narrowed both the fiscal and current account surpluses. In 2007, the fiscal and external current account surpluses-to-GDP ratio fell to 12.5% and 25%, respectively, from 21% and 28.4% in the previous year. Nevertheless, the twin fiscal and current account surpluses were sizeable in 2007, at SAR178.5 billion and SAR356 billion, respectively. It is worth mentioning that sustained fiscal surpluses since 2003 helped the government to replenish its stock of deposits at SAMA (mostly invested in US treasuries) to SAR517 billion by yearend. Accordingly, net domestic public debt (of the central government) fell sizably to -17.5% of GDP, after hovering close to 80% of GDP back in 2003. This implies that the government holds assets that are in excess of its current debt level.

3. Twin Surpluses



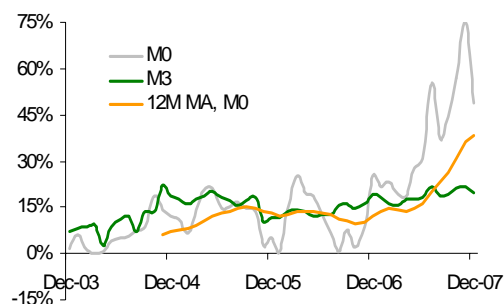
4. Domestic Public Debt



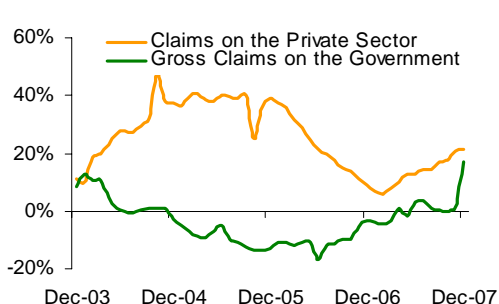
*Sources: SAMA, Ministry of Finance budget announcements and NCB

Money supply continued to expand at a rapid pace. By 2007 yearend, money supply (M3) accelerated to 19.6% Y/Y, the highest in recent years. In essence, the expansion in money supply is largely due to the government's continued injection of petrodollars through current and capital expenditures. These liquidity injections include domestic public debt settlements and the recapitalization of specialized credit institutions and the public investment fund. The impact of these fiscal liquidity operations are captured by the sustained strong growth in the monetary base (M0), reaching to 49% Y/Y towards the end of 2007, as shown in figure 5 below. Moreover, the expansion in money supply was also driven by the growth in domestic bank credit, especially the credit extended to the private sector, reflecting the impact of lower interest rates throughout 2007. By 2007 yearend, private sector claims accelerated to 21.4% Y/Y, while claims on the public sector expanded at a slightly slower pace of 17% Y/Y. Interestingly, as the claims on the public sector declined sharply throughout 2003 and 2006, the claims on the private sector expanded, as shown in figure 6. But in 2007, claims on the public sector began to accelerate in tandem with private sector claims.

5. Y/Y Growth in M0 and M3



6. Y/Y Growth in Claims



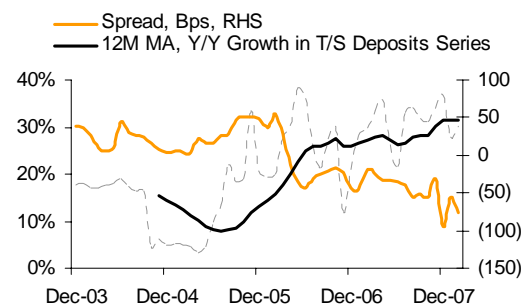
Sources: SAMA and NCB

Moreover, growth in money demand accelerated in 2007, mainly due to a lower opportunity cost of holding money and a higher trading volume on the local stock exchange market. After slowing down to 10.3% Y/Y in Dec 2006, the growth in money demand (using growth in M1 as a proxy) increased to 22.6% Y/Y in Dec 2007. This was partially driven by the demand for liquidity for equity trading purposes, as the Saudi stock market began to recover in 2H2007. But more importantly, the persistence of negative real interest rates has lowered the opportunity cost of holding money, and hence increased the demand for money. Faced with an excess supply of interest-bearing deposits and lower fund utilization rates, the rates on SAR-deposits by Saudi banks fell below their USD counterparts in the 2H2006. The negative spread persisted even after SAMA raised the policy interest rate corridor by 30bps to 5%-5.5% in Feb 2007. But with SAMA aggressively cutting the reverse repo rate by 75bps to 4.25% in Nov and again by 25bps to 4% in Dec, the negative spread widened to as high as 90bps by 2007 yearend. This has induced the shift towards demand deposits from time/saving deposits, which intensified towards the end of 2007. Interestingly, the negative rate differential, which reflects market expectations of a revaluation of the SAR, did not disturb the USD/SAR peg.

7. Y/Y Growth in M1*



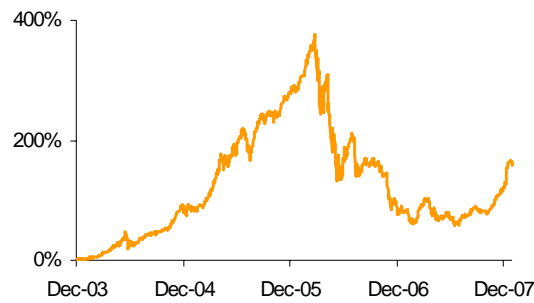
8. Interest Rate Spread**



* Proxy for money demand, ** 3M deposit rate on SAR-denominated deposits less 3M deposit rate on USD-denominated deposits, Sources: SAMA and NCB

The persistence of low or negative real interest rates has been a prime factor underpinning the robust stock market performance in 2007. Declining interest rates together with a recovery in bank lending activity has spurred investments in financial assets, which in turn has led to a revival in the Saudi stock market. After falling by nearly 53% for the whole of 2006, the stock market index began to show some tentative signs of recovery by the 2H2007, and with the surge in domestic liquidity the stock market index had increased by around 41% by the end of the year. Other factors lending support to the stock market rise in 2007 included: (1) the continued rise in oil prices, (2) the perception that Saudi Arabia is immune to the troubles in the global economy, (3) reforms enabling the access of GCC nationals and foreign residents to trade, (4) the entry of new brokerage companies providing further access to stock market trade, (5) strong IPO supply and demand, and (6) robust corporate performance.

9. Saudi Equity Market Index



Sources: Tadawul and NCB

Ironically, however, the banking sector witnessed a sharp decline in profits, mainly on the back of falling stock market brokerage fees. In 2007, growth in aggregate net income of the 11 locally incorporated banks declined by 14.5%, compared to a 31.2% gain in 2006. Stock market brokerage fees have significantly declined towards the end of the year due to: (1) increased competition amid the arrival of new brokerage firms, (2) lower traded volumes, following the stock market crash in 2006, and (3) a 20% cut in stock market trading commissions, enforced by the Capital Market Authority (CMA) in late 2006. On a positive note, this had led banks to refocus on core banking activities, and with strong corporate loan growth, core banking income increased by 13.9% in 2007, compared to 18.8% in 2006. In addition, the banking sector remained sound, with excess liquidity and high levels of capitalization. Total assets were worth SAR1.04 trillion by 2007 yearend, of which 8.1% were in cash and other liquid equivalents. The average risk-weighted capital adequacy ratio was 17.7% at the end of 2007, while nonperforming loans stood at less than 2% of total loans. Accordingly, it was not surprising to see that several banks received rating upgrades throughout the year.

Box 1: Inflation... A Growing Concern in Saudi Arabia

Inflation pressures in Saudi Arabia have risen considerably in recent months, owing to domestic and external factors. While inflation has traditionally been in the 1-2% range, prices have recently increased to 10.4% Y/Y in May 2008. Inflation is being mainly driven by rents and food prices. The renovation, rent, fuel, and water index increased to 18.5% Y/Y in May, while the foodstuffs and beverages index advanced to 15.1% Y/Y over the same period.

Domestic Factors:

1. Rising aggregate demand: The economic cycle is moving ahead strongly, given the acceleration in public and private investment expenditures. While fiscal policy is turning more expansionary in response to the sharp increase in oil revenues, there has been a substantial increase in private investments on the back of market liberalization reforms. However, the surge in domestic demand has contributed to supply shortages in some inputs, like cement and skilled labour, pushing up production costs and leading to higher prices.

2. Supply constraints in key sectors of the economy: The increase in rents is largely due to supply constraints in the housing sector, given: (1) a rapidly growing population and the large inflow of expatriate labor, (2) shortages of certain building materials, like cement and steel, (3) the absence of a mortgage finance law, and (4) restrictions on foreigners to purchase land or real estate. In the agricultural sector, domestic supply shocks contributed to higher food prices, including: (1) bad weather conditions, (2) lower subsidies since WTO accession in 2005, (3) higher input costs and (4) shortage of agricultural labor.

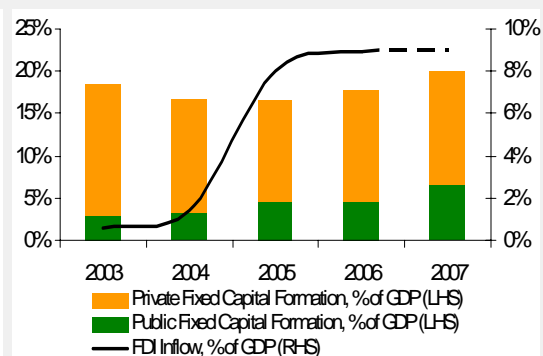
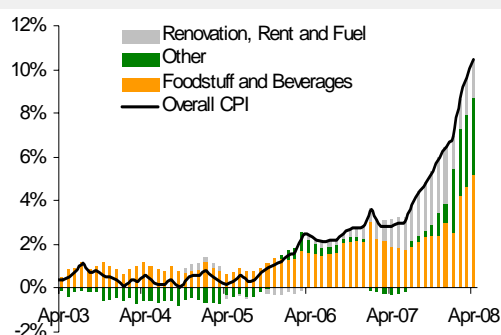
3. Excess liquidity: Money supply has accelerated in response to higher government spending, retirement of public debt, large foreign capital inflows and rising private-sector credit. The situation has been further complicated by the chosen monetary policy framework in Saudi Arabia (see Box 2). Successive interest rate cuts by SAMA resulted in negative real interest rates. This, together with strong fundamental drivers, helped fuel asset price appreciation in the real estate market. Land and real estate prices have significantly increased in the Kingdom, particularly in the capital city, Riyadh, and areas surrounding the new economic cities.

External Factors:

1. Higher world commodity prices: The surge in world prices for several commodities also contributed to inflation. The government has introduced subsidies this year on some imported food items like baby milk and rice, but these constitute approximately less than 2% of the CPI basket by weight compared to 26% for all food items. Prices of domestic agricultural produce have also risen because of higher prices for imported inputs like fertilizer and seeds. Higher freight and transportation costs also contributed to higher world commodity prices. Based on the share of Saudi imports from the top 18 major trading partner countries, weighted average export prices increased by 6.2% in the period 2005-07.

2. Exchange rate weakness: The depreciation of the USD and accordingly the SAR against the currencies of other major trading partners has added to imported inflation pressures in Saudi Arabia. Moreover, with a growing share of expatriate labor in the Kingdom, there has been increased pressure to increase wages denominated in SAR. The weighted impact of exchange rate movements against the SAR for the top 18 major trading partner countries amounted to 3.3% in the period 2005-07.

Inflation in Saudi Arabia is being mainly driven by rents and food prices. Investment has surged across the oil and non-oil sectors of the economy in recent years.



External factors have significantly contributed to inflation in the Kingdom.

Country	Weighted Average Export Price Inflation	Weighted Average Exchange Rate Inflation
1 United States	1.3%	0.0%
2 China Mainland	1.0%	0.0%
3 Germany	0.5%	0.8%
4 Japan	0.9%	-0.6%
5 England	0.1%	0.3%
6 Italy	0.7%	0.4%
7 France	0.0%	0.4%
8 South Korea	-0.3%	0.4%
9 India	0.5%	0.2%
10 UAE	0.1%	0.0%
11 Australia	0.4%	0.2%
12 Thailand	-0.1%	0.4%
13 Brazil	0.3%	0.4%
14 Switzerland	0.1%	0.1%
15 Sweden	0.1%	0.2%
16 Holland	0.2%	0.1%
17 Belgium	0.1%	0.1%
18 Turkey	0.2%	0.0%
Total	6.2%	3.3%

Sources: IMF, SAMA and NCB

Box 2: Monetary Policy Challenges in Saudi Arabia

Monetary policy in Saudi Arabia is constrained by the SAR peg to the USD, given open capital account movements. The long standing policy of linking the SAR to the USD has worked well in the past, as the economy was dominated by public expenditure that was entirely dependant on inflows from fluctuating oil revenues and real economic growth was low averaging at around 2% throughout the 1980s and 1990s. However, recent monetary policy easing in the US has forced SAMA to lower interest rates, leading to increasingly negative real interest rates at a time when the economy is already expanding. Since early Nov 2007, SAMA has cut the reverse repo rate in tandem with the US Federal Reserve by a cumulative 300bps to 2.0%, while keeping the official repo rate unchanged at 5.5%. Moreover, the persistent weakening of the USD has implied a real effective depreciation for the SAR, while the surge in oil revenues has placed more pressure on the government to increase public spending. All these factors added to domestic demand pressures, where inflation reached unprecedented levels in the Kingdom.

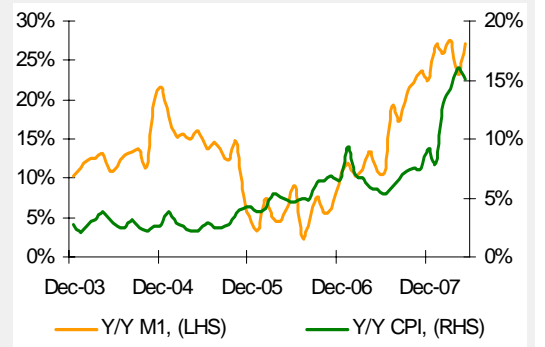
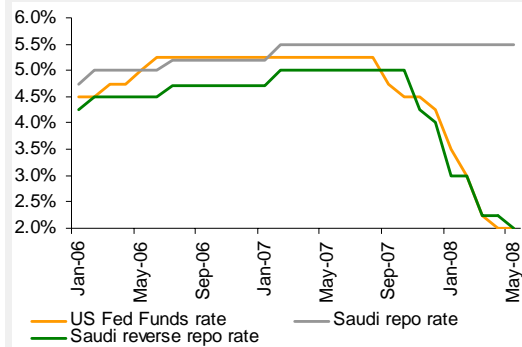
In order to offset the expansionary impact of lower interest rates on liquidity, while maintaining the exchange rate peg, SAMA has resorted to changing the reserve requirements for commercial banks. In the period between Nov 2007 and May 2008, SAMA raised the reserve requirement on demand deposits four times, from 7% to 13%, and for the first time lifted the reserve requirement on time and saving deposits to 4% from 2%. In theory, a higher reserve requirement reduces the supply of money available to banks for lending activity, thereby slowing down the growth in domestic credit and eventually money supply growth.

SAMA's decision to raise the reserve requirements has several implications. First, banks already hold reserve assets in excess of statutory requirements, which reached up to 50% in April 2008. Instead of cutting back on lending, banks opted to reduce other deposits with SAMA. Statutory deposits at SAMA rose to SAR50.4 billion in May 2008 from SAR28.8 billion in Nov 2007, while other deposits at SAMA fell by SAR35.3 billion, over the same period. Flushed with liquidity, banks accelerated private-sector credit, rising to 33.4% Y/Y in May 2008, and consequently money supply (M3) growth advanced to 21.6% Y/Y over the same period. Second, frequent changes in the reserve requirements can be highly disruptive to the operation of individual banks. Banks have already set aside around SAR31 billion since Nov 2007, which is equivalent to approximately 3% of total assets. But more importantly, a higher reserve ratio is associated with an opportunity cost for banks, i.e. the amount of interest income forgone if these reserves were invested in higher-yield assets. They are in effect a direct tax on banks, which will adversely impact the profitability of the sector.

Now that the monetary easing cycle in the US is reaching an end, SAMA might not be forced to cut interest rates again this year. This will certainly provide some relief for SAMA for some time. However, this does not omit the possibility of another hike in reserve requirements. The ceiling for reserve requirements is 15% according to Basel II regulations, but legally SAMA reserves the right to hike up to 17.5%. Recent issuances of treasury notes in combination with higher reserve requirements apparently have reduced money supply growth, but are unlikely to slow it significantly. Meanwhile, banks might be inclined to increase the spread between lending and deposit rates as signs of rising inter-bank rates have already emerged. Interestingly, increasing the cost of credit to borrowers will also help reduce money supply growth. Either way, SAMA should stay focused on guarding asset price appreciation and a possible build up in related vulnerabilities on bank financials through appropriate prudent measures. Meanwhile, we do not expect SAMA to revalue the SAR or change its long standing position on the SAR/USD peg. Accordingly, the fight against inflation will require more coordination between monetary and fiscal tools.

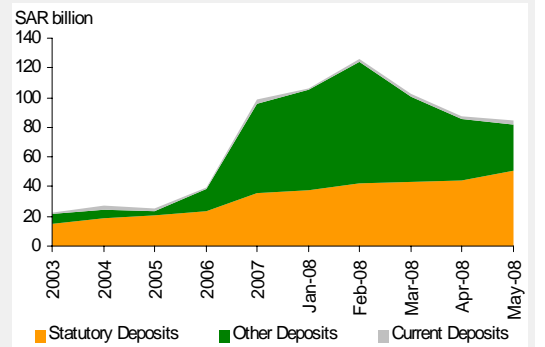
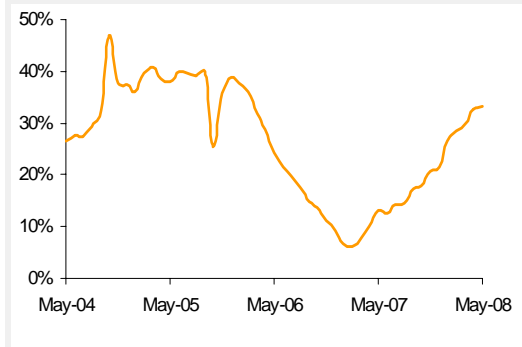
SAMA was forced to follow the Fed on interest rate cuts.

This induced the growth in money supply and inflation.



Despite hikes in bank reserve requirements, private-sector credit growth is still strong.

This is because banks already hold reserve assets in excess of reserve requirements.



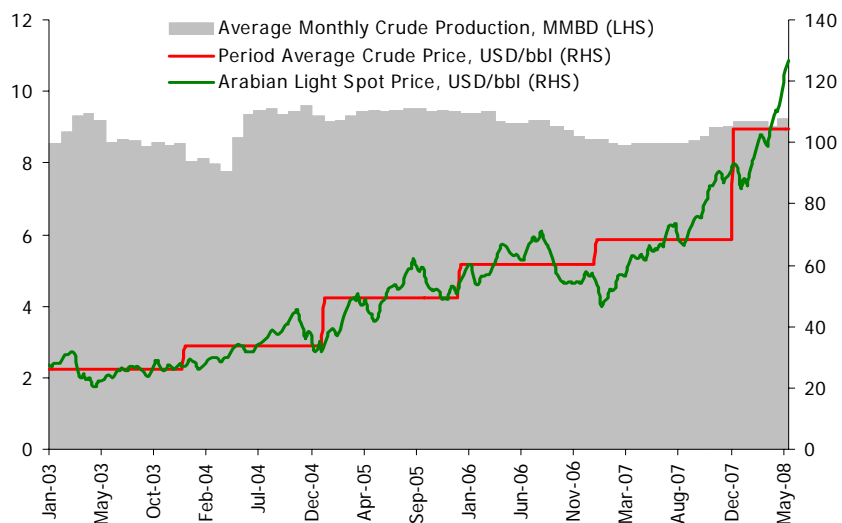
Sources: Reuters, SAMA and NCB

III. 2008 Macro Outlook

Demand and supply fundamentals will continue to support high oil prices in the long-run. Based on our assessment of the fundamentals we believe that the oil market will remain tight in 2008, for the following reasons. First, strong oil demand growth in emerging market economies, namely Asia and the Middle East, is expected to offset slowing demand in the US and other OECD countries. Second, non-OPEC supply growth is expected to fall short of demand growth for yet another year. Actual non-OPEC supply growth has consistently fallen below the forecasted figures, and is unlikely to improve in the long-run due to: (1) rising exploration and development as well as material costs that pushed up the marginal cost of oil production to USD60-70/BBL for non-OPEC members, and (2) foreign direct investment (FDI) restrictions in key oil exporting countries, like Russia. Third, OPEC supply growth is expected to remain relatively flat in the long-run. This is because most OPEC producers have very little spare capacity. Saudi Arabia has agreed to increase production by 0.2-0.3 MMBD in May 2008. But even with Saudi Arabia's excess capacity, of around 2.1 MMBD, a high oil price threshold, of around USD40-45/BBL, is required to deliver capacity expansions. Finally, geopolitical tensions in key oil producing countries have intensified recently, particularly in Nigeria and the Middle East.

Notwithstanding, it appears that speculation has gotten ahead of those fundamentals in the most recent oil price developments. Oil prices have significantly increased in recent months. The West Texas Intermediate (WTI) spot crude oil price reached a record high of around USD140/BBL in Jun, and the 2008YTD average is now 56% higher than average 2007 prices. The recent run up in oil spot prices has been largely driven by the ever-increasing volume of speculative purchases of future contracts. Crude oil futures offer a hedge against a falling USD and rising inflation and in an environment of declining global equities and interest rate cuts, investment in these contracts has become relatively attractive. The speculative bubble in the oil market has also found support from fundamentals, which helped shape market expectations of supply growth stagnating in the face of growing demand. However, as the USD stabilizes and inflation subsides, speculative investment in oil will gradually fall, and hence prices will largely reflect the underlying supply and demand fundamentals.

10. Saudi Oil Output and Prices

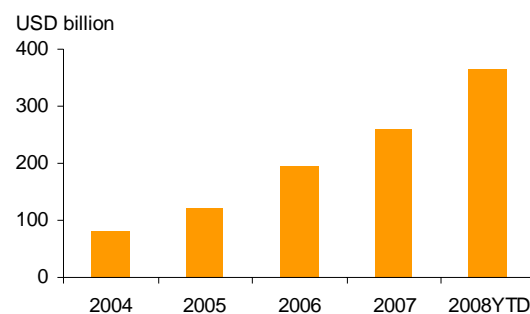


Sources: EIA, OPEC and NCB

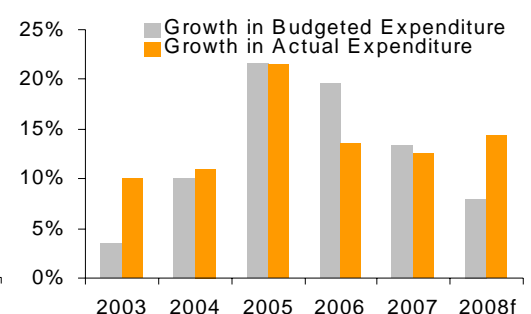
Accordingly, we have revised up our forecast for Saudi crude oil prices and output in 2008. During 5M2008, average Saudi crude oil price stood at USD101.3/BBL and average production of crude oil reached 9.15 MMBD, up from an average of USD68.5/BBL and 8.7 MMBD in 2007. Based on our assessment of the fundamentals and intensity of speculative oil investment, we expect Saudi oil output to increase by 0.6 MMBD to 9.3 MMBD in 2008, and Saudi crude oil prices to average around USD100/BBL, up by nearly 46% from the previous year. Consequently, this will have a positive impact on our outlook for the Saudi economy in 2008.

The current account surplus will be exceptionally strong this year, primarily on account of high oil export revenues. We expect oil export revenues to increase by 26% to a new record of around USD259 billion in 2008. Non-oil exports are also expected to be strong this year, but will grow at a slightly slower pace of around 8% to USD30 billion. Nevertheless, total exports are forecasted at around USD289 billion in 2008, compared with USD233 billion in the previous year. Imports are expected to grow by 11% to USD92 billion in 2008, which is the largest in recent years. This is based on robust domestic demand and higher global prices for food, raw materials and capital goods this year. Accordingly, we expect the current account surplus to reach an all-time high of USD138 billion in 2008, much larger than the USD95 billion in 2007, but relative to GDP it will stand at around 28% in 2008. The economy's robust external position will be reflected in higher net foreign assets this year. In 2007, these assets grew by 30% to USD312 billion, and had reached USD365 billion by May 2008.

10. Net Foreign Assets*



11. Growth in Public Expenditures



*In Banking System only, Sources: SAMA and NCB

Higher oil revenues will also lift the budget surplus in 2008. We expect the budget surplus to be around SAR565 billion in 2008, by far, larger than the SAR40 billion that was released in the 2008 government budget. This is largely due to higher oil revenues, which are expected to reach SAR997 billion, while non-oil revenues are forecasted at SAR75 billion in 2008. On the expenditure side, SAR410 billion has been budgeted in 2008, out of which 40% are allocated to infrastructure and capital projects. However, the government will most likely exceed budgeted expenditures by an average of 13-15%, to reach around SAR507 billion, as has been historically the case. The government's inflation alleviation package, which includes a public sector pay rise and direct subsidies on foodstuffs, building materials, and other consumer goods will probably be one factor for the government's overspending this year. Also, consistent with its indirect fiscal stimulus strategy, the budget surplus will be large enough to stimulate the economy further by injecting additional funds into specialized credit institutions and the retirement of public debt.

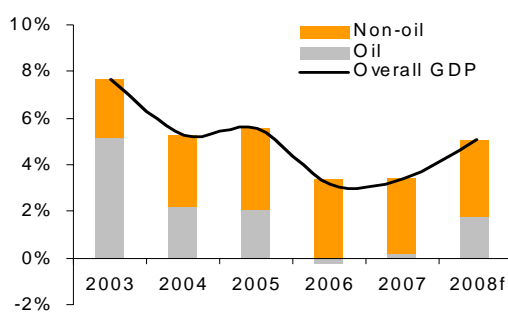
12. Government Revenue and Expenditure Balance

(SAR billion)	2007 Actual	2008 Budget	2008 Forecast
Total Revenue	622	450	1072
Oil	558	383	997
Non-Oil	63	67	75
Total Expenditure	443	410	507
Current	358	245	405
Capital	85	165	102
Deficit / Surplus	179	40	565

Sources: SAMA and NCB

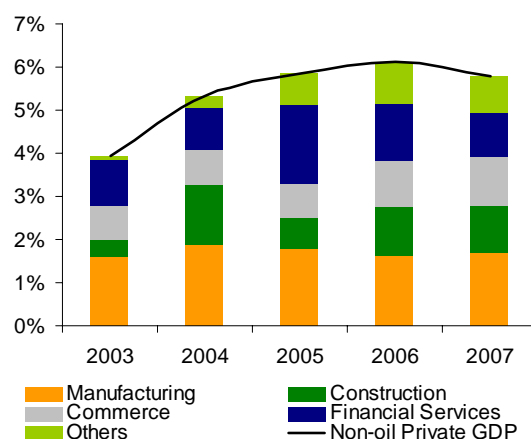
We forecast real GDP growth to accelerate to 5.1% this year in line with the rebound in crude oil output, while private investment in the non-oil sectors of the economy is expected to gather pace. The oil sector remains the core of economic activity in Saudi Arabia, providing the financial underpinning for government expenditure plans and broader economic confidence. In real terms, the contribution of this sector has slowed markedly as Saudi Arabia cut crude oil production in recent years. But with higher crude oil output and investment in production capacity, real oil GDP is set to increase by around 5.6% this year, providing a significantly positive contribution to overall growth. Meanwhile, private domestic demand has become an increasingly important driver of economic growth, underpinned by structural and market liberalization reforms. In particular, manufacturing, construction, commerce and financial services are the leading sectors of the economy (see figure 14). We forecast real non-oil GDP to increase by around 4.8% in 2008.

13. Real GDP Growth , Contribution



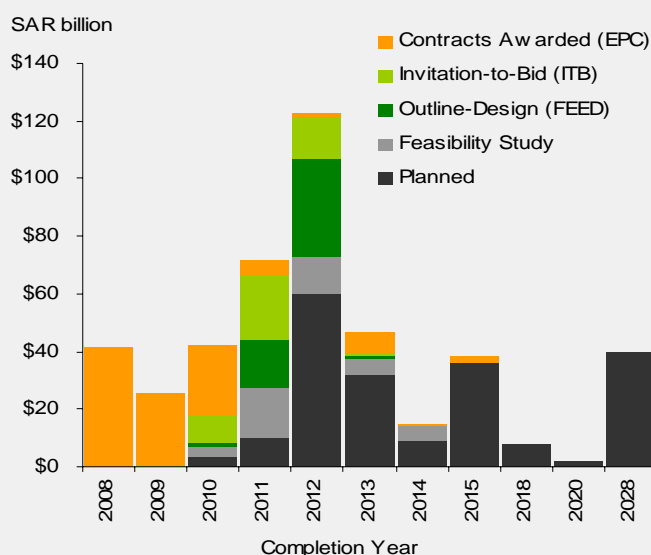
Sources: SAMA and NCB

14. Real Non-oil Private GDP Growth, Contribution

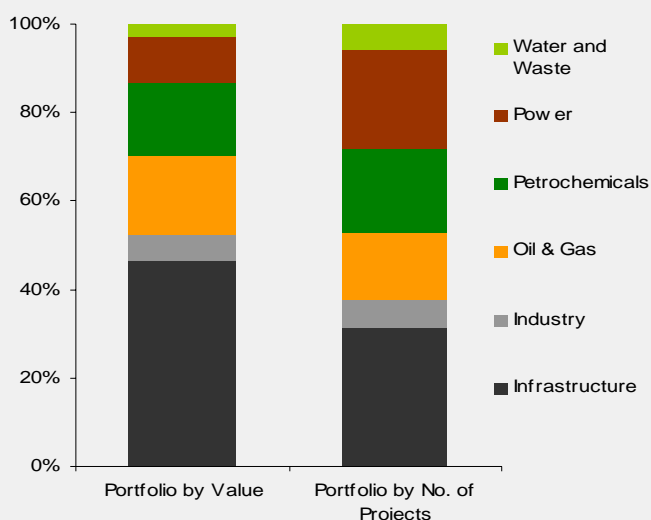


Box 3: The Saudi Construction Boom Building the Future


The Kingdom is on the verge of an unparalleled construction boom. Projects in excess of USD460 billion (SAR1,725 billion) are currently underway, all of which have significant construction components. This value figure, however, is a moving target, as projects are announced, re-scoped or cancelled on a daily basis. Nonetheless, forward expectations are for more projects to enter the pipeline.



Strategic projects, such as the Seven Economic Cities and Industrial Zones, Oil & Gas, Petrochemicals, Mining & Minerals, Transportation and Utilities, have all been designed to leverage the Kingdom's comparative advantages; a low cost energy producer and a strategic geographical location to expand the non-oil economy, specifically the non-oil private sector. To-date, private sector participation in the aforementioned mega-projects is close to 80% of total projects' dollar value, with the balance undertaken by the public sector, mainly in the form of seed capital and land subsidies.



Sources: MEED and NCB



As we move forward, it is imperative to ask two critical questions: will these projects actually materialize? And if so, will they achieve the economic diversification intended to reduce the Kingdom's reliance on oil? While it may still be early to give a decisive judgment on these two issues, there are, however, a number of indicators confirming that these investments are progressing on track.

First, roughly 70% of the 578 announced projects, valued at USD210 billion, are progressing through advanced execution phases, compared with only 37% in Mar 2006. They are mostly concentrated in the energy and public utilities sectors; Oil & Gas, Petrochemicals, Power and Waste & Water.

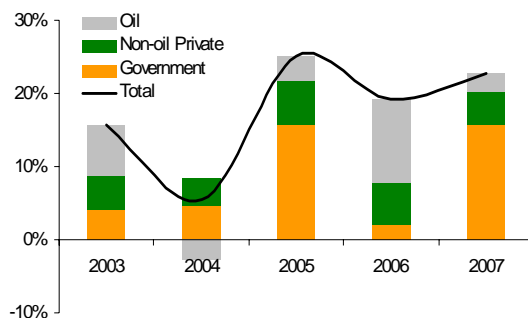
Second, this wave of investment expenditure will most likely produce a larger multiplier effect on national income, opposed to previous investment sprees by the government. In spite of the sizable import component for a number of projects, typically petrochemicals and oil & gas, more investments are geared towards the non-tradable sector, which includes construction, transportation, storage and communications, real estate development and utilities.

Finally, another distinguishing factor in the current investment boom is the growing role of the private sector, whether local or foreign, in the origination, planning, financing and execution of projects. Public-Private Partnerships (PPP) are rapidly forming, with the government providing seed capital for projects initiation, while the private sector focuses on finance and execution. This new dynamism not only ensures the economic viability of the selected projects, but also broadens the non-oil private sector base, while reducing the fiscal burden on the government.

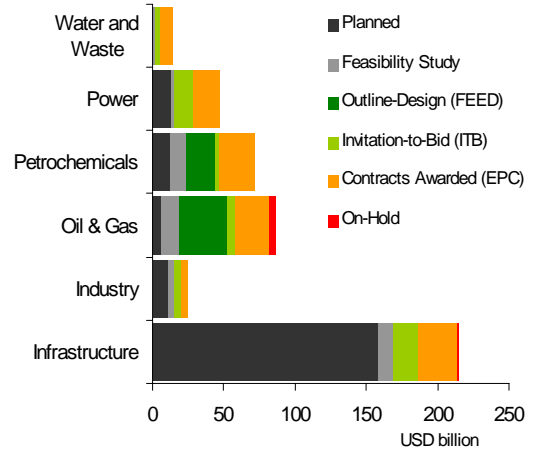
With this noticeable progress supported by direct and indirect prudent fiscal stimulus and firm oil prices, the medium-term outlook for the Kingdom's economy is highly promising.

Investment expenditure will be a key driver of growth in 2008. In 2007, nominal gross investment expenditure grew 22.8%, mainly driven by the growth in government investment expenditure as shown in figure 15. Although higher levels of investment will feed into inflation in the short-run, it will ease various supply bottlenecks within the economy over the longer run. Our bullish stance on investment is based on the following factors: (1) roughly 70% of the 578 announced projects, valued at USD210 billion, are in the advanced execution phases (see figure 16), (2) a significant portion of investment expenditure is being led by the private sector, around 80% of the total value of the mega projects, (3) incremental project additions have picked up since Mar 2008 (see figure 17), (4) liberalization initiatives are now accruing to many sectors, namely, services, petrochemicals and cement, as per Saudi Arabia schedule of commitments in the WTO accession agreement, (5) sizeable FDI inflows, which are expected to have grown in excess of the USD18.3 billion attained in 2006, as foreign companies participate in extensive joint ventures, (6) accelerating corporate credit growth (34% Y/Y in 4Q07) and (6) strengthening backward and forward linkages, particularly in the oil, petrochemical and mining sectors.

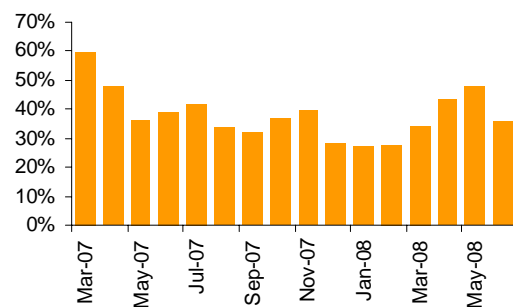
15. Growth in Investment Expenditure



16. Projects, Classified by Status



17. Y/Y Growth in Projects' Additions

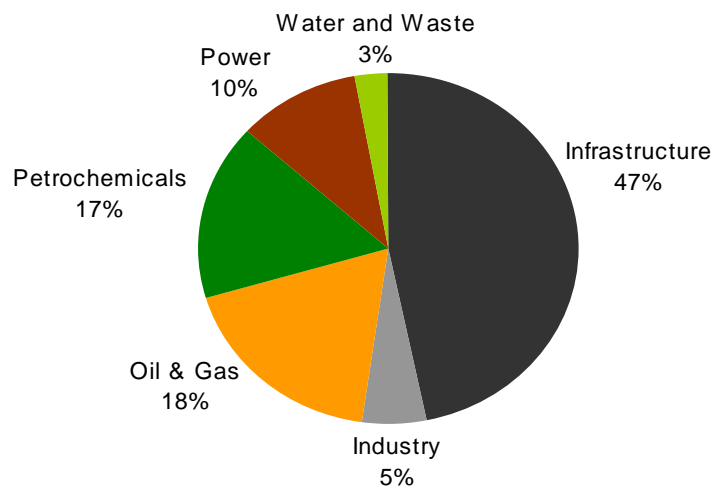


Sources: SAMA, MEED and NCB

The Saudi government investment plan can be characterized as a strategic plan focused on the development of capabilities at the national level. These capabilities can be grouped under three broad headings: physical investment, human capital development and technology acquisition. As noted earlier, the government capital expenditure is accelerating, largely spent on infrastructure and heavy construction projects, including schools/universities, roads, railroads, airports and water/sewage plants. The government has also mobilized sizable resources to develop human capital through the expansion of existing universities while building new ones. Finally, the government is investing in technological infrastructure, such as the King Abdullah University for Science and Technology, thus providing the basic scientific knowledge to further develop new emerging industries. At the same time, the government has been more selective on the type of FDI inflows in order to expedite technology transfer. The outcome of this new strategy will certainly enable the private sector to play a greater role in Saudi Arabia's economic growth and structural transformation process.

In the current phase of the investment plan, the government is building a competitive advantage in five main industries: oil, petrochemicals, fertilizers, aluminum and steel. This choice was to ensure a greater role for energy-intensive industries since the country has 25% of world's oil reserves, but only 2% of its energy-intensive industries. Aramco, Sabic, and Ma'aden will be spearheading government plans through joint ventures with local and foreign investors. The ultimate success of these projects will depend on two dimensions: (1) the synergy that can be developed among the five industries since there is a huge degree of interdependence among them in terms of the provision of energy and feedstock and (2) the rapid development in infrastructure in terms of railways, ports, roads and utilities so to increase the efficiency of input-output logistics.

18. Projects, Classified by Sector



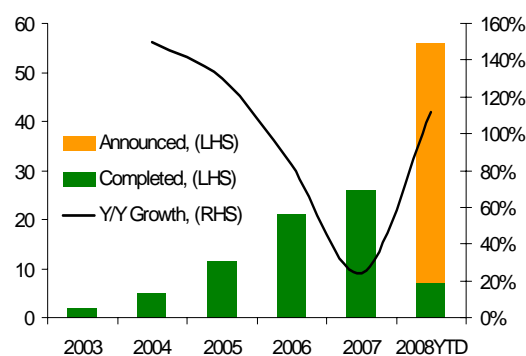
Sources: MEED and NCB

Amongst the strongest drivers of investment demand in Saudi Arabia are capacity expansions currently undertaken by the oil & gas and petrochemical sectors, mainly Saudi Aramco, Sabic and Ma'aden. Despite facing delays, Saudi Aramco announced plans for key projects to increase both its crude production and refining capacities. It is aiming to raise its crude oil capacity by 2.2 MMBD to 12 MMBD by the end of 2009, as well as its total refining capacity, from 2.1 MMBD to as much as 3.7 MMBD by 2012. Saudi Aramco will invest USD129 billion during the next five years on new energy projects, of which USD70 billion will be financed through joint ventures. Sabic is also moving forward with its expansion plans to boost production of basic and intermediate chemicals, fertilizers, and steel to reach more than 50 million tones by 2010. Mining activities undertaken by Ma'aden are progressing, especially phosphate and bauxite mining in the northern region, which will be the feedstock for producing phosphate fertilizers and aluminum, respectively. The Saudi Arabia General Investment Authority, SAGIA, expects the Kingdom to be a global player by the time such projects are up and running, with the diammonium phosphate (DAP) accounting for 10% of global production in two years, and the planned upstream aluminum projects, especially the Jizan and Jubail smelters, having a combined productive capacity of 3.1 MMTPA of primary aluminum by the end of 2012, at 7% of the global production.

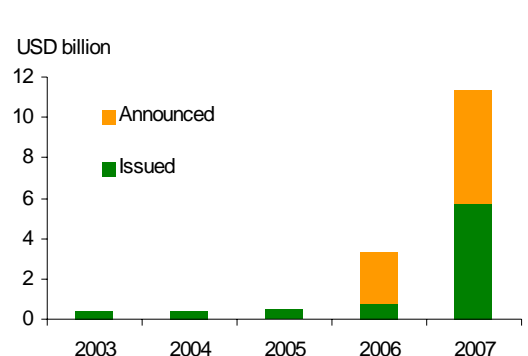
On the financing side, we believe that constraints are at best minimal, as banks are no longer the only source of finance to Saudi companies. Historically, banks have dominated the financial system in Saudi Arabia, being the main provider of funding to companies besides self-financing. In fact, bank credit to the private sector, both consumer and corporate, account for a major source of banks' resources (SAR626 billion in 1Q08), averaging above 50% of banks' total assets. Increases in fiscal current and capital expenditures and rising domestic saving over the last few years have rendered Saudi banking awash with liquidity, as credit to the corporate sector (SAR386 billion) accounts for nearly 60% of non-oil GDP. But with Saudi accession to WTO and financial liberalization, foreign financing and direct access to capital markets have accelerated, reducing corporate sector reliance on banks' funding. In the period between Mar 2007 and Mar 2008, fresh funding by the corporate sector (excluding foreign financing) increased by 29.8% Y/Y to SAR143.7 billion in 1Q08.

The corporate sector today can choose from a wide array of financial instruments. Since the beginning of the year, around SAR22 billion has been raised via initial public offerings (IPOs), compared with SAR18 billion for the whole of 2007. IPO activity in Saudi Arabia is likely to be strong in 2008 given, soaring domestic liquidity, ongoing market liberalization reforms and thriving domestic demand. Islamic financing, especially Sukuk are also becoming a vital avenue of raising funds, with their global volume rising to USD47.1 billion in 2007 compared with USD25 billion in 2006. In the GCC, the number of corporate Sukuk substantially grew by 62% Y/Y in 2007 and their value increased to USD13.5 billion in 2007 from USD6.8 billion in 2006, and USD2 billion in 2005. The Kingdom ranked third in 2007, after Malaysia and UAE, in its share from issuances of corporate Sukuk worth more than USD1 billion in three issuances. Overall, the total value of corporate Sukuk issued in 2007 was USD5.68 billion. We expect that growth in mega-Sukuk issuances will propel the currently non-existent small or medium-sized issuances, which will expand the Sukuk market in the Kingdom further.

19. IPOs, Announced vs. Completed



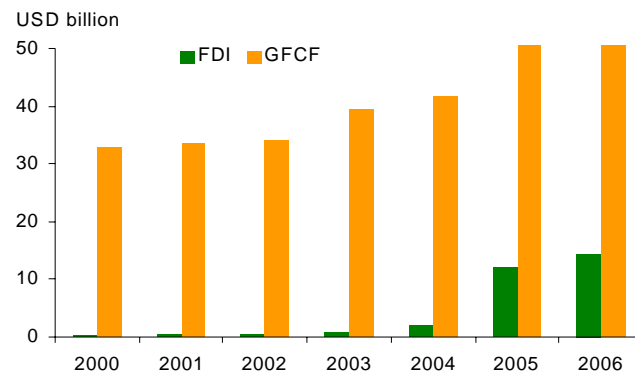
20. Sukuk, Announced vs. Issued



Sources: Zawya, Islamic Finance Information Service (IFIS) and NCB

FDI inflows are expected to continue their steep rise well into 2008. According to UNCTAD, FDI inflows increased by 51% to USD18.3 billion in 2006. We believe that FDI is driving overall investment spending in the Kingdom higher, as the share of FDI in gross fixed capital formation (GFCF) has increased significantly, from an average of 1% in the period 1990-2000 to a remarkable 32.1% in 2006. The surge in FDI inflows is associated with: (1) the extensive number and diversity of projects currently underway, amounting to at least USD460 billion, (2) the substantial increase in government and consumer spending levels, around 17.5% Y/Y and 6.5% Y/Y in 2007, respectively, (3) incentives like land and energy subsidies, (4) proximity and access to low cost energy resources and (5) lower barriers to entry across various sectors, with new regulations eliminating minimum capital requirements, speeding up company registration and easing restrictions on foreign investments. All of the abovementioned factors have improved the Kingdom's rank in the 2008 Doing Business Report prepared by the IFC-World Bank Group, from 38 to 23 out of 178 countries, making it one of the best ten performers worldwide. The 2007/08 Global Competitiveness Report prepared by the World Economic Forum also ranks Saudi Arabia 35 out of 131 countries, right after China.

21. FDI and GFCF



Sources: UNCTAD, SAMA and NCB

IV. Risks

Our forecasts indicate a strong economic outlook in the Kingdom despite the less benign global economic outlook. The risks to this central scenario decreased considerably since the beginning of the year as the Saudi economy appeared not to be affected by the global financial turmoil. Oil prices are likely to remain high as demand from emerging market economies is expected to support global demand for oil even if economic growth in advanced economies slows. Concerns over falling inventories and geopolitical tensions in the major oil producing regions, however, kept supply pressures elevated. The persistent current and fiscal accounts surpluses along with the build up of a sizable net foreign asset position has significantly reduced the vulnerability of the Saudi economy to negative terms of trade shocks and sudden fiscal retrenchment. In addition, the resilience of the banking system to systemic shocks has also improved sharply due to both top-down and bottom-up drivers. Top-down, as repeatedly highlighted by credit rating agencies, refers to the improvement in the government fiscal position and accordingly its ability to bailout banks in case of a bank-specific or systemic crisis. Bottom-up, the Saudi banking sector, as confirmed in the recent upgrade by Fitch of five Saudi Banks, remained profitable, liquid and sound up to 2Q2008. Table 22 below depicts key macro and banking sector vulnerability indicators of Saudi Arabia between 2002 until 2007.

22. Key Systemic Macro and Banking Sector Risk Indicators

	2003	2004	2005	2006	2007
1. Macro Risks					
Overall Budget Balance/GDP	4.5%	11.4%	18.4%	21.0%	12.5%
Gross Domestic Public Debt/GDP	85.0%	66.0%	40.2%	27.4%	18.7%
Net Domestic Public Debt/GDP	78.0%	55.5%	19.8%	2.1%	-17.5%
Net Banking Sector Claims on the Government (SAR bn)	94.2	48.5	-112.8	-214.9	-372.5
Overall Current Account Balance/GDP	13.1%	19.7%	28.5%	28.4%	24.9%
Net Factor Income/Merchandise Imports	8.8%	9.8%	9.1%	10.9%	12.1%
Net Foreign Assets/Imports of Goods and Services	119.2%	135.1%	178.3%	210.2%	206.4%
Net Foreign Assets/M2	78.5%	91.0%	131.4%	167.0%	169.3%
Merchandise Import Coverage (1Yr ahead imports, in months)	21.1	23.9	33.1	41.6	43.7
2. Banking Sector Systemic Risks (11 Locally Incorporated Banks)					
Gross Loans-to-Deposits Ratio	67.5%	73.8%	84.0%	80.8%	81.0%
Minimum Risk Assets/Total Assets	37.2%	33.9%	28.4%	28.9%	28.9%
Cash and Cash Equivalents/Total Assets	4.3%	4.4%	3.8%	5.4%	8.1%
Tier 1 Capital Adequacy Ratio	17.4%	17.6%	18.2%	19.4%	17.7%
Non-Performing Loan (NPL) Ratio	3.9%	2.3%	1.7%	1.6%	1.6%
NPL Coverage Ratio	135.0%	231.4%	179.0%	176.7%	158.0%

Sources: SAMA, financial statements of commercial banks and NCB

Nonetheless, the US Iranian standoff remains extremely dangerous. While a military conflict in 2008 is unlikely, US policy will continue to focus on financially isolating Iran through sanctions and on deterring Iran through military deployment and regional alliances. Meanwhile, the prospects for a resolution are dim, thus the nuclear issue will continue to be the main source of geopolitical risk in the Gulf region. Iran has gone on the record as threatening to close the strait of Hormuz, if it is attacked. Although a possible military conflict will push up crude oil prices and Kingdom's revenues, a commensurate plunge in consumer and investor confidence would have a net negative impact on the growth of expenditure, prompt capital flight and depress the equity market. In addition, credit to the private sector will more likely contract, thus depressing aggregate demand. The Gulf, including Saudi Arabia, would be directly in the firing line if hostilities erupt. Accordingly, the magnitude and repercussions of a US/Iranian military conflict will be very serious and, by far, should exceed those of the US/Iraq war in 2003.

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