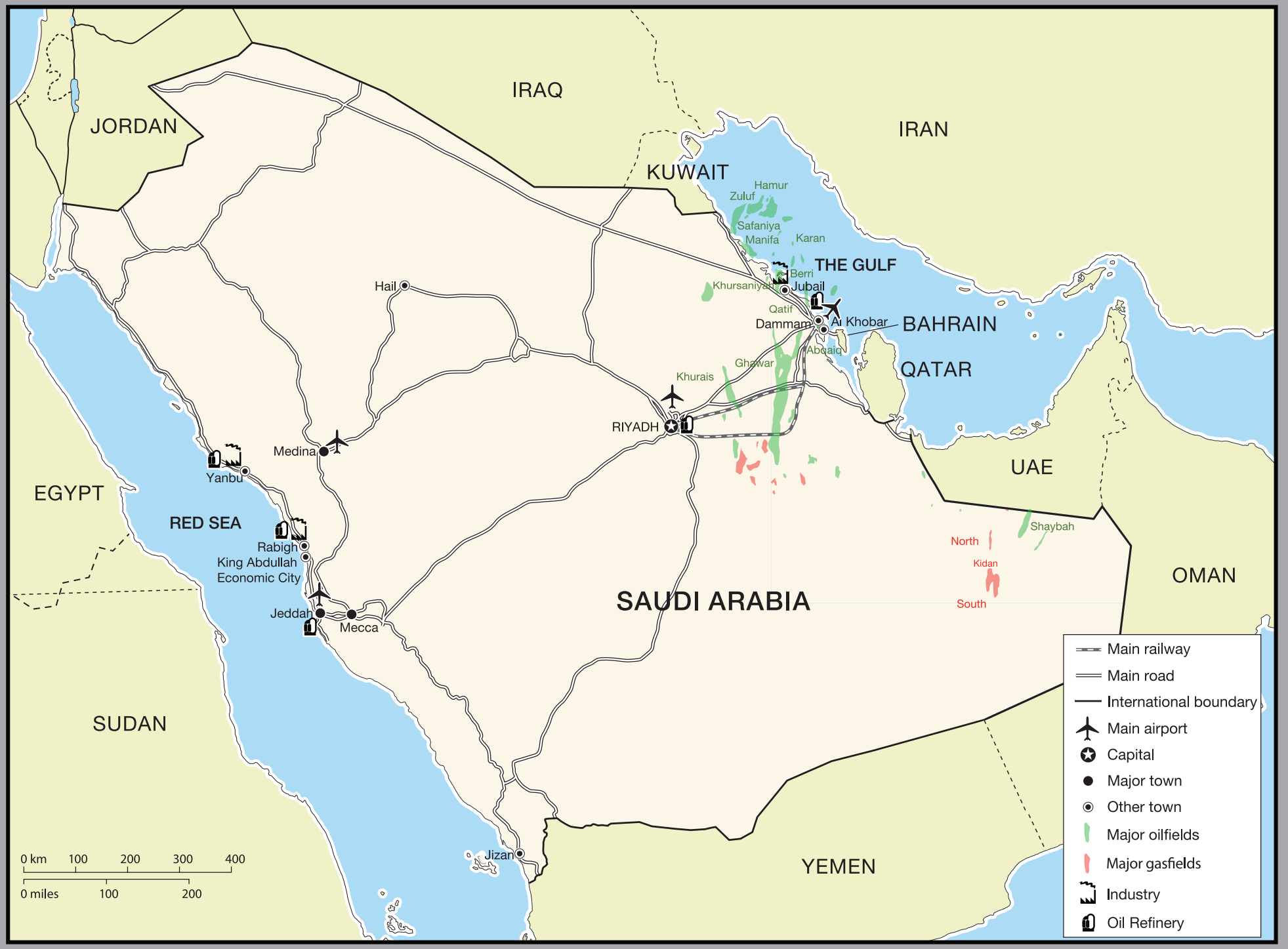
Saudi Arabia - Economic Insight

June 2011

QNB CAPITAL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Main railway
Main road
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Main airport
Capital
Major town
Other town
Major oilfields
Major gasfields
Industry
Oil Refinery

Outlook summary for 2011 and 2012

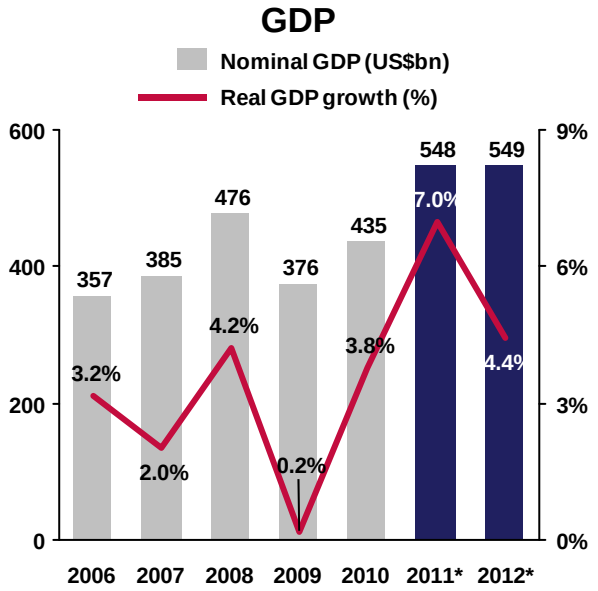
- The Kingdom of Saudi Arabia has a **population of 27.1m**, of whom 31% are expatriates. The national population has a relatively high proportion of young people, and the economy has struggled to create enough jobs for new labour market entrants. **The population is forecast to grow at an annual rate of 3.4% in 2011-12**

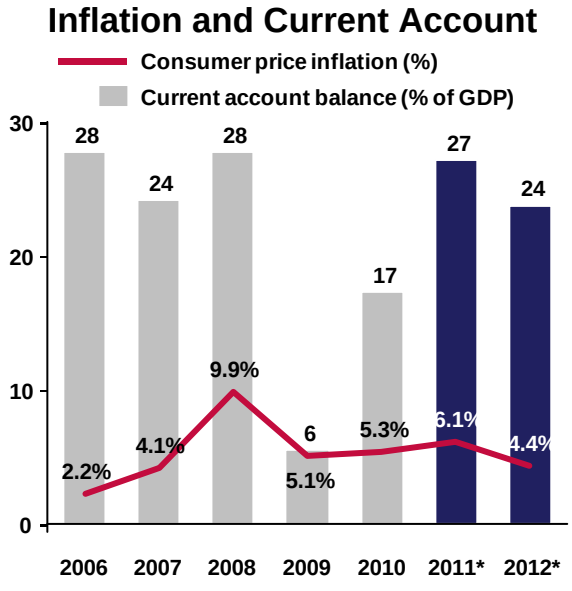
- **The Saudi economy is dominated by the oil sector**, which accounted for an average of 54% of GDP over the last five years. Despite being the world's largest oil exporter, the sizable population means that relative **oil wealth per national is lower than in other GCC countries**

- The government will continue to invest heavily in **oil refining and boosting natural gas production,** to help meet rising domestic energy demand. It is also supporting the petrochemicals sector and non-oil energy-intensive industries

- **Saudi Arabia aims to diversify the economy** from its dependence on oil, **create more jobs** and **spread wealth** to different regions. A key pillar of government plans is the development of four "**economic cities**", initiated with around $70bn of seed investment

- QNB Capital forecasts that **real GDP will grow at 7% in 2011 and 4.4% in 2012**, driven by higher oil production, particularly in 2011, in response to rising oil prices, and supported by strong government spending





Source: Ministry of Economy and Finance, *QNB Capital estimates and forecasts

- The **current-account surplus** is expected to expand to 27% of GDP in 2011, then shrink slightly in 2012, in line with our forecast for oil price movements. Surplus income is transferred to the Kingdom's growing stock of foreign reserves, which reached US$473bn in April 2011

- We forecast that **inflation will rise in 2011** to 6.1%, driven by increases in rent and food prices. Lower oil prices and an increase in housing supply from a major house building programme should relieve inflationary pressures in 2012

- **The fiscal surplus is expected to rise to an average of 12% in 2011-12**, from 6.7% of GDP in 2010, despite strong spending growth, as revenues are boosted by higher international oil prices and rising production

- The **banking sector** is prudently managed and loan penetration is low. The sector has suffered four consecutive years of falling profits, but lending and profits have begun to pick up in 2011

- The Saudi **equities market** has bucked the regional trend as the only GCC bourse to show positive growth in the first five months of 2011

- The **business environment** is improving. Saudi Arabia has risen 56 places since 2005 in the World Bank's Doing Business Rankings, and this economic openness has boosted competitiveness, according to the World Economic Forum

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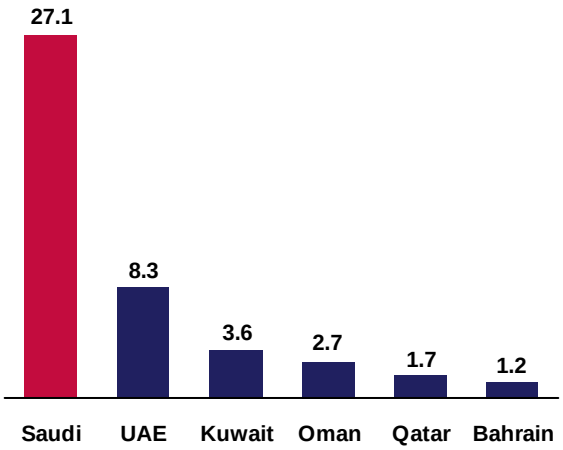
1. Country Overview and Demographics

A. Country Overview

Saudi Arabia's **population** was 27.1m in mid 2010 (Fig 1.1). This is more than three times greater than the UAE, the next most populous GCC state, and means that Saudi Arabia contains 67% of the total GCC population.

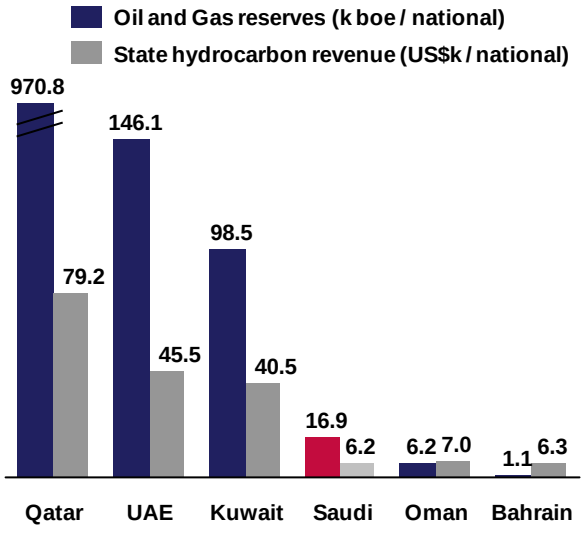
Fig 1.1 GCC Population (2010)
(million)



Source: Bahrain, Oman, Qatar and Saudi censuses 2010; QNB Capital estimates for Kuwait and UAE

The economy is dominated by the **oil sector**, which accounted for an average of around 54% of nominal GDP over the last five years. The Kingdom has the largest oil reserves in the world, which endow it with enormous wealth. However, that wealth is spread across the large population. Therefore, the government's annual hydrocarbons revenue per national of US$6,200 is lower than in every other country in the GCC (Fig 1.2).

Fig 1.2 GCC Oil and Gas Wealth (2009)



Source: BP, IMF, QNB Capital analysis

Export revenues from the oil sector accrue to the **government**, which disperses them throughout the economy. Therefore, the government has a vital role in supporting and stimulating the economy. In 2009, it announced a US$400bn investment and development stimulus package (106% of GDP). This was one of the largest stimulus packages, as a percentage of GDP, announced by any country in response to the global financial crisis. The Kingdom normally spends around one third of GDP per year through the state budget.

The country's **long-term vision** is embodied in its five-year development plans. The ninth plan, covering 2010-14, includes a total of US$384bn of planned spending, or around 18% of 2010 GDP per year. The government usually spends more than expected compared with the five-year plans and the annual budgets. The overriding objectives of the 2010-14 development plan are:

- **Employment**—create enough jobs for the growing national labour market
- **Regionalisation**—spread economic wealth throughout the country's regions
- **Diversification**—build the non-oil economy to reduce dependence on the oil sector

The development of the **education** system is central to creating the skilled labour force that is needed to achieve these objectives. The largest item in the ninth development plan was human resources, which accounted for 51% of planned spending. This illustrates the Kingdom's commitment to developing its human capital.

The government is also seeking to boost demand for nationals within the labour market through **Saudization** policies. These require companies to employ a set proportion of locals. However, Saudization has not yet succeeded in its core goal: to raise the proportion of nationals in the private sector workforce (Section 1B).

The construction of "**economic cities**" is central to development plans (Section 3C). The government has launched projects to establish four new cities at different locations across the country. Initial investments are estimated at around US$70bn. They are planned to be developed over a timeframe of approximately 20 years, housing between 4m and 5m inhabitants and contributing around US$150bn to annual GDP.

The cities are planned as hubs for petrochemicals, mining, the knowledge economy and logistics industries. This will help with diversification away from the oil sector into more labour-intensive areas—it is hoped that the cities will create more than 1m jobs. Some of the cities are deliberately located in low-income areas with the aim of spreading wealth and jobs to these regions.

The government sees the **private sector** as a key enabler for it to meet its objectives. A dynamic and efficient private sector could create the jobs, growth and new industries that the country needs. The government supports the private sector through large development funds, public-private partnerships, and through privatisations of public companies. It has also worked to improve the business environment through reforms, and provides regulatory and financial incentives to private sector companies involved in the economic cities

projects. Furthermore, the 2010-14 five-year plan included the creation of a new commission to oversee small and medium-sized enterprises and enhance their economic contribution.

In its five-year plan, the government set a number of targets, some of which are listed below (Table 1.1). These will provide a benchmark to measure whether it is achieving its employment, regionalisation and diversification objectives.

Table 1.1 Economic Plan Targets (2010)

Target for 2010-2014	Current (2010)
Unemployment of **5.5%**	**10%****
Saudis make up **54%** of the workforce	**48%**
Non-oil private sector growth of **6.6%**	**5.8%***
Real growth in per capita GDP of **2.9%**	**0.6%***
Share of non-oil real GDP at 1999 prices of **81.3%**	**77%** (2009)

Source: Ministry of Economy and Planning, Ninth Development Plan, *QNB Capital estimates, ** Preliminary figure from the Ministry of Labour

The Kingdom has significant comparative advantages for the development of **heavy industry** that flow from its natural resources and its abundant supply of cheap energy. It aims to leverage these to expand energy-intensive industries and to add value to its natural resource wealth.

The national oil company, Saudi Aramco, is leading the expansion of oil **refining** to add value to crude oil production (Section 3B). It is also on a drive to boost production of natural **gas**, primarily for domestic power production (Section 3A). Another majority state-owned company, Saudi Basic Industries Corporation (SABIC), has pioneered the Saudi **petrochemicals** sector (Section 3B). This is moving the Kingdom further up the hydrocarbons value-chain and provides a foundation for further diversification in the future. These industries and others, such as energy-intensive **aluminium** production, are integrated into large-scale industrial complexes, enabling the sharing of infrastructure. The government is also investing heavily in **basic infrastructure** such as roads, railways, airports, ports and communications networks.

B. Demographics

Population

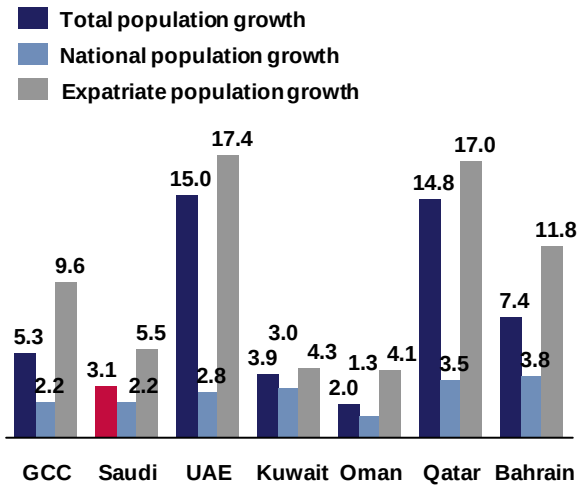
The total population grew at a CAGR of 3.1% from 2004-10

Saudi Arabia carried out its latest census in April 2010 and announced the preliminary results in August 2010. The **total population** recorded in the census was 27.1m. This implies a CAGR of 3.1% since the previous census in 2004 when the population was 22.5m. We forecast that the population will grow to 29m in 2012.

Saudis accounted for 18.7m, or 69% of the total population in 2010. The CAGR of the Saudi national population between the 2004 and 2010 censuses was 2.2%. This is slower than the national population growth in all other GCC countries except Oman (Fig 1.3). Saudi national population growth has slowed owing to a falling fertility rate. In 2008, there were 3.1 births per women, down from 4.2 in 2000. National population growth is forecast to slow fractionally to a CAGR of 2% in 2011-12, reaching 19.5m in mid-2012.

Fig 1.3 GCC Population Growth Rates

(% CAGR to 2010 census from previous census)



Source: National statistical authorities

The **expatriate** population was 8.4m, representing 31% of the total, according to the 2010 census. It has grown at a CAGR of 5.5% from 2004-10. The growth rate of the expatriate population has been slowing since the 1990s when it averaged around 10% per annum. More developed economies tend to grow at a slower rate. Therefore, in the long term, as Saudi Arabia continues to develop, its expansion will slow and growth in demand for expatriate labour will continue to decelerate.

In the shorter term, variations in the rate of economic growth will impact the expansion of the expatriate labour force. Therefore, when economic growth slowed in 2009, it is likely that the growth of the expatriate population also slowed. In 2011-12, QNB Capital forecasts that there will be a rebound in expatriate population growth as higher oil prices, particularly in 2011, drive a strong economic recovery. Therefore, we expect the expatriate population to grow at a CAGR of 6.5% during 2011-12 to 9.6m.

Overall, the total population was estimated to be 57% **male** and 43% **female** in 2009. There is a gender imbalance as 70% of non-Saudis living in the Kingdom are male. This is mainly because there is greater demand for male than female labour. The proportion of male expatriates is lower than elsewhere in the GCC, for example, in Oman it is around 80%. This is probably because the relatively large national population has stronger demand for domestic female workers than other

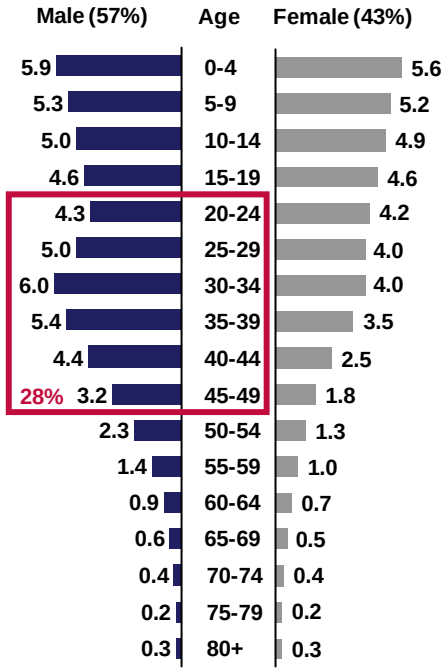
GCC countries and because a lower proportion of Saudi women work when compared with their GCC peers.

36% of the Saudi population is under 15

The latest available data on the breakdown of the population by **age** are official estimates for 2009, prior to the latest census. The 2009 data underestimated the population by about 0.9m, or 3.7%. The breakdown shows that the population is relatively youthful (Fig 1.4). This is mainly a consequence of a young national population—in 2009, 57% of the Saudi population was under 25 and 36% under 15.

Fig 1.4 also shows that there is a bulge in the size of the working age male population with 28% of the total population being male and aged 20 to 49. This is a consequence of the large and predominantly male expatriate labour force.

Fig 1.4 Population by Age and Gender (Mid-2009 Estimates)



Source: Central Department of Statistics and Information, Ministry of Economy and Planning

Labour force

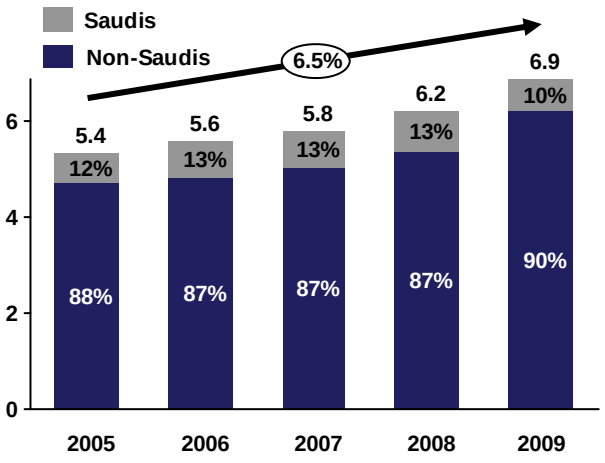
Based on pre-census estimates, the total labour force was 8.6m in 2009, or about one-third of the total population. Owing to the country's youthful demographic profile, the labour force is growing substantially faster than the population, at a CAGR of 9.7% in 2004-09. The labour force is 85% male due to the large expatriate labour force, which is particularly predominant in the construction and services sectors. There are also cultural restrictions that impede the full participation of Saudi women across various professions.

The **private sector** provided 80% of jobs in 2009. However, 90% of private sector jobs are taken by non-Saudis. Labour market participation is 37% amongst Saudis, who argue that low-cost expatriate labour drives down wages, discouraging Saudis from working in the private sector. In contrast, the public sector is 92% staffed by Saudis, who prefer the security and benefits provided by the government. This means that around 57% of working Saudis are in the public sector.

The Labour Ministry stated in January 2011 that Saudi Arabia needed to create 5m jobs for nationals by 2030. That implies an average of 250,000 jobs for Saudis per year; although, given the country's youthful demographic profile, the required number of jobs will increase year to year. According to Labour Ministry data, the private sector created 673,601 jobs in 2009, but only around 10% of these will have gone to Saudi nationals. The state created 69,726 jobs in 2009, the majority of which will have gone to Saudis. QNB Capital estimates that around 131,000 jobs were created for Saudis in 2010, well short of the number believed to be necessary by the labour minister. The failure to create enough jobs for nationals has caused steadily rising **unemployment** amongst Saudis (see unemployment section below).

The private sector labour force is 90% expatriate

Fig 1.5 Private Labour Force by Nationality (2005-09)
(million people)



Source: Ministry of Labour

Encouraging more nationals to take up employment in the private sector will be essential to tackling unemployment. This is recognised by the government, which has adopted a policy of **Saudization**. This involves efforts to boost skills and increase the contribution of qualified Saudis to the labour force. The Ministry of Labour and the Human Resource Development Fund, working in coordination with other government agencies, have conducted employment campaigns and training programmes to create job opportunities for Saudis. There are also quotas applied to different sectors that require companies to employ locals. The quotas range from requirements for between 5% and 20% of the company's labour force to be Saudi.

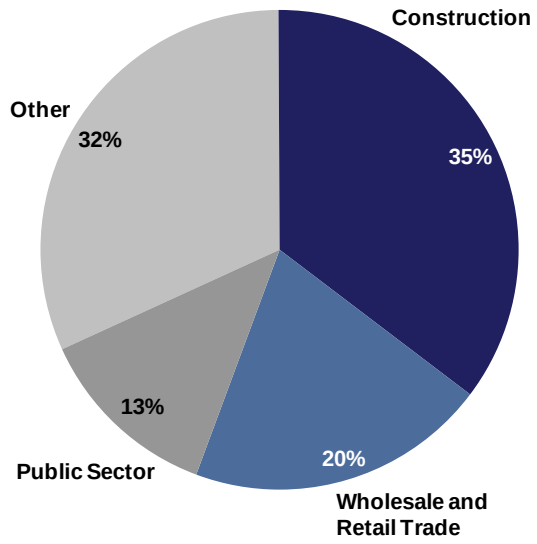
SAMA stated in its 2010 annual report that Saudization had led to the employment of 35,445 additional job seekers in 2009. However, expatriate employment in the private sector has grown even faster. As a result, the proportion of Saudis in the private sector workforce shrunk to 10%, lower than its level in 2005 (Fig 1.5). This is a setback for Saudization policies.

The Ministry of Labour is about to introduce new policies to encourage Saudization. Private companies will be classified into red, yellow and green categories according to how well they have performed in hiring locals. Those in the red category will be prevented from renewing visas of expatriate workers. Meanwhile, green category companies will be able to select expatriate workers from the other two categories and transfer their sponsorship. The existing employers of these expatriate workers will be powerless to prevent this. Additional incentives for green category companies are to be published on the Ministry of Labour website in June 2011. The Ministry says that the plans are designed to be pragmatic, taking account of the high level of expatriate employment, and that most private companies will initially be categorised as green.

Additionally, the Minister of Labour was reported to have said at the end of May 2011 that foreign workers who had been in the Kingdom for more than six years would not be able to renew their work permits. The Minister omitted a timeline and specific details. It is probably intended to encourage companies to train nationals. However, the implementation of the plans has not yet been confirmed.

Major infrastructure and building projects are driving growth in the private workforce

Fig 1.6 Private and Government Labour Force (2008)
(% share)



Source: Ministry of Labour

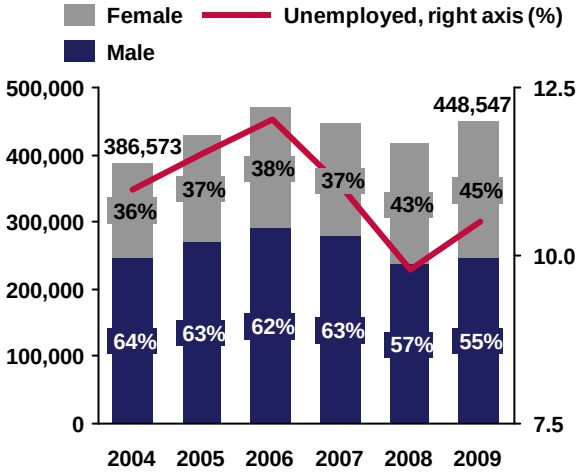
The private sector labour force grew at a CAGR of 6.5% from 2005-09. The **Construction** sector accounts for 42% of private sector employment, or 35% of the total labour force (Fig 1.6), and is 94% non-Saudi. The sector has been driving employment growth in the private labour force. The number of construction workers grew by 14% in 2009 to 2.9m, in response to the major infrastructure and city-building projects that are underway.

The other major employer is the **wholesale and retail trade** sector, which accounts for 23% of the private sector labour force and 20% of the total labour force. The number of employees in this sector grew by 8.8% in 2009 to 1.6m. In 2009, 88% of workers in the sector were non-Saudi. Saudi Arabia's increasing consumerism and expanding services sector have driven this growth.

Unemployment

Saudi unemployment peaked at 12% in 2006. It then fell to 9.8% in 2008 but subsequently rose to 10.5% in 2009 (Fig 1.7). Job creation in the public sector was insufficient to provide employment for new Saudi labour market entrants and those leaving the private sector. The Ministry of Labour has given a preliminary indication for unemployment in 2010 of 10%, a slight improvement on 2009.

Fig 1.7 Unemployment amongst Saudis (2009)

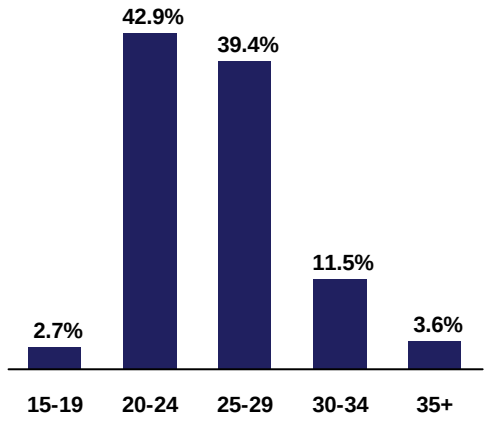


Source: CDSI and Ministry of Economy and Planning

The number of unemployed females is increasing faster than unemployed males. It rose by 13% in 2009, compared with an increase of 3.8% for males. Growing numbers of females are receiving a full education, resulting in more of them entering the labour market.

The number of unemployed is higher amongst younger age brackets (Fig 1.8). A total of 96% of unemployed are under the age of 35, and 82% are between the ages of 20 and 29. Young Saudis are either unwilling or unable to take on the jobs that are currently carried out by the 6.2m expatriate workers in the Kingdom. The lower wages obtained by foreign workers, along with the need to have advanced skills and knowledge, are also barriers to Saudi employment.

Fig 1.8 Saudi Unemployment by Age (2009)
(% of total unemployed)



Source: Ministry of Labour

In February 2011, the government introduced unemployment benefits for job seeking nationals for the first time. This illustrates that the government is becoming increasingly concerned about the welfare of Saudi job seekers.

Workforce skill level

The government is investing heavily in education.

- Human resources development was the second largest item in the 2010 state budget, accounting for 25% of the total
- There are currently 106,000 students studying abroad under the King Abdullah Scholarship Programme
- The government plans to bring all Saudi students who are paying for their own studies abroad into a state scholarship programme, reducing the costs for the students
- The government has set aside SR100m (US$26m) for students in need of financial support

A more skilled workforce is needed to meet the government's plans for diversification and economic development. There is evidence that the workforce is becoming more skilled. The proportion of the labour force that has at least a Bachelor degree has increased from 18.4% in 2007 to 19.2% in 2009. However, it is unclear whether this increase is the result of an increase in the number of skilled expats or skilled Saudis.

The proportion of the workforce that has reached the post-graduate level has fallen from 1.8% in 2007 to 1.5% in 2009. This is an indication of a lack of high-level skills within the Saudi workforce. As a consequence, the government has begun to undertake efforts to increase its support for postgraduate education.

According to the Ministry of Education, the number of students studying abroad is expected to reach 130,000 this year from 106,000 currently. The highest proportion of these students is studying in the US (30%) and the UK (15%) and the most popular courses are business management, economics and computer and information technology. The overseas education programme should help improve skills within the workforce.

Regionalisation

The population is concentrated around the administrative regions of Riyadh (including the capital city of Riyadh) and Makkah in the west, which includes the cities of Makkah, Medina and Jeddah. These areas account for 50% of the population. A further 15% is located in the oil-producing eastern regions and is concentrated around the cities of Dammam and Al Khobar. The remaining 35% is sparsely spread across the Kingdom's large land area. Based on the 2010 census, there were 13.6 people per sq km in Saudi Arabia (compared with about 150 people per sq km in Qatar).

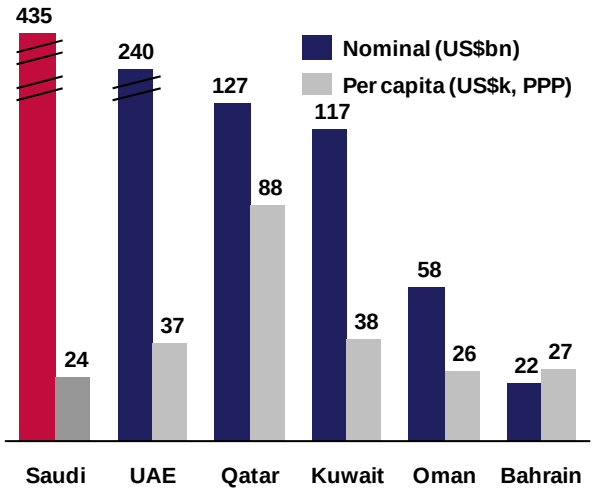
The government aims to reduce the concentration of the population around Makkah and Riyadh and help spread economic wealth more widely. Part of its strategy is to achieve this through major projects, such as the economic cities. This will help address regional unemployment, which is particularly high in certain areas such as the Northern Borders (17%), Al-Jawf (14%) and Jazan (13%)—these numbers include the national and expatriate population and compare with average unemployment amongst the total population of 5.4%.

2. Gross Domestic Product

A. Nominal GDP

Saudi Arabia is the GCC's largest economy

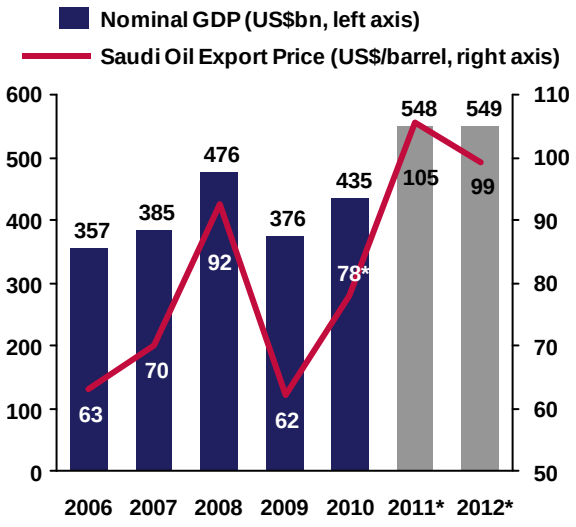
Fig 2.1 GDP in the GCC (2010)



Source: IMF and QNB Capital estimates; Note: Purchasing power parity (PPP) adjusts GDP relative to prices in each country

Saudi Arabia's nominal GDP grew by 16% in 2010 to reach US$435bn from US$376bn in 2009. The Kingdom is the largest economy in the GCC, with almost double the GDP of the next largest economy, the UAE, and more than triple Qatar's GDP. Nominal growth in 2010 compares with a historical CAGR of 8% from 2000-09.

Fig 2.2 Nominal GDP and Oil Prices (2005-10)



Source: SAMA, *QNB Capital forecasts

Oil exports are the main driver of nominal GDP growth

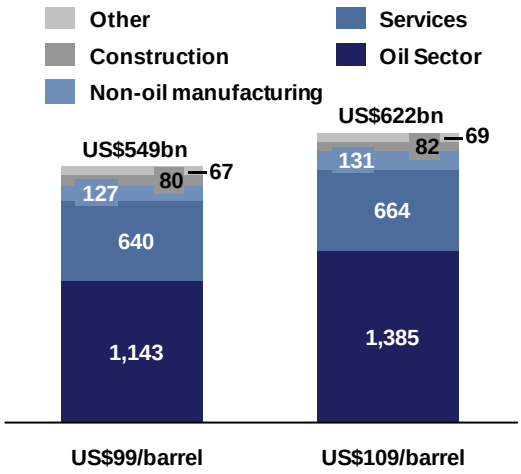
Oil exports usually account for just over 50% of Saudi nominal GDP. GDP is therefore heavily impacted by changes in international oil prices. The oil price spike in mid-2008 raised the average export price of Saudi crude to US$92/b[1] and consequently nominal GDP rose 24% to US$476bn (Fig 2.2). A drop in oil prices in 2009, when Saudi crude exports averaged US$62/b, drove GDP down 21% to US$376bn.

Saudi oil prices have subsequently recovered, averaging an estimated US$78/b in 2010 and US$108/b in the first five months of 2011. Currently, oil prices include a significant risk premium due to unrest in the Middle East. However, QNB Capital expects that this premium will contract because the oil market is likely to remain well supplied. On this basis, we forecast that oil prices will fall from their current highs, and that Saudi crude will average $105/b in 2011 and US$99/b in 2012.

Based on this oil price forecast, nominal GDP is expected to grow by 26% in 2011 to reach US$548bn. Although we expect crude oil prices to fall in 2012, an increase in crude production and growth in the non-oil economy will lead to a small increase in overall nominal GDP of 0.2%, taking it to US$549bn.

A US$10/b increase in our oil price forecast would boost 2012 GDP by a further 13%

Fig 2.3 Impact of Higher Oil Price Forecast on Nominal GDP in 2012
(US$bn)



Source: QNB Capital forecasts

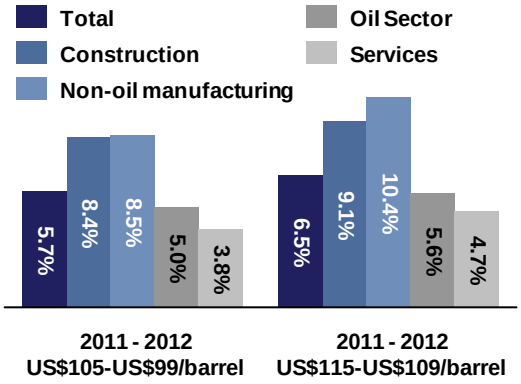
The nominal GDP forecast is highly sensitive to oil prices. If oil prices in 2011-12 were to exceed the levels we are forecasting by US$10/b, nominal GDP would be around 13% higher than our current forecasts for 2012 (Fig 2.3), reaching US$622bn. Most of this impact would be experienced in the oil sector but the effects would resonate throughout the economy as higher oil revenue would enable an increase in government spending, which would stimulate growth in the private sector.

The increase in oil prices would also have an impact on real GDP (Section 2C). Overall, in real terms, we would expect GDP growth to be 0.8 percentage points higher at

[1] Saudi crude normally trades at a small discount to Brent, a benchmark for international crude oil prices. The discount is currently around US$3/b

6.5% in 2011-12 if oil prices were US$10/b higher than we are forecasting (Fig 2.4), i.e. if our forecast was US$115/b in 2011 and US$109/b in 2012. Most of this additional growth would come from the non-oil sector, particularly non-oil manufacturing, as oil revenue flows through the economy.

Fig 2.4 Impact of Higher Oil Prices on Real GDP Growth (CAGR, 2011-12)



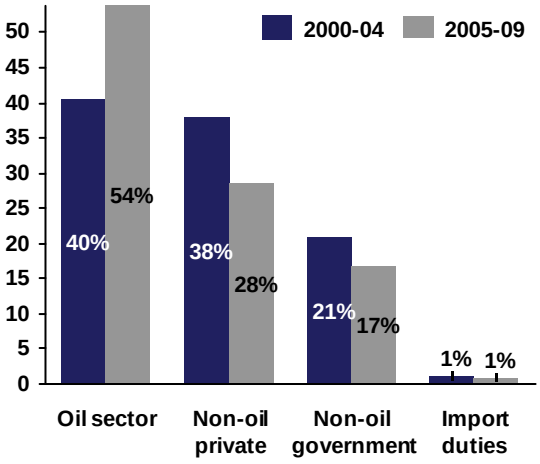
Source: QNB Capital forecasts

However, if oil prices rose a further US$15 to around US$130/b and US$124/b in 2011 and 2012 respectively, the Kingdom may become concerned that demand could be seriously undermined. In this scenario, it may increase oil production more dramatically to try and lower prices, boosting real growth in the oil sector.

B. Economic Structure

The share of the oil sector in nominal GDP is growing despite diversification efforts

Fig 2.5 Average Breakdown of GDP (2000-09)



Source: SAMA and QNB Capital analysis

The average share of the **oil sector** in nominal GDP increased in 2005-09 compared with 2000-04 (Fig 2.5). Its share peaked at 60% of GDP in 2008, when oil prices also peaked, but fell to 48% in 2009 when oil prices dropped. As the GDP breakdown varies significantly owing to the volatility of oil prices, five-year average shares provide a clearer view of the evolution of the economic structure.

With average oil prices forecast to be higher in 2011-12 than in 2008-10, the share of the oil sector in the economy is expected to continue to grow, despite government efforts to diversify the economy. We forecast that the share of the oil sector in nominal GDP will average 58% during 2011-12.

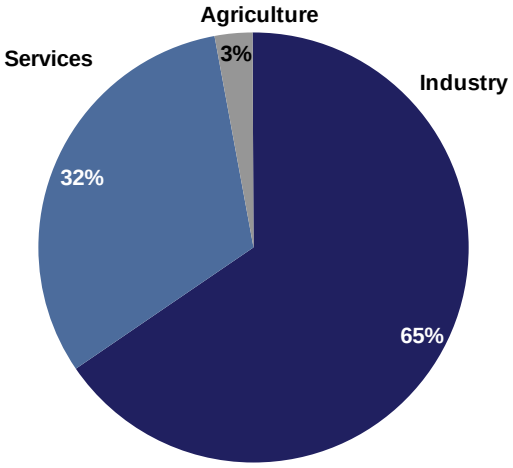
The contraction in GDP shares of the other parts of the economy (Fig 2.5) is due to the large nominal increase in the size of the oil sector rather than slow growth elsewhere. The CAGRs of nominal GDP in both the **non-oil private sector** and the **non-oil government sector** were around 7% from 2005-09.

Economic Sectors

The economy can also be split according to the three standard economic sectors. **Industry** is the largest component (Fig 2.6) as it includes oil. About a fifth of the industry sector, equal to around 12% of GDP, is **non-oil industry**. This sector has been boosted by government diversification efforts. The most important components of non-oil industry are:

- The petrochemical sector— this is classified as non-oil although it is uses oil and gas as feedstock
- Construction, which has benefited from large government investment projects, including the economic cities

Fig 2.6 Average Breakdown of GDP by Economic Sector (2005-09)



Source: SAMA and QNB Capital analysis

Most of the remainder of the economy falls within the **services** sector. Its largest subsector is finance, insurance, real estate and business services. This subsector is likely to see strong growth in 2011-12 for a number of reasons:

- The government is aiming to establish Riyadh as a regional financial hub

- The government has recently introduced plans to build an additional 500,000 houses, creating large financing opportunities
- A new mortgage law has been approved and is scheduled to be introduced this year, although it has faced persistent delays since proposed amendments were first written in 2005

Agriculture is a small and dwindling element in the economy, accounting for an estimated 2.6% of GDP in 2010, compared with a peak of 6.2% in 1998. A large wheat subsidisation programme has been scaled back after being assessed as unsustainable.

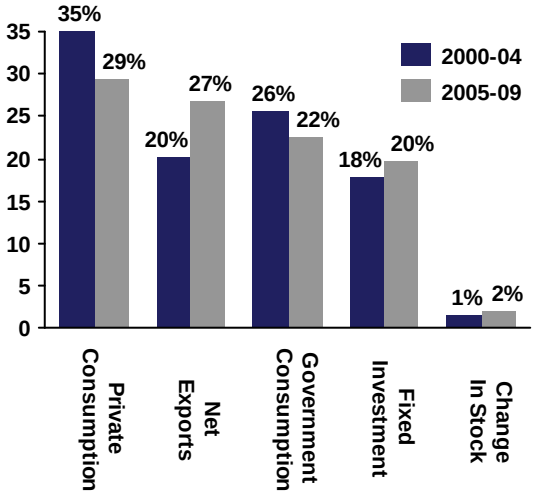
GDP by Expenditure

The share of fixed investment in nominal GDP is increasing

The share of **fixed investment** in nominal GDP averaged 20% in 2005-09 compared with 18% in 2000-04 (Fig 2.7). It peaked at 25% in 2009, owing to the decline in oil exports, and we expect that it will average 22% in 2010-12. This strong performance is largely a result of:

- Government efforts to develop basic infrastructure
- Major projects, such as the economic cities
- Expansion of heavy industry, particularly in the oil sector, petrochemicals and for aluminium production

Fig 2.7 Average Breakdown of GDP by Expenditure (2005-09)



Source: SAMA and QNB Capital analysis

The share of **net exports**[2] also increased in 2005-09, compared with the previous five years as a result of the oil price spike. Lower oil prices in 2009 caused a contraction in net exports to just 11% of GDP. With the recovery in oil prices, we expect net exports to average 27% of GDP in 2010-12.

[2] Net exports are total exports less total imports

Total **exports** are the most important component of GDP by expenditure, considered separately from imports. Their share averaged 62% of GDP in 2005-09. This provides an indication of the high dependence of the Saudi economy on external demand.

Growth in **imports** has been robust owing to strong domestic demand, including major infrastructure and construction projects. Imports averaged 36%[3] of GDP in 2005-09 compared with 25% in 2000-04.

GDP by expenditure provides an indication of consumption, or demand, in different parts of the economy. Since 2006, there has been a steady decline in **government consumption** relative to **private consumption**. This suggests that government policies to encourage private sector growth are achieving some success. Other important factors driving growth in private sector consumption are:

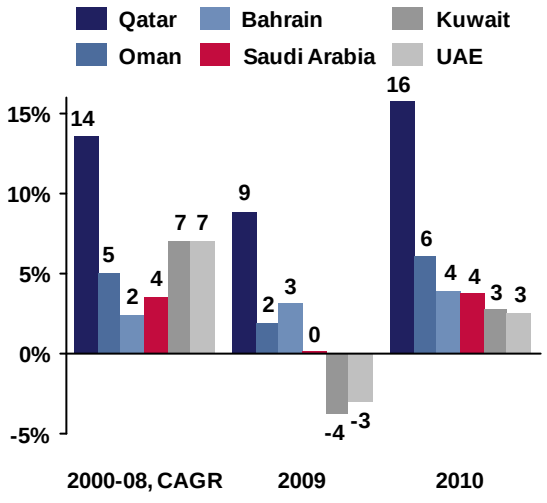
- High population growth
- Rising disposable incomes
- A burgeoning retail sector

C. Real GDP

Real GDP growth is slower in Saudi Arabia than in most other GCC countries

Fig 2.8 Regional Comparison of Real GDP Growth (2000-10)

(% change, unless otherwise indicated)



Source: National sources, IMF and QNB Capital estimates

During 2000-08, Saudi real GDP grew at a CAGR of 3.5%. Compared with the other GCC states, this rate of growth was only higher than Bahrain's real GDP growth (Fig 2.8). GCC growth decelerated during the global slowdown in 2009. Saudi Arabia fared better than Kuwait and the UAE, with flat rather than negative growth. This may have been because Saudi Arabia was less dependent on debt financing, particularly international

[3] Total exports at 62% less total imports of 36% does not sum to the net exports of 27% shown in Fig 2.7 owing to rounding

debt financing, for its investment projects. The financial crisis, therefore, would have caused higher interest rates and a greater contraction in lending in Kuwait and the UAE than in Saudi Arabia. This would have hampered the viability of projects, constraining growth.

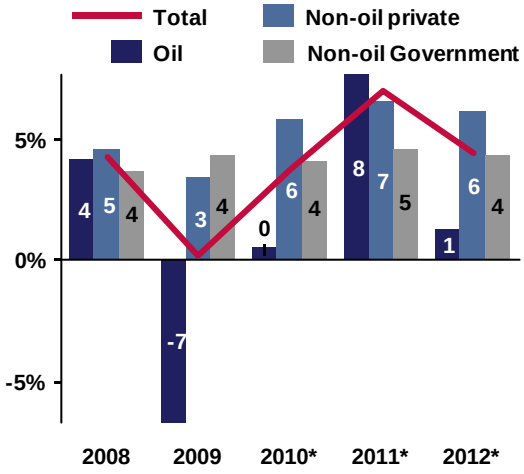
The recovery in Saudi Arabia's real GDP growth in 2010 has been broadly in line with growth in most of the rest of the GCC. At 3.8%, Saudi real GDP growth in 2010 has also been higher than its 2000-08 CAGR.

Non-oil growth compensated for a contraction in the oil sector in 2009

In 2009, real GDP growth slowed to 0.2%. Real GDP excludes the effects of price changes and relates purely to the volume of production. Real growth in 2009 was held back by a 6.7% contraction in the **oil sector** (Fig 2.9). This was primarily a consequence of a voluntary 11% cut in crude oil production from 9.2m barrels per day (b/d) in 2008 to 8.2m b/d in 2009, according to the International Energy Agency (IEA). In the wake of the 2008 financial crisis, OPEC[4] became concerned about falling oil prices and weak global demand. It therefore implemented output quotas for its members. As the largest producer within OPEC, Saudi Arabia tends to lead by example in terms of compliance with quotas, as evidenced by its production cuts in 2009.

Fig 2.9 Real GDP Growth by Major Sector (2008-12)

% change



Source: SAMA, *QNB estimates and forecasts

The contraction in the oil sector in 2009 was partly offset by the **non-oil government sector**, which grew by 4.4% in real terms. The government stepped up spending to soften the impact of the global recession. Growth in the government sector was therefore higher than it had been in the previous five years when the CAGR was 3.5%.

The **non-oil private sector** accounts for the largest proportion of real GDP (48% in 2009) [5]. It grew by 3.5% in 2009. Although this was a slowdown from a CAGR of 5.5% in 2004-08 and growth of 4.6% in 2008, it was sufficient to keep overall real GDP growth positive. The slowdown was due to consumers, companies and banks, being concerned about global economic conditions and reigning in spending, investment and lending, respectively. Private consumption contracted by 1.5% in real terms in 2009.

The non-oil private sector is also affected by developments in the oil sector, as revenue from oil exports are dispersed throughout the wider economy[6]. Therefore, the drop in oil prices in 2009 contributed to the slowdown in non-oil private sector real GDP growth.

2010 real GDP growth of 3.8% has most likely been driven by the private sector

SAMA has released an overall preliminary real GDP figure for 2010 of 3.8%. However, it has not yet provided a breakdown.

Crude oil production only increased by around 1% in 2010, according to SAMA, and therefore, oil sector real GDP growth is likely to be low. Government spending growth slowed, based on the preliminary budget released in December. This implies that the bulk of real GDP growth in 2010 must have come from the non-oil private sector. We estimate that this sector expanded by around 5.8%[7]. Growth in the private sector has most likely been buoyed by higher oil prices and recovering demand and confidence. These factors will have encouraged investment in the private sector, leading to more growth, particularly in sectors such as construction.

Higher oil production will boost growth in 2011, but it will slow in 2012

In 2011, we expect real GDP growth to rise to 7% (Fig 2.9). Higher crude oil production will drive this growth. Saudi Arabia increased oil production in early 2011 in response to rising prices and a fall in production in Libya, following the outbreak of unrest. We therefore expect oil

[4] The Organisation of the Petroleum Exporting Countries (OPEC) is a grouping of 12 oil-exporting countries, which aims to coordinate policies between its member states in order to stabilise oil markets and ensure: a steady income for oil-producing nations; secure supply to oil-consuming countries; and a fair return for investors in the oil sector. OPEC accounts for over 40% of world production and is therefore able to influence global oil markets by coordinating production adjustments and setting production targets for its members.

[5] Real GDP is based to 1999 when international oil prices averaged US$18 /b. As the non-oil private sector has been growing at a faster rate than other sectors in the economy, it has taken on an increasing importance in real GDP. In 2004-08 the oil sector grew at a CAGR of 1.4% in real terms compared with 3.7% in the overall economy. The share of oil in real GDP fell to 28% in 2009 owing to these slower growth rates. As international oil prices have increased in recent years, the oil sector constituted a much higher share of nominal GDP in 2009 (48%). It could therefore be argued that real GDP growth figures are weighted too heavily in favour of non-oil growth. If they were to be rebased to a more recent date, giving oil GDP greater weight in the calculations, there would probably have been a contraction in real GDP in 2009 and it would also have been slightly lower in 2010

[6] Via government spending or through companies that provide goods and services to the oil sector and other oil-dependent sectors

[7] Supporting the assertion that private sector growth has been picking up, bank credit to the private sector, which provides an indication of activity and confidence, grew by 5.7% in 2010, having stagnated in 2009

production to average 6.5% higher than in 2010, driving overall oil sector growth to 7.7%[8].

In addition to the oil sector, growth in 2011 will also be supported by the private and government sectors. The government announced two new large spending initiatives in the first quarter of 2011 (Section 6B), worth a total of US$130bn, or 24% of estimated 2011 GDP. The initiatives provide support to low-income families, increased public sector wages and included a plan for the construction of 500,000 new houses. There will be delays implementing some of these initiatives, but they will still provide a strong impetus. Increases in public sector wages have already been implemented and are likely to be replicated in the private sector, providing a particularly strong boost to GDP growth this year. Additional spending packages will also support real growth within the government sector, which we expect to be 4.6% in 2011.

On the back of high oil prices, an expansive government sector and a recovery in bank lending[9], we expect real growth in the private sector[10] to accelerate to around 6.6%.

In 2012, with the private sector growing strongly again, the government is likely to ease its fiscal support to the economy. Increases in oil production are also likely to be minimal as world oil demand is only forecast to increase by around 1.4%. We therefore expect a slower real GDP growth rate of around 4.4% in 2012.

[8] Growth in the oil sector as a whole will be higher than growth in oil production as production and activity increases in other parts of the sector

[9] In the first four months of 2011, bank lending to the private sector grew at an annualised rate of 11%

[10] As a gauge of corporate activity, total earnings at publicly listed companies were up 3.7% in the first quarter of 2011 compared with a year earlier. The stock exchange is dominated by petrochemicals companies, which benefited from high oil prices. Earnings from all other sectors were down on a year earlier, mainly as a consequence of the economic impact of regional unrest. We expect private sector activity and company earnings to rise during the rest of the year as the effects of high oil prices and government spending feed through the economy

3. Production by Sector

Mining and Quarrying (Section A) was the largest component in nominal GDP in 2009 (Fig 3.1). It includes oil and gas, as well as metals and minerals mining.

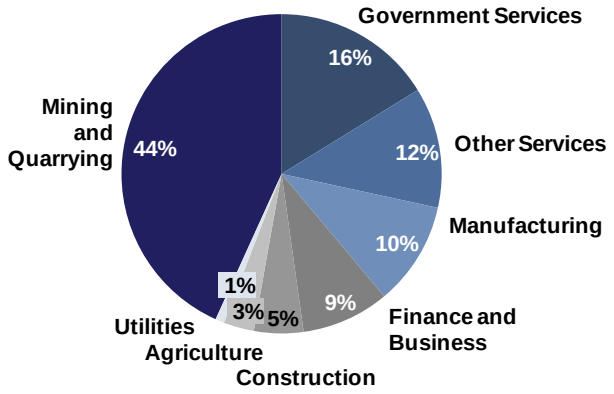
Manufacturing and Utilities (Section B) together, account for 11% of GDP. Petrochemicals and petroleum refining dominate the former and rising demand for water and power drive the latter.

Construction (Section C) will be supported by projects related to the economic cities and a drive to expand the housing stock.

Services (Section D) account for 37% of GDP in total. Government services are the second largest component of GDP, an indication of the importance of the public sector in the economy. Growing private consumption drives other services sectors.

Agriculture only accounts for a small and dwindling proportion of nominal GDP. Its share declined from a peak of 6.2% in 1998 to 2.9% in 2009.

Fig 3.1 Share of GDP by Sector (2009)



Source: SAMA

A. Mining and Quarrying

- Natural resources policy is driven by rising domestic energy consumption
- New oil field developments have recently added to Saudi's substantial spare production capacity
- Gas production is being increased to feed power stations and free up oil for exports
- There is a growing focus on metal and mineral mining, which has so far been underexploited

Oil

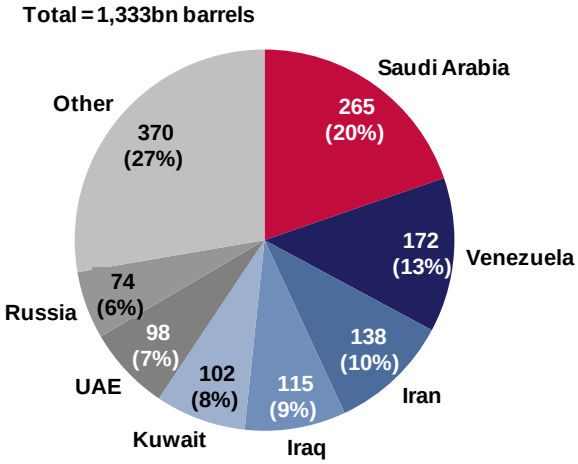
Saudi Arabia's proven oil reserves were estimated at 265bn barrels at the end of 2009, according to British Petroleum (BP). This is 20% of proven world oil reserves[11] (Fig 3.2). The Kingdom has the highest level of proven reserves in the world, well ahead of the next largest, Venezuela, which has 172bn barrels[12].

At current production rates, oil reserves would last around 88 years

At 2009 levels of production (around 8.4m b/d), Saudi Arabia's oil reserves would last for 88 years. However, new discoveries and improved recovery rates at existing fields are likely to extend production well beyond this horizon. Furthermore, proven oil reserves are actually rising—they stood at 261bn barrels at the end of 2000.

Fig 3.2 World Proven Oil Reserves (2009)

(bn barrels and % share)



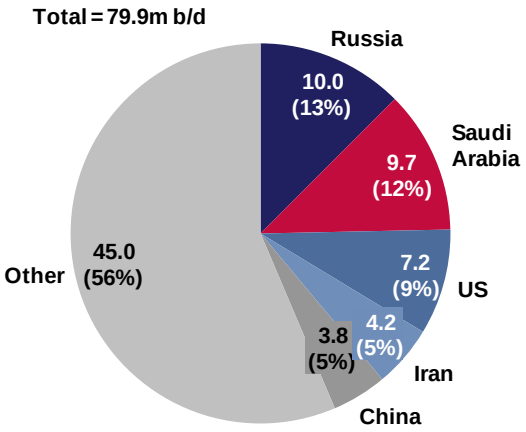
Source: BP Statistical Review of World Energy

Oil reserves provide the fundamental base for the Saudi economy. The challenge for the country is to utilise this natural resource wealth to create a diverse economy and jobs for the large and rapidly growing population.

Oil Production

Fig 3.3 World Oil Production (2009)

(crude oil, condensates and NGLs, m b/d)



Source: BP Statistical Review of World Energy

[11] BP defines proven oil reserves as those that are: "generally taken to be those quantities that geological and engineering information indicates with reasonable certainty can be recovered in the future from known reservoirs under existing economic and operating conditions"

[12] Venezuelan oil reserves have been substantially revised up in recent years to include the Orinoco Belt tar sands, although there is no current production from them. The reserves of the conventional producing fields are substantially smaller

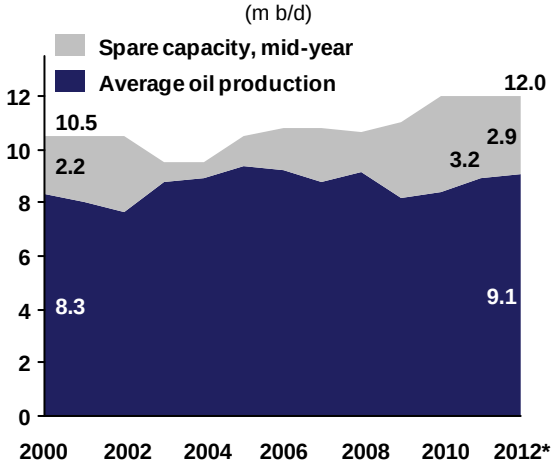
Saudi Arabia has traditionally maintained substantial spare capacity, averaging about 1.8m b/d in the 2000s (Fig 3.4). This gives the Kingdom flexibility in production levels and the ability to have an influence on global oil markets. After spare capacity shrunk to around 0.6m b/d in 2004, Saudi Aramco implemented expansion plans. In 2009 alone, Saudi Aramco boosted production capacity at various oil fields by around 2.55m b/d (Table 3.1). Owing to declining production at various oil fields, the increase in overall capacity was less than this.

Table 3.1 Production Capacity Increases at New and Existing Fields (2009)

Hydrocarbons Projects	New or Existing	Capacity added in 2009 (m b/d)
Khurais	New field	1.20
Khursaniyah	New field	0.50
Shaybah	Existing field	0.25
Nuayyim	New field	0.10
Enhanced production	Existing fields	0.50
Total		**2.55**

Source: Saudi Aramco Annual Review

Fig 3.4 Crude Oil Production (2000-12)[13]



Source: IEA, *QNB Capital forecasts in 2011-12

Sustainable production capacity was 12m b/d as of April 2011, according to the IEA[14]. This left Saudi Arabia with around 3.2m b/d of spare capacity. The Kingdom has historically aimed to maintain spare capacity at around 1.5m-2m b/d. However, spare capacity is unlikely to decline significantly in the short term, owing to existing plans to further expand production:

- An expansion of 0.25m b/d is underway at Shaybah
- A new offshore oil field, Manifa, is expected to add 0.5m b/d by 2013. A further 0.4m b/d expansion has been put on hold owing to excess spare capacity

Oil output decisions take the conditions in global oil markets into account

Despite capacity to increase production, output is constrained by OPEC production targets. As OPEC's largest producer, Saudi Arabia is prominent within the organisation and can therefore exert considerable influence on oil prices. OPEC quotas have targeted Saudi crude oil production of 8.1m b/d since late 2008.

Therefore, oil production is not dependent on capacity. It is determined by policy decisions, within Saudi Arabia and OPEC. These decisions take into consideration supply, demand and prices within global oil markets.

Nonetheless, there are scenarios in which Saudi Arabia may be prompted to increase production, for example:

- If there is a supply shock that increases geo-political concerns, such as the Gulf War in 1991 when production was increased from 6.4m b/d to 8.1m b/d
- If oil prices spike, Saudi Arabia may increase production to calm markets[15]

Oil production has averaged 8.9m b/d in the first four months of 2011, according to the IEA. It was increased sharply with higher oil prices and in response to lost production in Libya. However, there has been little increase in demand for additional Saudi supply as a result of the Libya crisis, according to the Oil Minister[16].

Oil production is expected to rise to meet domestic and international demand

From a supply-side perspective, there is little incentive for Saudi Arabia to cut production during the rest of 2011 and in 2012. Oil prices are relatively high and quota compliance by other OPEC countries is slipping.

Weak demand could limit Saudi oil production in the short term. Exports account for the bulk of demand for Saudi crude (Fig 3.5). However, with the global economy in relatively good health[17], especially in emerging markets, world demand for oil is likely to continue to expand[18].

[13] The spare capacity data is mid-year, which leads to some small discrepancy with average production data when compared with the information from Aramco relating to increases in production capacity

[14] Sustainable production is defined as a production level that can be reached within 30 days and sustained for 90 days

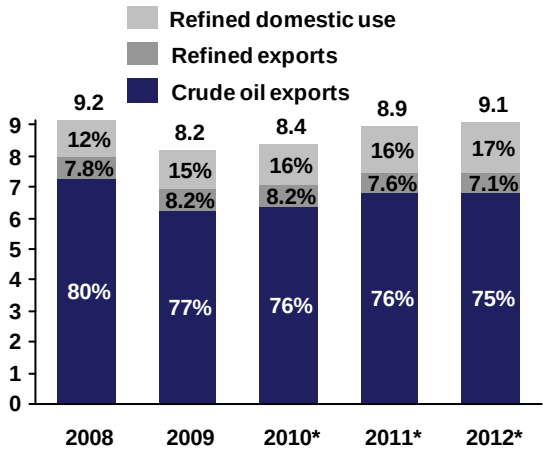
[15] High oil prices could result in an adjustment in patterns of consumption towards alternative sources of energy, which could lead to weak demand for oil in the long term

[16] There are a number of possible explanations for the lack of demand for Saudi crude oil: Libyan crude oil is particularly low in sulphur content and Saudi oil may not be a good replacement, despite efforts to produce a suitable blend; world consumption may be falling in response to rising oil prices; mispricing of Saudi crude could be discouraging purchasers/refiners; or, refinery maintenance, which peaks at this time of year, may be causing weak demand

[17] The IMF forecasts real GDP growth of 4.4% in 2011 and 4.5% in 2012 in its April 2011 World Economic Outlook. The OECD forecasts world real GDP growth of 4.2% in 2011 and 4.6% in 2012 in its June 2011 Economic Outlook

[18] The IEA forecasts that world oil demand will average 89.2 m b/d in 2011, 1.5% higher than average demand in 2010, which was 87.9m b/d. Total world oil supply in 2010 was 87.4m b/d and average 88.4m b/d in the first quarter of 2011, according to the IEA

Fig 3.5 Uses of Crude Oil Production (2008-12)
(m b/d)



Source: Ministry of Petroleum and Mineral Resources. *QNB Capital estimates and forecasts

Rising domestic use of crude oil is expected to decrease exports

We estimate that the share of domestic use of refined crude oil rose from 12% of crude oil production in 2008 to 15% in 2009 (Fig 3.5). This was partially a consequence of production being cut in response to lower demand for exports. However, growth in the domestic use of crude oil was 8.7% in 2009, despite minimal real GDP growth. We expect an increasing proportion of oil production to be used domestically in 2010-12 in order to meet rapidly expanding energy demand:

- The growing population and economy will continue to drive growth in demand for refined oil products for transport and in energy demand from oil-fuelled power stations
- Growing demand for water is increasingly being met through desalination, which is energy-intensive
- In the short term, Saudi Arabia's options for alternative energy sources to crude oil are limited
- Some crude oil is also used in the domestic petrochemical industry

Mining and Quarrying Forecast

Higher oil production and prices will drive increases in mining and quarrying GDP

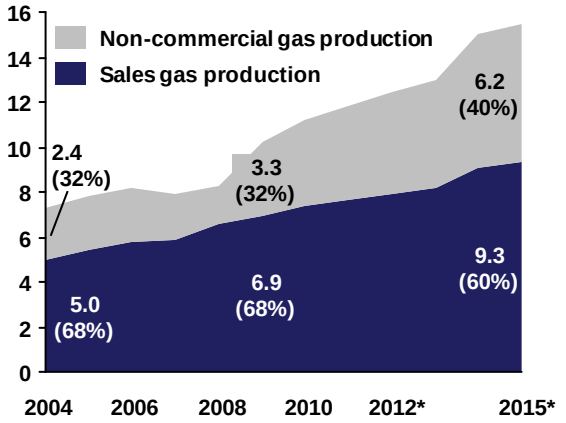
Rising domestic and foreign demand will provide some impetus for oil production increases in 2011-12. Therefore, QNB Capital expects Saudi oil production to rise by 6.5% from 8.4m in 2010 to an average of 8.9m b/d in 2011 and by 1.4% to 9.1m b/d in 2012 (Section 2C gives a more detailed explanation).

This will drive real GDP growth in the mining and quarrying sector to 7.7% in 2011. The smaller increment in oil production in 2012 will lead to slower real growth in the mining and quarrying sector of 1.5%. Taking into account the impact of higher oil prices, the sector will increase its share in nominal GDP to 53% in 2012 from 44% in 2009.

Natural Gas

Saudi Arabia aims to boost gas production to free up oil for export

Fig 3.6 Production of Natural Gas (2004-15)
(bn cubic feet/day)



Source: Saudi Aramco, *QNB estimates from 2011-15, based on Saudi Aramco statements

In 2009, Saudi Arabia had the fifth largest gas reserves in the world[19] but was only the ninth largest gas producer. This suggests that its gas resources may be under-utilised. According to Saudi Aramco, only 15% of the country had been "adequately explored for gas" in 2007.

As a result of rising domestic energy demand, Saudi Arabia is aiming to boost natural gas reserves and production. Using more gas for power generation would free up oil for export. Natural gas is also needed as a feedstock to the growing petrochemicals industry.

Total raw gas production grew at a CAGR of 6.9% from 2004 until 2009 (Fig 3.6). Saudi Aramco is in the process of bringing a number of large gas fields into production:

- A new processing plant at Khursaniyah oil field began operation in 2010 and is expected to add 1bn cubic feet/day (cf/d) of associated gas20 production in 2010-11
- A new offshore, non-associated gas field, Karan, is being brought into production in 2011-13 with expected capacity of 1.8bn cf/d
- The Wasit gas project is a 2.5bn cf/d, offshore gas project that is expected to come online in 2014-15

[19] Saudi Arabia had proven natural gas reserves of 280trn cubic feet in 2009, according to BP's 2010 Statistical Review of World Energy. Russia was the country with the largest natural gas reserves with 1,567trn cu ft. This compares to Qatar's reserves of 896trn cu ft

[20] Associated gas is a by-product of oil extraction. Non-associated gas is produced from fields that do not contain significant amounts of oil

According to Saudi Aramco, total raw gas production will rise 52% from 10.2bn cf/d in 2009 to 15.5bn cf/d in 2015. Raw natural gas can be flared, re-injected or processed after being extracted. Processing of the gas yields sales gas, which can be piped to end-user markets, and other by-products, such as condensates, sulphur, ethane and NGLs. Raw gas is expected to yield 9.3bn cf/d of sales gas in 2015, a 34% increase over 2009 production of 6.9bn cf/d (Fig 3.6).

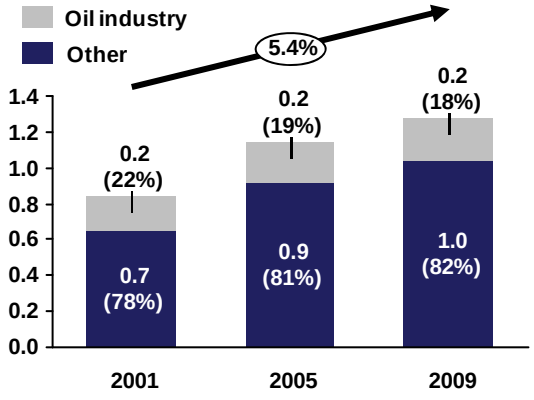
Saudi Arabia's natural gas exports are negligible. Total domestic natural gas consumption grew at a CAGR of 4.4% in 2004-09, compared with the 6.9% increase in production over the same period. Additional supplies will boost natural gas use in power stations and petrochemical plants.

New gas supplies will fuel power stations and underpin industrial development

In 2009, the oil industry consumed 18% of gas production, while the remainder went to other public and industrial uses (Fig 3.7). Gas usage within the oil sector, for the power generating requirements of the oil industry and reinjection into oilfields, has remained broadly constant since 2001 and is likely to continue to take a gradually smaller share of production. Future output increases have been earmarked for domestic projects outside the oil industry and will mainly be used for:

- Power stations
- Desalination plants
- Feedstock for petrochemical plants and other industries

Fig 3.7 Consumption of Natural Gas (2001-09)
(m barrels of oil equivalent/day, CAGR indicated)



Source: Ministry of Petroleum and Mineral Resources

To encourage industrial development, the government subsidises domestic gas prices, which are amongst the lowest in the Gulf at US$0.75 per million British thermal units (mBtu)[21]. This compares with US price for natural gas of around US$4.6/mBtu[22] in May 2011 and even higher prices in Europe and Asia. Current prices are very low compared with international levels and are likely to be below the cost price of Saudi Arabia's future production increments[23]. Therefore, the Kingdom may increase gas prices in the near future. Existing pricing arrangements are set to expire at the end of this year.

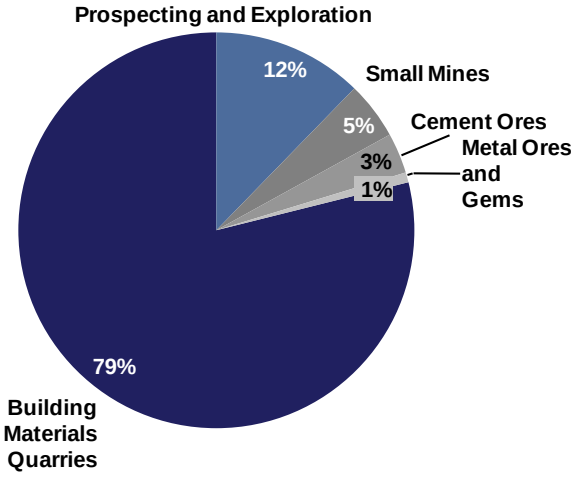
The current pricing structure means that the gas sector is undervalued in nominal GDP calculations. Therefore, increasing gas production will have a negligible impact on overall GDP, compared with the ups and downs of the oil sector. By selling gas at relatively cheap prices, the Saudi government is subsidising industry. This provides an incentive for investment and encourages economic development and diversification.

Mining

Mining production has become increasingly geared to construction and industry

The Ministry of Petroleum and Mineral Resources (MOPMR) is encouraging increased investment in the mining sector. There were 1,564 mining licenses at the end of 2009, an annual increase of 11%. A large proportion of licenses are related to the construction sector, including building materials and cement licenses (Fig 3.8). The largest increase in 2009 was in the number of licenses issued for prospecting and exploration, which rose by 34%. This suggests that the MOPMR is aiming to boost production.

Fig 3.8 Active Mining Licenses by Sector (End-2009)



Source: Ministry of Petroleum and Mineral Resources

Production of zinc and copper by the majority state-owned Saudi Arabian Mining Company (Maaden) increased rapidly in 2006-09, at a CAGR of 57% (Fig 3.9). Zinc is used in the construction sector to coat iron and steel. It is also used in the petrochemicals industry for rubber production. Copper is heavily utilised as a

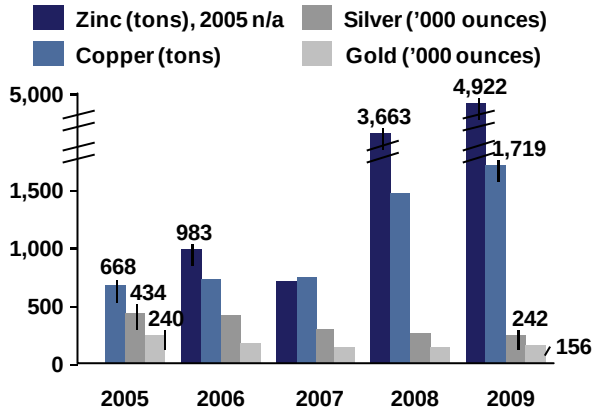
[21] US Energy Intelligence Administration (EIA) website, 2011
[22] The Henry Hub spot gas price is a US benchmark for domestic gas prices. It was US$4.6/mBtu at the end of May 2011

[23] Saudi Arabia's gas production in the past has largely been associated with oil production. However, future increments are mainly offshore, or in locations that are difficult to extract from. Gas from new offshore fields is expected to cost US$3.5-US$6/mBtu, according to industry analysts

building material in the construction sector and in telecommunications.

Gold and silver production contracted from 2005-09 at a CAGR of -12%. Maaden had formerly concentrated on the expansion of its gold mining operations. However, in recent years, the focus has shifted towards supporting the material needs of construction and industry.

Fig 3.9 Maaden Mining Production (2005-09)



Source: Maaden

B. Manufacturing and Utilities

- Manufacturing averaged 9.3% of GDP in 2005-09, while the share of utilities averaged 0.9%
- The expansion of petroleum refining and petrochemicals production is moving Saudi Arabia up the hydrocarbon value chain from raw exports
- From 2013, new refineries will stem the fall in exports of petroleum products
- Manufacturing production will be boosted by major investment in various industrial hubs on the Gulf and Red Sea coasts
- Large private and public investment is going into power and desalination plants to meet rapidly rising demand for **electricity** and **water**

Refining

Petroleum refining accounted for an average of 3.2% of GDP in 2005-09, over a third of the manufacturing sector. Domestic refining capacity is around 2.1m b/d[24], equivalent to almost a third of total Middle East refining throughput of 6.4m b/d in 2009. Refinery production has remained broadly constant, falling at a CAGR of -0.8% in 2006-09.

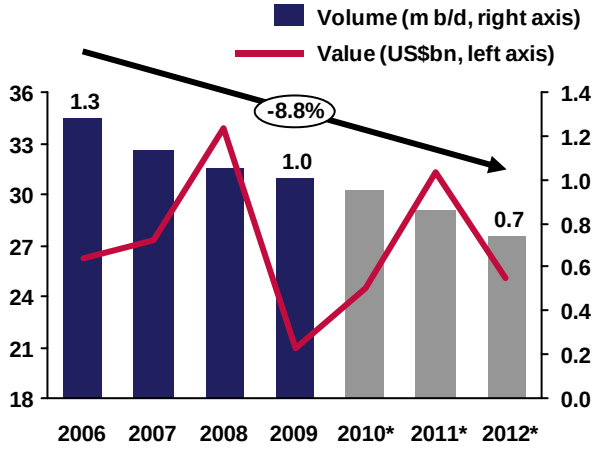
Rising domestic consumption of refined products is restricting exports

During 2006-09, domestic consumption increased at a CAGR of 8.7%. This has been a major factor in the decline in export volumes of refined products, which have fallen every year since 2006. This trend is likely to continue until 2012 (Fig 3.10):

- Economic development and population growth will drive increases in domestic consumption
- Production rises will be limited as no new refineries are due to come online until 2013 (see below)

As we expect higher oil prices in 2011, the value of refinery exports will rise from an estimated US$24bn in 2010 to US$31bn in 2011. In 2012, the continuing trend for lower refinery export volumes, combined with lower oil prices, will drive the value of refinery exports down to around US$25bn.

Fig 3.10 Refined Petroleum Product Exports (2006-12)



Source: IMF, *QNB Capital estimates and forecasts

Three new refineries will boost production by 57%, reversing declines in exports

The Kingdom has embarked on a major expansion of the refining sector to meet domestic needs and boost refined petroleum exports. There are plans to construct three large new refineries by 2016 adding 1.2m b/d, or 57%, to current capacity of 2.1m b/d (Table 3.2).

Table 3.2 New Domestic Refineries (2013-16)[25]

Location	JV Partner	Size (m b/d)	End-Date	~ Cost (US$bn)
Jubail	Total	0.4	2013	10
Yanbu	Sinopec	0.4	2014	11
Jizan[26]	-	0.4	2016	7
Total		**1.2**		**28**

Source: Saudi Aramco and Reuters

Saudi Aramco also has stakes in a number of international refining operations (Table 3.3). Three out of four of these are in Asia, which is a reflection of Saudi Arabia's increasing trade ties to the East (Section 4B).

[24] Nameplate capacity is 2.1m b/d but, given down time and maintenance, throughput at refineries has not risen above an annual average of 2m b/d in recent years. Therefore, in practice, capacity is probably slightly lower than 2.1m b/d

[25] See Appendix A: Key Refinery Projects for more details

[26] Aramco has taken on this refinery alone, having failed to find a JV partner

Table 3.3 Aramco's International Refineries

Country	Aramco Stake	Size (m b/d)	Capacity Expansion
US	50%	0.7	0.3m b/d in 2012
Korea	35%	0.6	None planned
Japan	15%	0.5	None planned
China	25%	0.2	None planned
Total		**2.0**	**0.3m b/d**

Source: Saudi Aramco

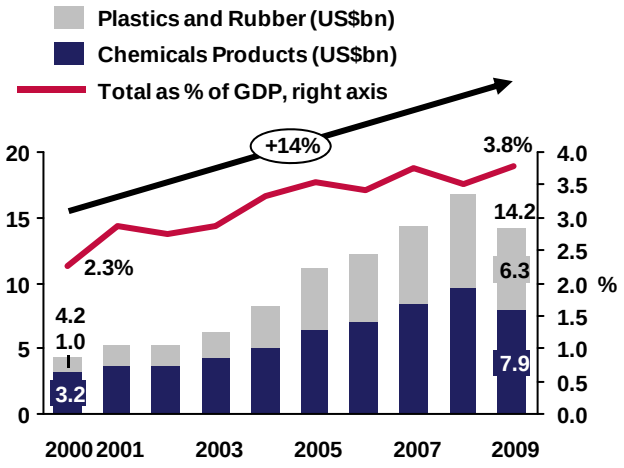
Petrochemicals

The expansion of the petrochemicals sector will encourage greater economic diversity

The petrochemicals sector[27] is the largest component of the non-oil economy. Its expansion has been a key focus of the government's recent diversification plans. Petrochemicals are heavily reliant on the hydrocarbons sector for feedstock and power. The government also provides natural gas to the sector at competitive prices, although these prices may be increased at the end of 2011 (Section A). It is hoped that the growth of the sector will provide outputs that will encourage other industries to develop around petrochemicals[28]. This could encourage greater economic diversity.

Expansion is boosting exports of plastics, rubber and chemicals

Fig 3.11 Exports of Plastics, Rubber and Chemicals (2000-09)



Source: SAMA

Production of petrochemicals has increased from 2m tonnes in 1970 to around 60m tonnes currently. Saudi Arabia is the 11th largest supplier of petrochemicals in the world, providing 7%-8% of global supply. It mainly produces basic petrochemicals[29], but has plans to increase production of more complex products[30].

The bulk of production is exported, and exports of plastics, rubber and chemicals increased at a CAGR of 14% from 2000-09 (Fig 3.11). There was a slight drop in demand in 2009 as a result of the global recession. However, this is expected to be temporary and, as a percentage of GDP, exports of these products rose to a historical high of 3.8% in 2009.

Additional projects will drive increases in production and exports

The Kingdom's expansion plans have targeted an increase in production of petrochemicals to 100m tonnes by 2015 and 130m tonnes by 2020. At least US$45bn of petrochemical projects were underway at the end of 2010, including four megaprojects (Table 3.4).

Table 3.4 Major Petrochemical Projects (2010)[31]

Location	Plant Type	Partners	~ Cost (US$bn)
Jubail	Rubber	SABIC[32]/ Exxon	5.5
Ras al-Zour	Fertiliser	SABIC/ Maaden	5.5
Rabigh	Petchems Expansion	Aramco/ Sumitomo	7
Jubail	Petchems	Aramco/ Dow Chemicals	20

Source: SABIC and Saudi Aramco annual reports, press reports

Petrochemical clusters will help form a basis for industrial expansion

Petrochemical projects are concentrated in industrial clusters in cities such as Jubail and Ras al-Zour on the east coast and Rabigh and Yanbu on the west coast. The government has supported the development of these clusters through the provision of basic infrastructure[33].

It is hoped that the clusters will serve as focal points to support the growth of other industries. For example, Maaden has entered into a joint venture (JV) with Alcoa (US) for a US$11bn integrated project including bauxite

[27] Petrochemicals are derived from hydrocarbons. They are a wide range of chemical compounds and have an array of uses. Petrochemical products are pervasive in modern economies. They are mainly used in the production of plastics, rubber, fertilisers, solvents, detergents, adhesives, synthetic fibres, lubricants, gels and industrial chemicals. The main basic petrochemical compounds are ethylene, methanol, propylene, benzene and butadiene

[28] For example, tyre plants that use rubber produced by the petrochemical industry

[29] Basic petrochemicals would include ethylene and methanol

[30] More complex petrochemical products would include styrene and polyethylene

[31] More details of these projects are given in Appendix B

[32] Saudi Basic Industries Corporation (SABIC) is the preeminent player in the petrochemicals industry. It is 70% government owned and is the largest publicly traded company in the Kingdom with US$85bn in total assets at the end of 2010. It produces and exports a range of petrochemicals and fertilisers. Its plants are concentrated in industrial clusters in the cities of Jubail on the Gulf coast and Yanbu on the Red Sea

[33] For example, in Ras al-Zour: a 1,500-km "minerals railway" is being constructed to transport raw materials to phosphate and aluminium plants; a port is being constructed for the export of fertilisers and aluminium products and the import of raw materials; and a JV involving Maaden and Saudi government utility companies is currently building a 2.4 gigawatts (gw) power plant in conjunction with a 1m cu metre/d desalination plant

mining and aluminium production[34], which will share infrastructure with petrochemical plants in Ras al-Zour.

The government is actively encouraging private investment into the petrochemicals sector, particularly for the production of more complex products[35]. The Kingdom may be attractive to investors because:

- It has abundant supplies of competitively priced feedstock
- It is located at the centre of east-west trade routes
- It is investing heavily in new infrastructure
- Saudi accession to the WTO in 2005 has led to lower tariffs in a number of export markets
- It achieved a ranking of 11th out of 183 in the World Bank's Doing Business report (Section 9)

Manufacturing is forecast to grow at a CAGR of 8.1% in 2010-12

Overall, the manufacturing sector grew at a CAGR of 6% in real terms from 2005-08, but slowed to 2.3% in 2009. The completion of petrochemical and fertiliser projects that were launched in the boom years, particularly the Ras al-Zour fertiliser project in 2011, and investment in industrial hubs should drive future growth. Higher oil production will also boost refining activity. We therefore forecast that the real GDP growth of the manufacturing sector will bounce back in 2010-12 to a CAGR of 8.1%.

Electricity

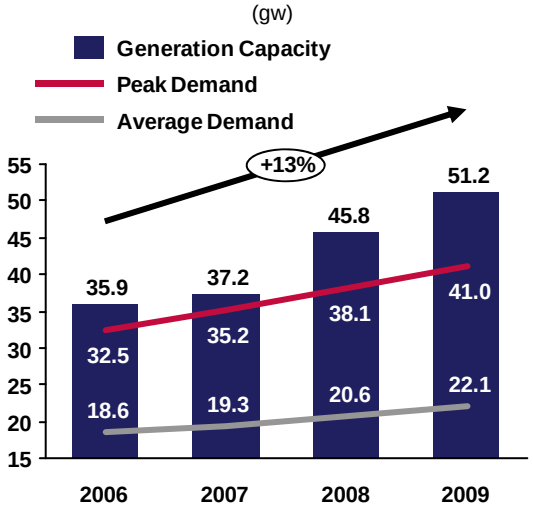
High population growth, urbanisation and economic development are leading to strong increases in demand for both electricity and water.

Strong demand growth is leading to expansion in the electricity sector

Average electricity demand rose at a CAGR of 5.9% from 2006-09. Government estimates of future demand growth are 8% per year, which will be driven by major investments in housing and new economic cities. Generation capacity is considerably higher than average demand. However, electricity demand peaks in the hot summer months, owing to higher usage of air conditioning units. This means that peak loads often exceed generation capacity in some regions, leading to supply shortages and blackouts. Peak demand rose at a CAGR of 8.1% from 2006-09.

Therefore, the government has stepped up investment in generation capacity, which has increased faster than demand, at a CAGR of 13% from 2006-09 (Fig 3.12) to 51.2 gw. Capacity should have increased by a further 6 gw, or 12%, to 57.2 gw, by the end of 2011, when we estimate that peak demand will be around 47.9 gw. This implies that peak demand will rise from 80% of generation capacity in 2009 to 84% in 2011. Therefore, generation capacity expansion will need to be accelerated to maintain the existing cushion over peak demand.

Fig 3.12 Electricity Consumption and Generation (2006-09)



Source: Electricity and Cogeneration Regulatory Authority

Expansion will present opportunities for the private sector

According to the Electricity and Cogeneration Regulatory Authority (ECRA), there are plans to invest US$100bn in electricity projects over the next ten years. Around one third of this will be spent on new generation capacity[36], including some allocations for alternative power sources. The remainder will be used to expand the transmission network[37]. ECRA estimates that generation capacity needs to increase to 75 gw by 2018 and 120 gw by 2030. This implies a CAGR in generation capacity of 9.9% during 2010-18, which seems achievable, given the even higher growth achieved in the sector in 2006-09.

The Saudi government is seeking to include the private sector in these plans, expecting it to contribute around 30% of total investment. Private companies already have stakes in existing power stations. The government is also in the process of privatising some majority state-owned utility companies[38].

The target for 10% renewable energy usage by 2020 will free up oil and gas resources

[34] The project includes a bauxite mine (with an initial capacity of 4m t/y), an alumina refinery (capacity of 1.8-2m t/y), an aluminium smelter (capacity of 0.7m t/y) and a rolling mill (capacity of 0.4m t/y). First production from the mine and refinery is expected in 2013 and from the smelter and mill in 2014. The aluminium production will be based in Ras al-Zour and bauxite will be transported to the plant via the same new "minerals railway" that will carry phosphates to the fertiliser plant

[35] The strategic focus is on the production of more complex products, such as specialty chemicals (for example, resins and adhesives) and engineering thermoplastics

[36] See Appendix C for major projects

[37] The transmission network is being expanded by 30,000 km—this will almost double the length of the existing network, which was 39,195 km in 2009

[38] The Saudi Electricity Company (SEC) is 20% publicly listed with 80% owned directly by the government. There are plans to split the company into four separate generation units (to encourage competition in the sector) and two more companies for transmission and distribution. These plans were first announced in 2002 and, owing to the complexity of the breakup, may take some time to materialise

Currently, about half of electricity generation is gas powered and the other half is oil powered. The government hopes to increase the proportion of gas used in power stations. However, natural gas adds more value when used as feedstock to petrochemical plants. The government is therefore committed to finding alternative energy sources. It has set the goal of 10% of the energy mix being from **renewable** sources by 2020, from close to zero at present.

There is a particularly enormous potential for **solar power** in Saudi Arabia. There are currently only small-scale solar power projects in place. However, large investments are being made into research and development in this area. A total of US$2.5bn is expected to be invested in two factories producing solar power parts, with production scheduled to begin in 2013. The King Abdullah City for Atomic and Renewable Energy has been established as a cluster of alternative energy research and development initiatives—this is a separate project to the four economic cities (Section C). The oil minister has said that the Kingdom hopes to become a major exporter of solar energy in the next 30 to 50 years. Solar power has the potential to give an enormous boost to the long-term economic prospects of Saudi Arabia.

The feasibility of **nuclear power** is also being investigated. In February 2011, Saudi Arabia signed a nuclear cooperation agreement with France, which is an initial step towards developing the technical capacity for the production of nuclear power.

An interconnected GCC grid raises the possibility of exporting power

Saudi Arabia is involved in the establishment of an interconnected GCC electricity network to enable member-states to share energy resources. It now links all the GCC countries bar Oman, but is limited in transmission capacity. The extension of linkages could eventually make it possible for Saudi Arabia to export power further afield.

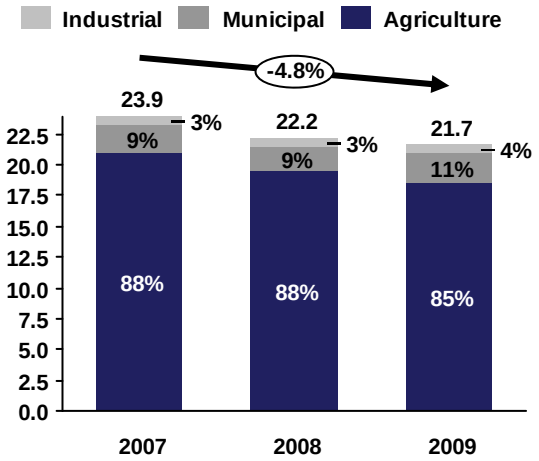
Water

Despite scarcity, Saudi Arabia ranks third in the world for per capita water consumption

Water resources in Saudi Arabia are scarce. Nonetheless, Saudi Arabia ranks third after the US and Canada for high daily per capita consumption of water at 249 litres/d in 2009.

In 2007, 88% of water consumption was for agriculture, largely because of a wheat subsidisation programme that had been running for 30 years to ensure self sufficiency. The programme was rapidly depleting groundwater resources and the government began scaling it back in 2008. This has driven the reduction in water consumption from 2007-09 (Fig 3.13).

Fig 3.13 Water Consumption (2007-09)
(bn cubic metres)



Source: Ministry of Electricity and Water

There are plans for expansion as desalination plants are operating below capacity

The bulk of current consumption is met from underground sources, but these are limited. There is a growing need for **desalinated water** to meet demand. The state-run Saline Water Conversion Corporation (SWCC)[39] has the capacity to produce 3.2m cubic metres/day (cm/d) of desalinated water. There are also four private desalination plants, which have the capacity to produce 1.7m cm/d. Actual production in 2009 was about 2.8m cm/d.

Despite nearly 50% of spare capacity, there are plans for substantial further expansion of desalination[40]:

- A near doubling of capacity by building ten new desalination plants in 2010-14, of which around half will be private
- US$24bn in public investment in 2011-20

Solar powered desalination will be the way of the future

The first phase of construction of **solar powered desalination** plants has begun. An initial pilot scheme led by IBM and Saudi research institutions, involves the construction of a 30,000 cm/d plant, enough to meet the water needs of 100,000 people. The second phase will scale this up to 300,000 cm/d and a third phase will introduce solar powered desalination to each region in Saudi Arabia.

Utilities GDP Growth

Overall, the CAGR of the electricity, gas and water sector was 6% from 2005-09. We expect strong demand and government investment to lift the CAGR slightly higher in 2010-12 to 6.3%, although growth will be

[39] Plans for the privatisation of SWCC into seven separate units have been announced
[40] See Appendix C for current major projects

uneven. Government investment is an important driver of expansion in the utilities sector. A contraction in government capital spending as a percentage of GDP in 2010 will lead to weaker growth in 2011 at around 5.4%, as investment takes time to impact growth. However, growth will accelerate again in 2012 to around 6.7%, based on strong planned capital spending in 2011.

C. Construction

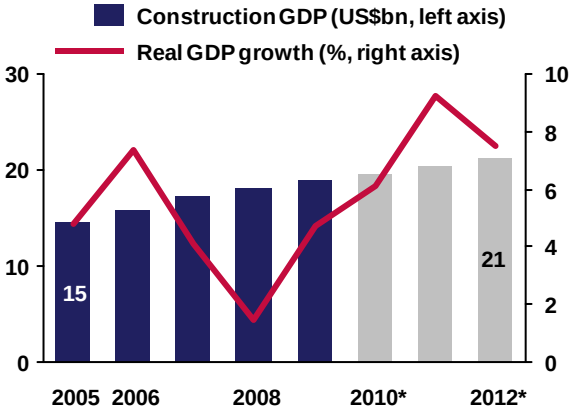
The construction sector accounted for an average of 4.5% of GDP in 2005-09, down from an average of 6% in 2000-04. As with other sectors, the downward trend is a result of the rapidly expanding oil sector.

A slowdown in growth in 2008 was only temporary as bottlenecks were cleared

From 2005-09, the sector grew at a real CAGR of 4.4%. Growth slowed to 1.5% in 2008, mainly owing to delays in processing contracts and high demand for major contractors in the region. However, growth picked up to 4.7% in 2009 despite weaker overall economic conditions. This suggests that bottlenecks eased as construction elsewhere in the region slowed down, freeing up more contractors. The government also supported growth by stepping up investment in construction projects in 2009.

Growth in 2011-12 will be supported by house building and the new economic cities

Fig 3.14 Construction Sector (2005-12)



Source: SAMA, *QNB Capital estimates and forecasts

Growth in the construction sector is closely related to government spending, which in turn is dependent on oil prices. Based on our assumptions for these variables we estimate that construction growth accelerated to 6.1% in 2010. We forecast that construction growth will pick up to 9.3% in 2011 before slowing slightly to 7.5% in 2012. Growth will be boosted by government house-building plans and by investment in economic cities.

Cement sales in the Kingdom give an indication of activity in the construction sector. They reached an all-time high of 4.3m tonnes in March 2011, 16% higher than in February. Although sales fell to 4.2m tonnes in April, this still represented 16% growth on a year earlier. Therefore, ongoing government projects appear to be giving a significant boost to the sector.

Economic Cities

New cities aim to drive regionalisation, diversification and job creation

A central pillar of government plans to spread economic wealth, diversify the economy and create jobs, is the construction of four "economic cities" at strategic locations across the country (Table 3.5). The government plans to invest almost US$70bn in the cities and for them to eventually contribute US$150bn to GDP annually. They are expected to have between 4m and 5m inhabitants. The government is offering a number of investment incentives and supportive regulations.

Table 3.5 Economic Cities (2011)

City	Cost (US$bn)	Initial Jobs
King Abdullah Economic City	27	1m
Jazan Economic City[41]	27	100,000
Prince Abdul Aziz bin Mousaed City[42]	8	55,000
Knowledge Economic City[43]	7	20,000

Source: Saudi Arabian General Investment Authority

The largest and most advanced of these projects is **King Abdullah Economic City** (KAEC), situated on the Red Sea coast, just north of Jeddah. The city is designed for a population of 2m and aims to create 1m jobs. A port is under construction, planned to be one of the ten largest in the world. The total initial investment to establish the city is estimated at US$27bn.

Basic infrastructure, including utilities and an initial road network, has been built, along with a handful of office buildings. There are already major industrial developments situated at the northern edge of the planned city and within an "Industrial Valley" area of the development. These include a US$10bn integrated refinery and petrochemicals facility, Petro Rabigh, which is currently undergoing a US$7bn expansion; and a US$4bn steel manufacturing complex run by Rajhi Steel Company. This will provide a foundation for the establishment of smaller-scale industries.

Another draw for the city is the **King Abdullah University of Science and Technology** (KAUST), on the southern edge of the KAEC development. KAUST was opened in 2009 with a US$10bn endowment from the government and aims to become a leading global

[41] Situated on the Red Sea coast to the south of the country, near Yemen, one of Saudi Arabia's poorer areas, Jizan economic city is planned as a zone for energy-intensive industries and a logistics hub

[42] The city is intended as a transport and logistics hub in the centre of the country, near Hail. It will leverage its central location and the agriculture and minerals sectors

[43] It is hoped that Knowledge Economic city will help drive the development of a knowledge-based economy in Saudi Arabia. It will be situated near Medina and will include a number of technology colleges, an Islamic civilisation studies centre, a business centre and a medical campus

university in the areas of science, technology and engineering.

Government commitment to the economic cities will ensure ambitions are partly realised

By providing basic infrastructure and start-up investment in the economic cities, the government hopes to trigger broader development and private sector participation. Similar large-scale economic planning has worked in the past. The successful industrial cities, Yanbu and Jubail, were developed in a similar manner, although they are limited in the extent of their residential developments. It may take time to realise, but the government's commitment and investment in the economic cities is likely to ensure that they will achieve their ambitions to diversify the economy and create jobs.

Housing Shortages

There is a shortage of housing in Saudi Arabia. To meet demand the Kingdom needs to build around 230,000 houses per annum. This compares with an average of just 22,000 houses per annum over the previous 25 years.

Strong government assistance will support growth in the housing sector

In addition to the economic city programmes, the government is providing considerable support to the house-building sector. It announced a range of measures in February and March 2011:

- A decree for the construction of 500,000 new houses at a cost of US$67bn
- A US$11bn capital injection for the Real Estate Development Fund (REDF)[44]
- A 63% increase in the value of REDF mortgages to US$133,333 from US$80,000
- A US$4bn increase in the budget for the General Housing Authority[45]

In March 2011, the Shura Council[46] made final amendments to the mortgage law and passed it to the King for final approval. The law should be passed this year, but has suffered repeated delays in the past. With housing now a prime national priority, the passage of the mortgage law could be accelerated. All of these developments should help support growth in the housing sector.

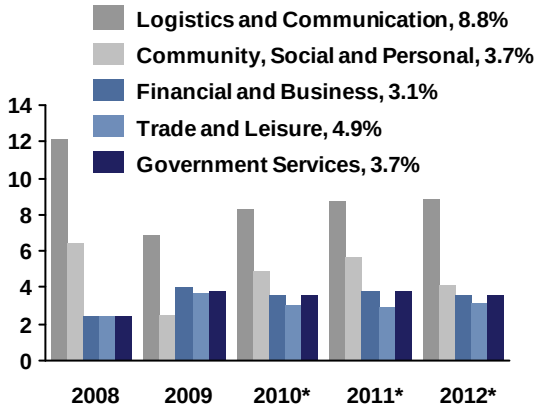
D. Services

The services sector normally accounts for about a third of nominal GDP. The sector has grown at a real CAGR of 4.2% from 2005-09. This is higher than overall GDP, which grew at a real CAGR of 2.5% from 2005-09.

[44] A government fund that provides loans to nationals for house purchases
[45] A new Ministry of Housing was created at the end of April 2011 to replace the General Housing Authority (GHA). The minister will be the same person who was the director of the GHA
[46] The Shura Council is a consultative assembly and a formal advisory body. It proposes and examines laws and government reports and budgets

Communications will continue to drive growth in the services sector

Fig 3.15 Real GDP Growth in the Services Subsectors (2008-12)
(% change; 2010-12 CAGR shown in legend)



Source: SAMA and *QNB estimates and forecasts

Growth has been led by the **logistics** and **communications** subsectors. Combined annual growth in these sectors peaked at 12.2% in 2008. It achieved real growth of 6.9% in 2009, despite a decline in transport activity, suggesting that communications have been driving growth in this sector. Based on Communication and Information Technology Commission (CITC) data for 2009:

- Active mobile subscriptions rose 23% to 36m
- Broadband subscriptions rose 105% to 2.8m
- Internet users rose 7.7% to 9.8m
- Telecoms revenues rose 15% to US$18bn

We expect growth in the logistics and communication subsector to be around 8.8% annually in 2010-12 (Fig 3.15). Ongoing projects to expand airports[47], ports[48], railways[49] and roads[50] will continue to drive growth in transport. Meanwhile, mobile and internet subscriptions will support expansion in communications. The number of mobile users has continued to expand despite high penetration. According to the CITC, there were 36m active mobile subscriptions in 2009, a penetration rate of 142%, as many people have more than one SIM card. Penetration of broadband subscriptions and internet users remains relatively low at 32% and 38% respectively, leaving room for growth.

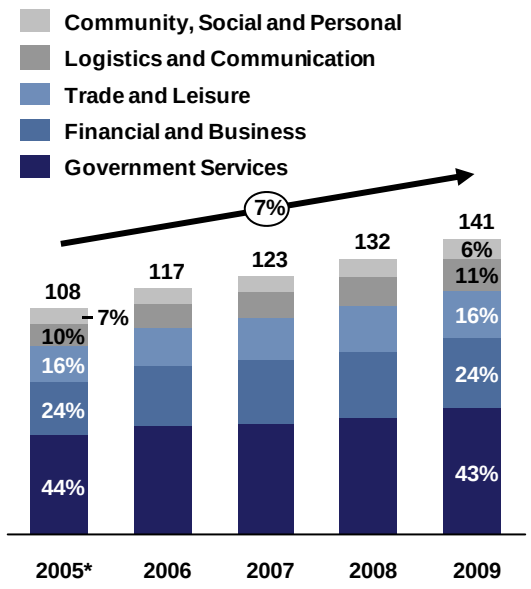
Government services, which include healthcare and education, is the largest component of the services sector. It has been an important driver of growth (Fig 3.16). Real growth in this sector picked up to 3.8% in 2009 from 2.4% in 2008 as the government stepped up

[47] There are three airport expansions underway at Medinah, Dammam, and Jeddah
[48] A major port is being built at King Abdullah Economic City and a major port expansion is taking place at Jubail
[49] There are three major ongoing railway projects: the north-south railway for mining resources; a Makkah, Jeddah, Rabigh and Madinah railway; and a Riyadh-Jeddah railway
[50] Contracts for 6,000 km of roads were awarded in 2010

spending to compensate for a private sector slowdown. With large government commitments, we expect real growth in the sector to be sustained in 2010-12.

The large population and strong growth in private consumption are important factors in the strength of non-government services sectors. **Financial services** will be boosted by the growth of a number of new private insurance companies and, potentially, by an increase in home-secured lending, particularly once the mortgage law is passed.

Fig 3.16 Services Subsectors (2005-09)
(US$bn)



Source: SAMA, *Sums to 101% owing to rounding

The shares of the different subsectors within services have changed little between 2005 and 2009 and we expect minimal change in 2010-12. We forecast that real GDP growth in the services sector will achieve a CAGR of 4.5% in 2010-12, a slight increase from 4.2% in the period from 2005-09.

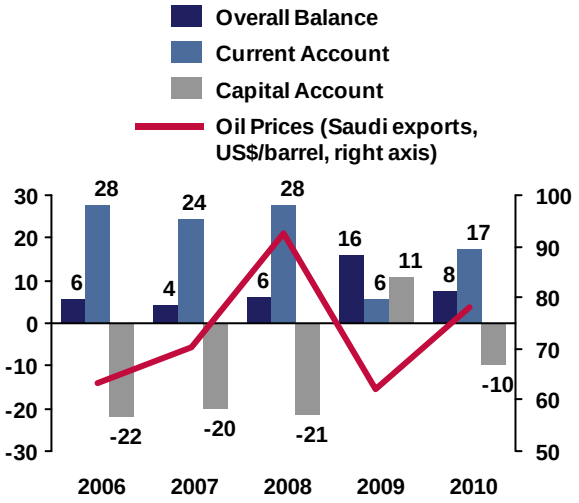
4. External Sector

A. Balance of Payments

The external surplus from oil exports is used to purchase foreign reserve assets

The overall balance of payments, the sum of the current account and the capital account[51], averaged 8% of GDP in 2006-10 (Fig 4.1). Saudi Arabia usually records a current-account surplus, which averaged 21% of GDP during 2006-10. The surplus is mainly a consequence of the inflows of revenue from oil exports. It is usually partly offset by a capital-account deficit, which averaged 13% in 2006-10. This deficit is mainly a result of SAMA utilising the inflows from oil exports to purchase reserve assets abroad[52], categorised as a capital-account outflow.

Fig 4.1 Balance of Payments (2006-10)
(% of GDP)



Source: SAMA

Foreign reserve assets were repatriated in 2009

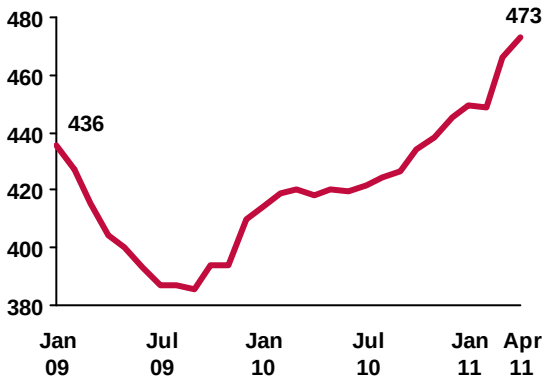
The overall balance of payments rose to 16% of GDP in 2009, compared with an average of 5.4% in 2006-08. This occurred despite a contraction in the current-account surplus from 28% of GDP in 2008 to 5.6% in 2009 as oil prices dropped. The increase in the overall surplus was due to a turnaround in the capital account from a deficit of 21% of GDP in 2008 to a surplus of 11% in 2009. This was primarily a result of foreign reserve assets being repatriated owing to:

- Concern about the trends in market valuation of some foreign assets following the financial crisis
- The perceived need for the government to inject money into the local economy

These concerns were alleviated in 2010 by a global economic recovery and higher oil prices. The capital account returned to deficit as the government again began purchasing reserve assets abroad. Therefore, despite a higher current-account surplus in 2010, the capital-account deficit pulled the overall balance of payments down to 7.6%, closer to the pre-crisis average.

Capital-account trends are reflected in stocks of international reserve assets, which declined during most of 2009 (Fig 4.2). This was reversed in 2010-11 as the capital account has returned to a deficit. Foreign reserves reached US$473bn in April 2011, a new high and an 11% increase on a year earlier.

Fig 4.2 International Reserves (Monthly, 2009-11)
(US$bn)



Source: SAMA

B. Current Account

The current-account surplus fell from 28% of GDP (US$132bn) in 2008 to 5.6% (US$21bn) in 2009 (Fig 4.3). It subsequently rose to 17% (US$75bn) in 2010. The movements are primarily a result of variable inflows from oil exports, which are included under the trade balance.

The large goods trade surpluses are offset by deficits in the non-physical balance. This includes trade in services, current transfers in and out of the country and flows of income from companies and investments. The most important outflows within the non-physical balance are:

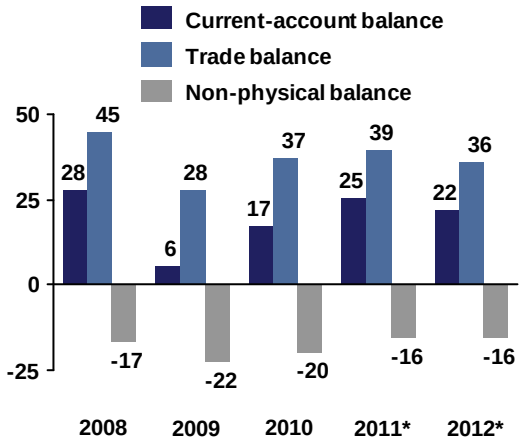
- **Imports of services**, particularly for the government
- Payments by Saudi tourists travelling abroad
- Expatriate workers remitting their income to their countries of origin

Our forecasts for the rise and fall of the current-account balance in 2011-12 are driven largely by our average price expectations for Saudi oil of US$105/b in 2011 and US$99/b in 2012.

[51] The capital account comprises payments that relate to ongoing obligations, such as investments or repayment of debt, as opposed to the current account, which comprises payments for immediate exchange with no future obligations, such as receipts for exports

[52] Saudi Arabia's reserve assets as at the end of April included US$338bn of foreign securities, which are mainly US Treasury securities. Foreign currency and deposits abroad accounted for US$121bn of reserve assets. Most countries only count foreign currency holdings as reserve assets. Other GCC countries manage foreign securities within sovereign wealth funds that are separate to their central banks. Saudi Arabia includes its foreign securities holdings in reserve assets as they are highly liquid and similar to holding cash. The IMF also makes the same classification. However, this complicates direct comparisons between its reserve assets and the reserve assets of other countries

Fig 4.3 Current Account (2008-12)
(% of GDP)

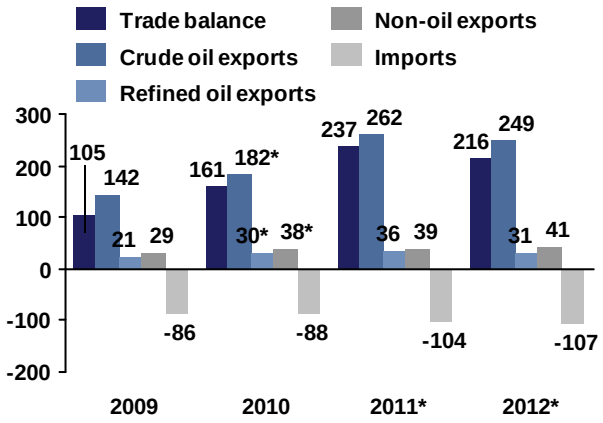


Source: SAMA, Ministry of Finance, *QNB Capital estimates forecasts

Trade Balance

The trade balance dominates the current account. The surplus rose 53% to US$161bn, or 37% of GDP, in 2010 (Fig 4.4) as oil export receipts increased.

Fig 4.4 Trade Balance (2009-10)
(US$bn)



Source: SAMA, *QNB Capital forecasts

With higher oil prices in 2011, we expect the trade surplus to rise by 47% to US$237bn and then to drop slightly to US$216bn in 2012 as oil prices fall. Economic growth, strong investment, government spending and higher commodity prices will drive growth in imports, which will rise by around 19% in 2011. These drivers will stabilise in 2012 when we expect import growth to slow to 3.1%.

Oil accounted for 85% of exports in 2009, estimated to have increased to 88% in 2010

Total **exports** were US$250bn in 2010 according to the CDSI. As more detailed official data is not yet available, we have estimated the breakdown of exports into oil and non-oil components. There was a 26% increase in oil prices, and oil production rose by about 2.9%. As a result, we expect petroleum exports to have risen by around 30% to US$212bn in 2010, despite rising domestic consumption. Therefore, oil constituted around 88% of total exports in 2010, slightly higher than the 85% in 2009 (Fig 4.5).

Diversification efforts have not yet managed to significantly boost non-oil exports

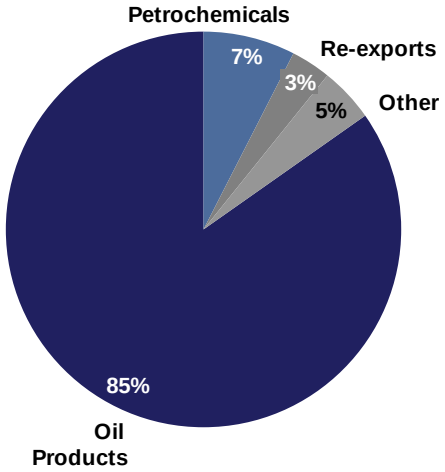
The petrochemical industry is classified as non-oil, but is actually heavily dependent on hydrocarbons for its feedstock (see Section 3B). It accounted for 7% of exports in 2009[53]. A further 3% of exports were re-exports[54]. This implies that only 4.5% of exports are not heavily dependent on hydrocarbons and originated in Saudi Arabia.

Around half of these are food exports, which have been rising in recent years, but could fall in the future since the government is withdrawing substantial support to the agricultural sector. This leaves a limited base from which to build non-oil exports that originate in the Kingdom:

- Base metals and articles (US$1.9bn, or 1% of exports in 2009)
- Machinery and electrical equipment (US$1.3bn, or 0.7% of exports in 2009)

The export success of the petrochemicals industry is a positive initial step and the diversification efforts that are underway will contribute further to export revenues.

Fig 4.5 Goods Exports (2009)



Source: Central Department of Statistics and Planning, Ministry of Economy and Planning

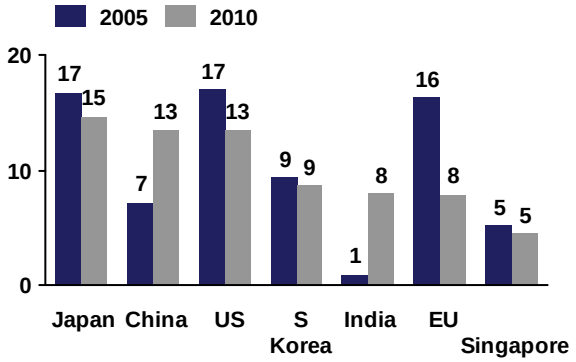
Oil exports have shifted East as demand has grown in Asia and contracted in the West

[53] A full breakdown of exports for 2010 is not yet available. The broad structure of exports is unlikely to have changed significantly from 2009. Higher oil prices will have led to a small increase in the share of oil products

[54] Re-exports occur when countries import and then export the same goods, often through free-trade zones. This may occur for logistical reasons as goods need warehousing, or transfer to smaller ships for regional distribution

The destination of Saudi exports has shifted from West to East (Fig 4.6). In 2005, 33% of exports went to the EU and US, but this fell to 21% in 2010. Over the same period the share of exports to Asia rose from 56% to 66%. This is mainly due to rising demand in Asia[55]. Notably, strong demand growth in China has driven its share of Saudi exports from 7% in 2005 to 13% in 2010. Demand in Western countries has been falling[56] owing to higher efficiency, use of alternative energy sources and higher oil prices. The US has also been making an effort to diversify its sources of oil supplies, leading to a large drop in its share of Saudi exports from 17% in 2005 to 13% in 2010.

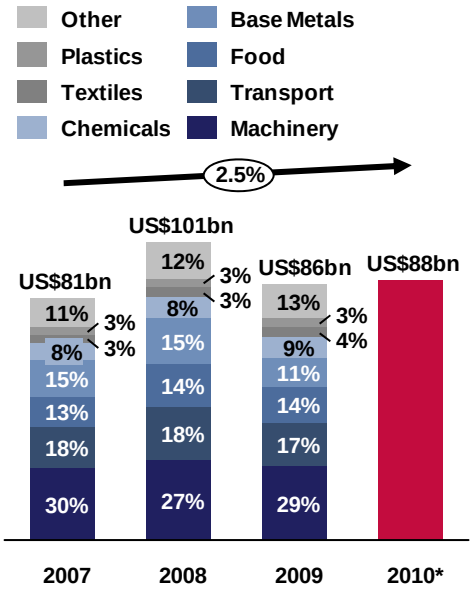
Fig 4.6 Export Destinations (2005 and 2010)
(% of total exports)



Source: IMF, Direction of Trade Statistics

Sluggish import growth suggests economic activity and confidence is weak

Fig 4.7 Imports (2007-10*)



Source: Central Department of Statistics and Information, *An overall figure has been provided for 2010 but no breakdown

[55] Demand for oil in Asia rose 10% from 15.5m b/d in 2005 to 17.1m b/d in 2010
[56] Demand in the OECD, which is predominantly Western countries, fell 7.4% from 49.8m b/d in 2005 to 46.1m b/d in 2010

Total **imports** were US$88bn in 2010 according to the CDSI, an increase of 1.7% over 2009 (Fig 4.7). The breakdown for imports in 2010 has not been released yet.

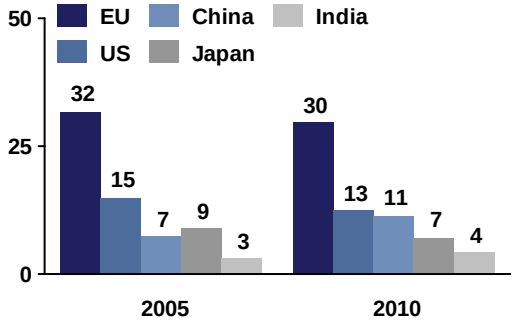
The bulk of imports are capital inputs for Saudi Arabia's infrastructural and industrial development projects. For example, the machinery, metals, chemicals and plastics categories—which accounted for 52% of imports in 2009—will be predominantly related to infrastructure and petrochemical projects. Vehicles account for the majority of the transport category.

There was a peak in imports in 2008. Higher oil prices helped boost government capital spending on major projects. This also increased confidence amongst consumers and businesses leading to high investment. These trends were reversed in the 2009 slowdown with imports falling by 15%. The relatively small increase in total imports in 2010 suggests that a recovery in economic activity and confidence is underway.

Import sources have shifted to developing countries

Saudi Arabia's imports from major economically developed trading partners (the EU, US and Japan in Fig 4.8) have fallen in terms of their share of total imports between 2005 and 2010. Meanwhile, the shares of emerging market countries such as China and India have risen. This is part of a worldwide trend of rising imports from these rapidly growing developing countries. It is also a consequence of the strengthening trade ties between Saudi Arabia and Asian countries.

Fig 4.8 Import Sources (2010)
(% of total imports)



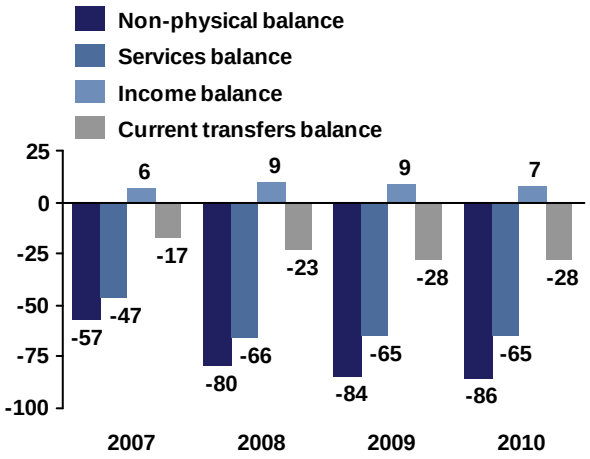
Source: IMF, Department of Trade Statistics

Non-Physical Balance

The non-physical deficit has risen from US$57bn (or 15% of GDP) in 2007 to US$86bn (20% of GDP) in 2010 (Fig 4.9). With a deficit of US$65bn in 2010, **services** is the most important item in the non-physical balance.

Government services account for over a third of total services imports (Fig 4.10). These are a result of foreign companies working for the government, largely in the rapidly growing national health and education sectors, which have a high participation of skilled foreign labour.

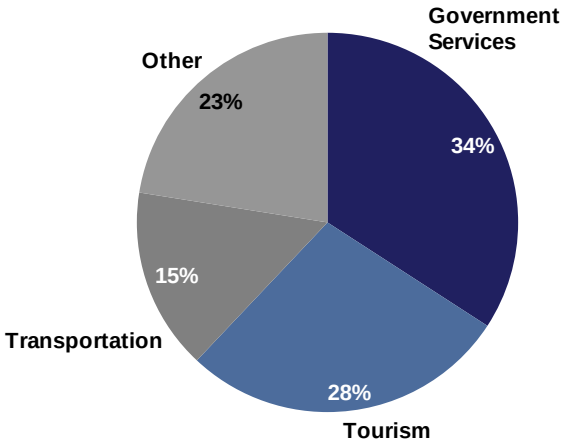
Fig 4.9 Non-Physical Balances (2007-10)
(US$bn)



Source: SAMA

Tourism accounts for 28% of services imports. Saudi residents spent US$21bn (4.9% of GDP) abroad in 2010, an increase of 63% since 2006. This is interrelated with **transportation**, which also recorded a deficit, amounting to US$12bn, in 2010. This is most likely a result of outflows to foreign providers of airline services.

Fig 4.10 Services Imports (2010)



Source: SAMA

More services are being provided domestically, a positive indication of economic diversification

Services imports have stabilised since 2008, which is a result of zero growth in government services and a general reduction in imports from other, smaller, services sectors. For example, between 2006 and 2010, **financial services** imports fell 85% from US$6.5bn to US$1bn and exports from the sector increased from zero to US$1bn. Similarly, the **construction services** deficit has fallen from US$6.3bn in 2007 to US$3.8bn in 2010, as local contractors have taken on more work. These trends suggest that the domestic services sector is increasingly able to meet the country's needs. This is a highly positive indication of economic development and diversification.

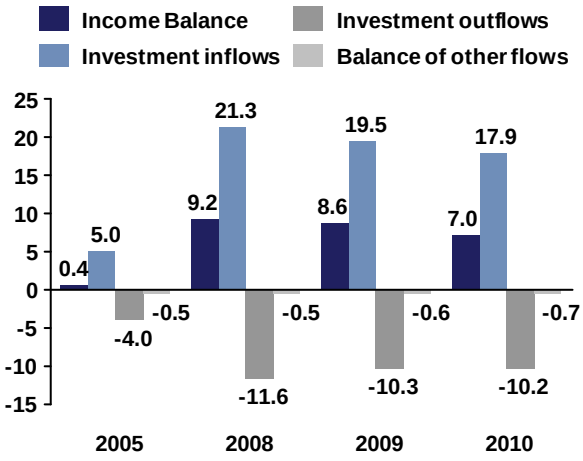
Growing remittances suggest dependence on foreign labour is rising

The **current transfers** deficit has risen since 2007 but stabilised in 2010. In 2010, 94% of this deficit was outflows from workers remitting their earnings to their countries of origin.

Remittances have grown at a CAGR of 14% from 2005-10 while the expatriate population has been growing at around 5.5%. This implies that the disposable income of expats has increased at a CAGR of around 8.1%. Remittances reached US$26bn in 2010, which equates to 6% of GDP, or an average of US$3,106 per foreign worker. This compares with 2005 remittances of US$14bn (4.3% of GDP) or US$2,123 per foreign worker. The increase in the remittances per foreign worker suggests that the proportion of skilled workers in the foreign labour force is increasing. The growth of remittances in absolute terms and as a percentage of GDP suggests that the Kingdom is becoming increasingly dependent on foreign labour, despite Saudization plans.

Income flows from investments have tracked the boom-bust economic cycle

Fig 4.11 Income Balance (2005 and 2008-10)
(US$bn)



Source: SAMA

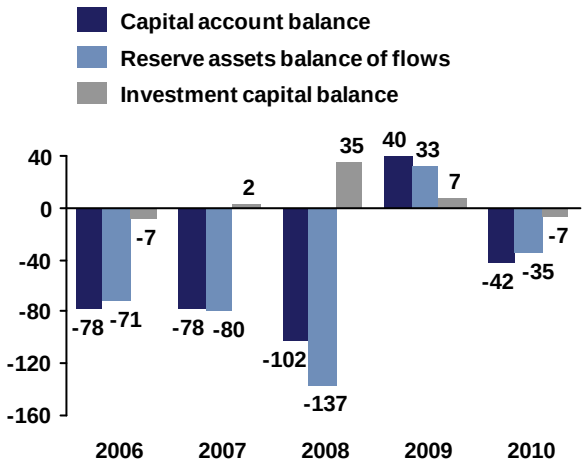
The **income balance** is the only component of the non-physical balance to have recorded a consistent surplus in recent years. Inflows from investments overseas grew at a CAGR of 62% in the 2005-08 boom (Fig 4.11) but have subsequently fallen at a CAGR of -8.2% in 2009-10, curbed by the financial crisis. Outflows of income from foreign investments in Saudi Arabia have followed a similar pattern, but have declined more gradually since 2008.

C. Capital Account

The capital account mainly involves the flows of investment capital that yield the income items under the current account. The capital account is usually in deficit

in Saudi Arabia, mainly because the state uses oil revenues to purchase foreign reserve assets (see Section A earlier for an explanation of the changes in reserve asset flows).

Fig 4.12 Capital Account (2006-10)
(US$bn)



Source: SAMA

FDI inflows fell in 2010, raising concerns about knowledge transfer and investor confidence

Investment capital flows are subdivided into direct investment, portfolio investment and other investment. The balance of investment capital flows averaged a surplus of US$5.9bn in 2006-10. This was primarily a consequence of a year of exceptional inflows when oil prices peaked in 2008. Inward **foreign direct investment** (FDI) increased 62% to a peak of US$39bn in that year. Outflows of investment were US$4bn. Portfolio and other investment flows, which usually record net outflows, fell sharply as a consequence of the financial crisis in the last quarter of 2008.

Saudi Arabia's share of global FDI rose from 2.2% in 2008 to 3.2% in 2009. FDI held up relatively well during the global slowdown, only falling 7.6% to US$36bn. This compares with a 37% fall in global FDI.

However, in 2010 FDI fell sharply, by 41%, to US$22bn. FDI is central to economic development plans. In particular, FDI is vital for the transfer of technology and know-how, which can enhance productivity and boost growth. FDI is also an indicator of external confidence in a country's growth prospects.

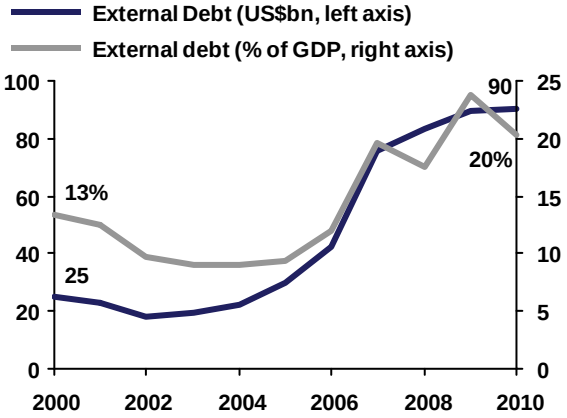
The slowdown in FDI is probably temporary and related to the number of projects reaching financial close. It is estimated that US$45bn of key projects reached financial close in 2010 compared with an expected US$79bn in 2011. If all these projects complete in 2011, this could lead to higher flows of FDI and a recovery to above its 2008 peak of US$39bn.

D. Foreign Debt

External debt has risen, to finance major projects and provide trade credit for growing imports

There is no national source of data for external debt. Based on IMF data, external debt was US$90bn, or 20% of GDP, at the end of 2010. Approximately half of this is **short-term import financing**, which has been rising in line with growing imports.

Fig 4.13 External Debt Estimates (2000-10)



Source: Global Insight and IMF

The remainder is **longer-term debt**, either related to syndicated loan financing of major projects, or bond and sukuk issuance by large private and public-owned corporations. These forms of financing have expanded as companies have sought to diversify their sources of finance and as foreign currency lending by syndicates of international banks has been required to meet the massive scale of major projects.

5. Monetary Issues

A. Currency

The dollar peg is seen as providing stability, but limits the available monetary policy tools

The Saudi riyal (SR) has been pegged to the US dollar at a rate of SR3.750:US$1 since 1987. This limits the monetary policy tools at SAMA's disposal (Section B). The other GCC currencies, aside from the Kuwaiti dinar, also have long-standing pegs to the dollar.

It is unlikely that the currency will be de-pegged or re-valued for some time. The peg minimises the volatility of oil export revenues as oil is priced in dollars. The long-term stability of the peg also gives foreign investors confidence that their investments will not be negatively impacted by a devaluation. The dollar itself has been volatile in recent years, but even this has not prompted any moves towards changing the peg in Saudi Arabia or other GCC countries.

There are plausible scenarios that could lead to an adjustment to the peg in the long term

However, the peg could be adjusted in preparation for the launch of a GCC **Currency Union**. There are plans for a single currency including Saudi Arabia, Bahrain, Kuwait and Qatar (the UAE and Oman have withdrawn). A joint GCC Monetary Council has been established in Riyadh, with the Governor of SAMA as its current Chairman. It is likely that a GCC currency would initially be pegged to the dollar. This could eventually be changed to a basket of currencies that better reflect the trade relationships of the GCC. This would increase the stability of the value of all trade flows, imports and exports. However, it is also possible that the union could be achieved without any revaluation or de-pegging from the dollar. Each of the countries joining the union could adopt the new dollar-pegged GCC currency at a rate equivalent to their pre-existing peg to the dollar.

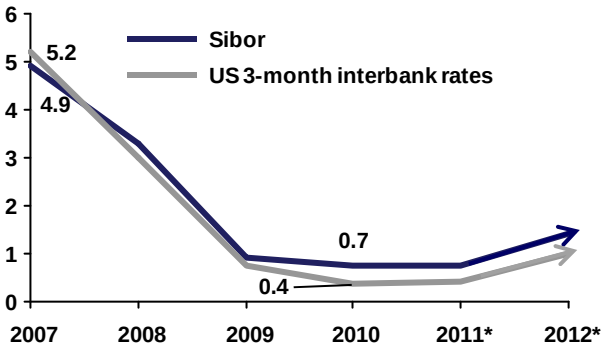
A less likely scenario would be an adjustment to the peg to help control spiralling **inflation**. In 2008, consumer price inflation spiked to 9.9% (Section C). Some analysts argued that an upward revaluation would help slow inflation by lowering import costs. However, an upward revaluation may have little impact. Food imports could drive inflation in the future, while domestic factors, such as rents, may be more important. Therefore, it would require a hyperinflation scenario, or a prolonged depreciation of the US dollar, for the Kingdom to seriously consider adjusting its exchange rate and undermining the stability and credibility that the long-term peg has created.

B. Money Supply and Policy Tools

SAMA is unlikely to raise rates until 2012, taking its lead from the US Federal Reserve

The dollar peg requires Saudi **interest rates** to broadly track US rates to deter major speculative capital flows seeking to arbitrage any interest-rate differential (Fig 5.1). Therefore, in a series of cuts, SAMA reduced its reverse repurchase rate from 1.5% in December 2008 to 0.25% by June 2009, after the US Federal Reserve dropped its benchmark federal funds rate to 0.00-0.25% in December 2008. Three-month Saudi interbank deposit rates (Sibor) fell from an average of 4.9% in 2007 to 0.7% in 2010. They have averaged 0.75% in the first four months of 2011.

Fig 5.1 Three-Month Interbank Rates, Annualised (2007-12)



Source: SAMA, *2011 is average for first four months, in 2012 QNB Capital expects rate hikes to begin

QNB Capital does not expect the Federal Reserve to begin raising US interest rates until 2012, once the recovery becomes more concrete. We expect Saudi Arabia to follow the lead of the Federal Reserve, which could impair bank lending growth.

SAMA mainly uses bank reserve requirements and lending limits as **monetary policy tools**. SAMA adopted an expansionary monetary policy in 2009, in response to the financial crisis, to encourage lending and maintain stability in the financial sector. Falling inflation in 2009 lowered the instability risks associated with liberal monetary policy. In 2009, the following policies were implemented:

- Commercial bank reserve requirement for demand deposits lowered to 7%
- Commercial bank reserve requirement for savings deposits lowered to 4%
- Repurchase rate was cut to 2% in June 2009
- Reverse repurchase rates were cut to 0.25% in June 2009
- Limits and low rates on Treasury Bill issuance to encourage the channelling of funds to the private sector

Money supply growth has dropped in 2009-10 with slow economic growth and weak lending

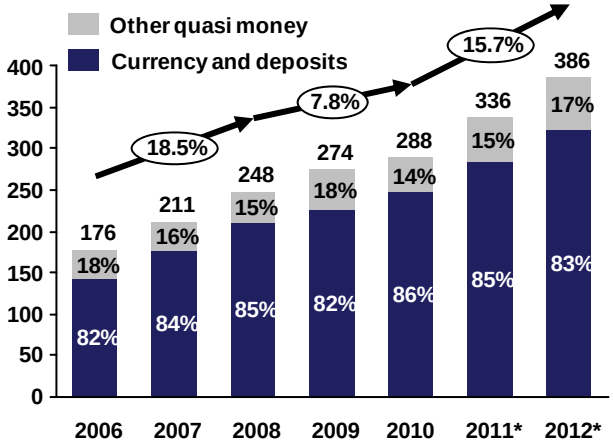
Broad **money supply** reached SR1.1trn (US$288bn, or 66% of GDP) in 2010. It grew at a CAGR of 13% from 2000-10, compared with a CAGR of 5.4% in the preceding decade. The acceleration was a result of the economic boom and high oil prices in the late 2000s (Fig 5.2), which also enabled the government to increase its expenditure in the domestic economy. However, money supply growth slowed from 18% in 2008 to 5% in 2010

owing to lower average oil prices in 2009-10 and an economic slowdown. Weak lending by banks to the private sector in 2009-10 also acted as a break on money supply growth.

Most of the money supply growth has been in currency and deposits, which grew at a CAGR of 14% from 2006-10, compared with **other quasi money**[57], which grew at a CAGR of 6.5%. Moreover, in 2010, there was a 15% contraction in other quasi money. This was most probably a result of a contraction in lending activity and a reduction in the amount of quasi-money financial instruments, such as letters of credit and repo transactions.

There has also been an increase in the amount of demand deposits relative to time and savings deposits. This is most probably a result of lower interest rates reducing the benefit of holding longer-term deposits.

Fig 5.2 Money Supply (2006-12)
(US$bn, CAGR also shown)



Source: SAMA, *QNB Capital forecasts

QNB Capital forecasts that money supply growth will accelerate to a CAGR of 16% during 2011-12. Money supply growth is expected to be driven by oil revenues flowing into the country and then being dispersed into the economy by government spending. Higher average oil prices in 2011-12, and large government spending commitments, will drive the acceleration in money supply growth. A recovery in bank lending will also add impetus.

C. Inflation

Historically, inflation in Saudi Arabia has been extremely low. The **consumer price index** (CPI) grew at a CAGR of 0.8% in the 1990s and 0.1% from 2000-05. From 2005-10, CPI inflation has been consistently higher with the index growing at a CAGR of 5.5% and spiking in 2008 at 9.9% (Fig 5.3).

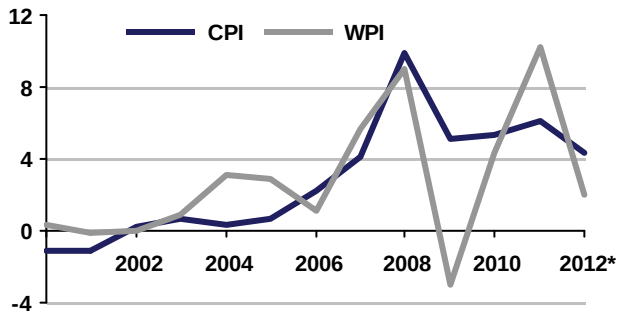
The **wholesale price index** (WPI), has followed a broadly similar pattern, growing at a CAGR of 1% in 1990-2003 and picking up to 3.2% in 2004-10 with a spike of 9% in 2008. In 2009, the WPI contracted by 3% as the costs of raw materials around the world fell. However, the 5.1% increase in the CPI in 2009 suggests that the lower costs were largely not passed on to end-consumers.

Average private sector **wages** remained stable in 2005-08 but fell by 27% in 2009, when a large number of Saudis left the private sector. The government gives regular pay rises to the bloated public sector, inflating wages.

An expansive and more open economy have led to higher inflation

Inflation has been driven higher by the economic boom, high oil prices and strong government spending, all of which have increased domestic demand. Saudi Arabia has also become an increasingly open economy, particularly since it joined the WTO in 2005, and this has added to the amount of **imported inflation**.

Fig 5.3 CPI and WPI Inflation (2000-12)
(Annual % change)



Source: CDSI, MEP, *QNB Capital forecasts in 2011-12

Consumer Price Index

Food and rent price rises have driven the increase in the CPI

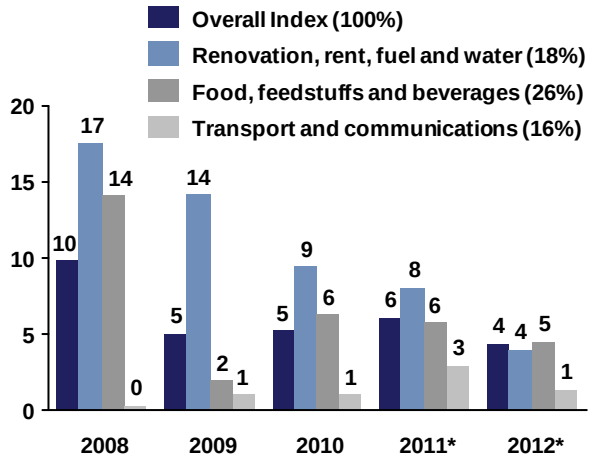
The rising costs of food and rent have driven the increase in the CPI. These items have the largest weighting in the basket of goods counted in the CPI at 26% and 18% respectively.

The component index for renovation, **rent**, fuel and water prices rose at a CAGR of 0.2% from 2002-06, but subsequently shot up to a CAGR of 12% from 2006-10, peaking at 17% in 2008. This was mainly a result of a shortage of housing as Saudi Arabia's young demographic profile is causing rapid housing demand growth, pushing up rent prices. Rental inflation slowed to an annual average of 9.4% in 2010 and 8.2% in the first quarter of 2011, and we expect it to average around 8% over the full year. A massive house-building programme, announced in early 2011, should begin alleviating some of the supply shortages by 2012. We therefore expect rental inflation to slow to around 4% in 2012. The

[57] SAMA classifies this as residents' foreign currency deposits, marginal deposits for letters of credit, outstanding remittances, and banks' repo transactions with private sector dealers. It excludes time and savings deposits, which are usually included as quasi money

introduction of a new mortgage law, which is expected in 2011, could also help to ease supply shortages. However, there is also a risk that a new mortgage law could increase demand for house purchases, pushing up prices with a knock-on effect on rental prices.

Fig 5.4 Consumer Price Index (2008-12)
(% change, index weighting in brackets)



Source: CDSI, MEP , QNB Capital forecasts

The categories omitted from Fig 5.4 are:

- Other expenses and services (13% of the index)
- Home furniture (11%)
- Fabrics, clothing and footwear (8%)
- Education and entertainment (6%)
- Medical care (2%)

The index for **food**, foodstuffs and beverages also accelerated from a CAGR of 3.4% in 2002-06 to 7.2% in 2006-10, with a spike of 14% in 2008. This category is heavily influenced by food import prices as most food is imported. Rising international food prices drove food inflation higher in 2006-08, but they then fell in 2009 and food inflation slowed to 2%. It then picked up again in 2010, averaging 6.3%, reaching a peak annual rate of 8.5% in November.

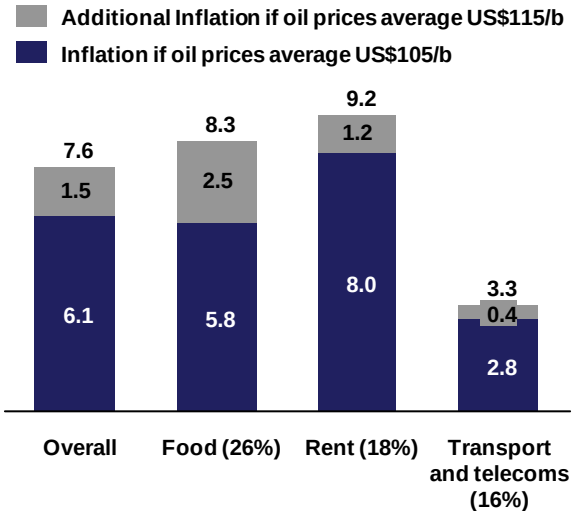
Food inflation has averaged 5.9% in the year to April 2011. The government has softened the impact of high international food prices in the first part of 2011 by increasing imports of wheat, which it subsidises in the domestic market. With persistent high international food prices, we expect food inflation to average 5.8% in 2011. A drop in international food prices in 2012 will lead to a deceleration in food inflation to around 4.5%.

Overall, CPI inflation will average 6.1% in 2011 slowing to 4.4% in 2012

Overall, rising food and rent prices will drive inflation to 6.1% in 2011. Upward price pressures are expected to ease in 2012 and inflation will slow to 4.4%.

Inflation is correlated to oil prices and government spending. High oil prices increase demand as they encourage more government spending and therefore drive price increases in the Saudi economy. Oil prices also increase shipping costs, driving up imported inflation, particularly in the food sector. Oil prices are volatile and, therefore, constitute the main risk to our inflation forecast. If oil prices were US$10/b higher than we are currently forecasting, we would expect inflation to be around 1.5 percentage points higher at 7.6% in 2011, all other things remaining equal (Fig 5.5). Most of the increase would occur in the food-related component of CPI.

Fig 5.5 Impact on CPI Inflation of US$10 Higher Oil Price Forecast (2011)
(CPI weightings in brackets)



Source: QNB Capital forecasts

Wholesale Price Index

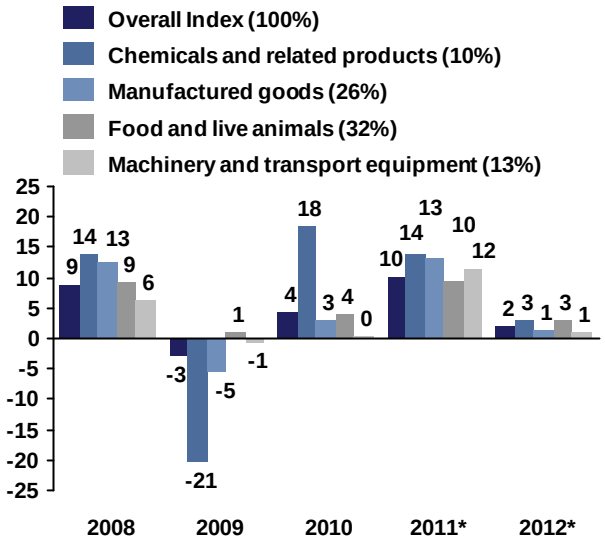
The highest weight in the WPI basket is given to **food and live animals**. This has faced similar changes to the food component of CPI, related to international food price movements.

Manufactured goods are the next most heavily weighted category. They were heavily affected by the boom-bust cycle in the global economy, rising 13% in 2008 before contracting 5.5% in 2009.

The **chemicals and related products** category represents prices in the petrochemicals industry, which are closely related to the oil sector and have experienced similar price movements.

The WPI has been more volatile than the CPI in 2008-10 as it is more responsive to changes in commodity prices. The WPI is therefore likely to rise and fall more sharply than the CPI in 2011-12, in line with changes in commodity prices. We therefore expect WPI inflation to pick up to around 10% in 2011, slowing to around 2% in 2012.

Fig 5.6 Wholesale Price Index (2008-12)
(% change, index weighting in brackets)



Source: CDSI, MEP, QNB Capital forecasts

Wages

The government increased public sector wages as part of two spending packages announced in early 2011. These included an increase in the minimum wage, a one-off payment of two months' salary and pay rises throughout the military. These pay increases will be mimicked in the private sector and have already been implemented at 27 listed companies, according to Jadwa Investment. This will lead to acceleration in wage inflation in 2011, which will increase demand and drive the CPI higher.

6. Public Finance

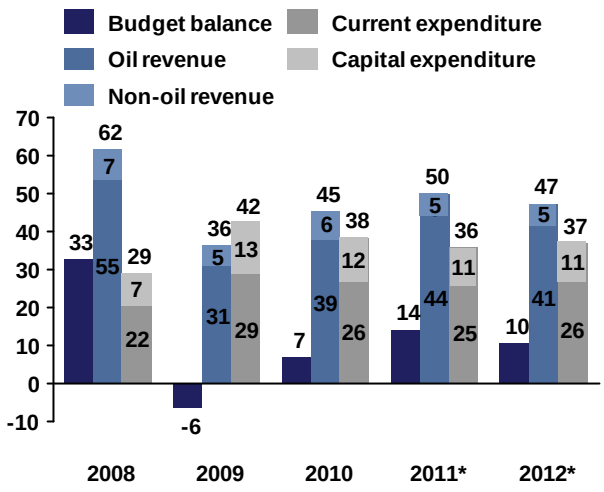
High oil prices will lift the budget surplus to 14% of GDP in 2011 and 10% in 2012

The actual revenue and expenditure of the government recorded a surplus of 6.7% of GDP, or US$29bn, in 2010, based on preliminary data from the Ministry of Finance. Revenue was 45% of GDP and expenditure was 38% (Fig 6.1).

Oil income accounted for 85% of actual budget revenue in 2009 and the budget balance rises and falls in line with changes in oil prices. It reached a peak surplus of US$155bn (33% of GDP) in 2008, and sharply declined to a deficit of US$23bn (6% of GDP) in 2009.

Based on a number of assumptions for revenues and expenditures in 2011-12 (discussed below), QNB Capital forecasts that the budget surplus will rise to US$78bn in 2011 and fall to US$57bn in 2012.

Fig 6.1 National Budget (2008-12)
(% of GDP)



Source: Ministry of Finance, *QNB Capital Forecasts

A. Revenue

Revenue will rise to an average of 49% of GDP in 2011-12

Actual budget revenue peaked at US$294bn, or 62% of GDP, in 2008, when oil prices were high, but fell 54% to US$136bn in 2009, in line with the drop in oil prices. The Ministry of Finance gave a preliminary overall figure for budget revenue in 2010 of US$196bn. It has not yet provided a breakdown of this revenue, but we estimate that oil revenue was around US$172bn, or 88% of the total.

The proportion of oil export revenue that is diverted to the state budget varies from year to year. Based on official data, government oil revenues were 93% of oil exports in 2008 and 71% in 2009.

The variation is probably driven by the level of planned government spending and by Saudi Aramco's cash requirements for new investments or to cover costs. We have based our forecasts on the assumption that the government will take around 81% of export revenue into the state budget in 2011-12, which is equivalent to the average proportion over the last five years. Based on this, and our price and production assumptions, we expect revenue from oil to increase by 40% in 2011 to US$274bn, dropping to US$260bn in 2012.

Faster economic growth will drive increases in non-oil revenue

Non-oil revenue is mainly derived from taxes on the profits of foreign businesses, fees and from import duties[58]. It grew at a CAGR of 25% from 2005-08 to reach US$31bn, but dropped to US$20bn in 2009. We expect that non-oil revenue has subsequently recovered and will grow at a CAGR of 18% from 2009-12 to US$33bn, or 5% of GDP, as imports and corporate profits expand.

B. Expenditure

Expenditure has grown faster than revenue over the last five years

Actual total expenditure grew at a CAGR of 12% from 2006-10 to reach US$167bn. This compares with revenue growth of 2.2% over the same period. QNB Capital forecasts that total expenditure will increase by 17% to US$196bn in 2011 and by a further 3.2% to US$202bn in 2012[59].

A breakdown of expenditure has not been released for 2010. Based on historical trends and planned expenditure, we estimate that current expenditure was US$115bn, or 69% of the total. This would mean capital expenditure accounted for US$52bn.

Actual current expenditure will be substantially above budgeted levels

The government has announced planned **current expenditure** for 2011 of US$86bn. However, the government bases its budget on highly conservative oil price assumptions and so consistently spends more than planned. Current expenditure was an estimated 154% of the budgeted amount in 2010. Owing to recent announcements of additional spending, we expect overspending to be slightly higher in 2011-12. Current expenditure will be around US$138bn in 2011, 160% of the budgeted amount, and US$143bn in 2012. In 2012, we expect a small drop in oil prices, which will have the effect of restraining expenditure growth.

[58] Saudi Arabia has the 8th lowest tax rates in the world according to the World Bank's Doing Business 2011 report. The total tax rate as a percentage of profit is 14.5%, which compares with 11.3% in Qatar, 14.1% in the UAE and 15% in Bahrain. High oil revenues enable Saudi Arabia to keep taxes low. The low-tax environment is designed to attract foreign businesses to the country

[59] In the past a drop in oil prices has not usually led to cutbacks in expenditure. For example, in 2009 oil prices fell by 33% but the government still increased expenditure by 15%. Therefore, the small drop in oil prices in 2012 is unlikely to lead to cutbacks in expenditure

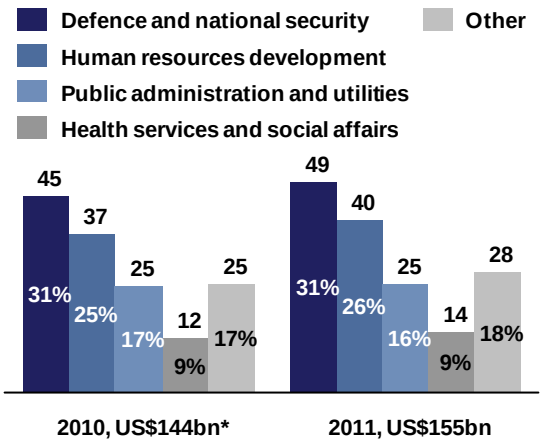
Capital expenditure is usually lower than is budgeted, and this trend will continue in 2011

Planned **capital expenditure** is US$68bn in 2011. However, the government usually only spends around 80% of planned capital expenditure, owing to delays in moving projects forward. The government has exhibited strong commitment to increasing capital spending in 2011, particularly with supportive measures and extra investment in the housing sector. We therefore expect spending to be a little closer to planned expenditure than usual at US$58bn in 2011 (85% of budgeted spending). We only expect a small increase in 2012 to US$59bn.

The Ministry of Finance does not provide a **sectoral breakdown** of the outturn of actual expenditure from the budget. It does, however, provide a breakdown of its planned, or budgeted, spending (Fig 6.2). The share of the major components of budget expenditure has remained relatively constant in 2010-11.

Fig 6.2 Government Planned Expenditure (2010-11)

(US$bn and % of total planned expenditure)



Source: Ministry of Finance, *Do not sum to 100% due to rounding

Some of the main spending commitments in the **2011 budget** were:

- Education spending of US$40bn—3,200 schools are under construction and 610 are expected to be completed in 2011 compared with 600 in 2010
- Health spending of US$14bn—12 new hospitals and clinics in addition to the 120 that are under construction
- Transportation spending of US$13bn—6,600 km of new roads are being built in addition to 30,200 km already under construction and four new airports are being constructed

In addition to the government budget, there are five **specialised credit institutions** (SCIs). The Ministry of Finance expects these to disburse US$13bn in 2011.

Additional spending packages will add impetus to the 2011 budget

Further to the spending outlined in the budget, two **additional spending packages** were announced in February and March 2011, totalling around US$130bn. The time period over which these funds will be disbursed was not announced, but it is likely to be 3-5 years.

The measures included US$26bn in additional support to low-income segments of society and the unemployed. It also extended the time period of an inflation allowance in public-sector salaries, which will cost around US$10bn. They also included US$67bn for a programme to build 500,000 houses (Section 3C). The other major provisions were:

- One-time payments of two months of salary to government employees and the military
- Two months' worth of living stipends to nationals studying under government scholarships
- A new monthly unemployment benefit of US$533 /month from November 2011
- A new minimum wage for government employees of US$800 /month
- An additional US$4.3bn for the health sector
- 60,000 new military jobs
- A one-level pay rise throughout the military
- Additional funding of US$8bn for the Saudi Credit and Savings Bank which provides interest-free loans to small- and medium-sized enterprises (SMEs)

Five-year plan

Five-year plans show an overriding long-term commitment to building human capital

The annual budget is part of a broader five-year development planning framework. In July 2010, the government approved the **ninth five-year development plan** for the years 2010-14, which included spending of US$385bn (89% of 2010 GDP). The plan was 67% larger than the eighth development plan and followed a US$400bn stimulus package announced in 2009 to boost economic growth during the fallout from the economic crisis[60].

The largest item in the plan is human resources development, accounting for 51% of the total, nearly three times the amount of the next largest item, social development and health (Fig 6.3). Spending on human resources increased at a CAGR of 14% in the first three years of the previous development plan. This is an indication of the Kingdom's overriding long-term commitment to education and building its human capital.

The biggest spending increases in the ninth plan were allocated to economic resources development[61] and transport and communications[62]. The government is

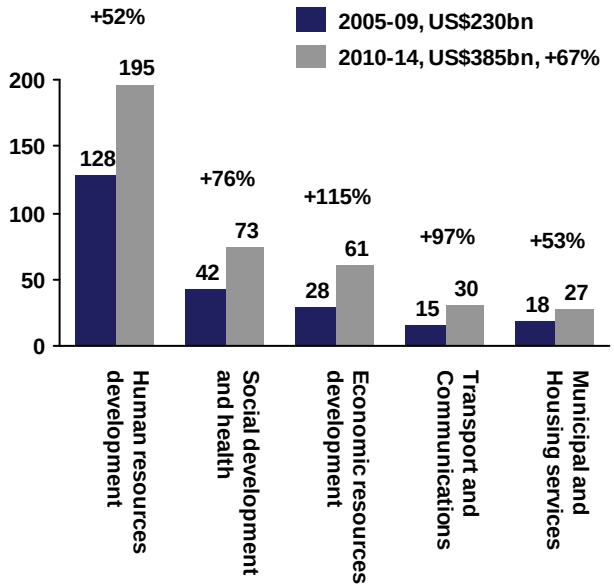
[60] Some of the spending in this package may overlap with subsequent budget spending and five-year plans

[61] These funds will be allocated to the development of agriculture, water, electricity, oil, gas, minerals, industry and general economic services

[62] A large portion of this increase will go towards: extending the broadband infrastructure to all regions of the country; improving access in educational establishments; and improving e-government services

building its basic infrastructure to provide a solid foundation for economic development.

Fig 6.3 Planned Spending in Five-Year Development Plans (2005-14)
(US$bn and % change also shown)



Source: Ministry of Economy and Planning

Major infrastructure projects in the 2010-14 five-year plan included:

- A US$7bn, 950 km east-west railway project, connecting Jeddah to Dammam
- Installation of 70,000 new sewerage connections and 600,000 domestic water connections

C. Public Debt

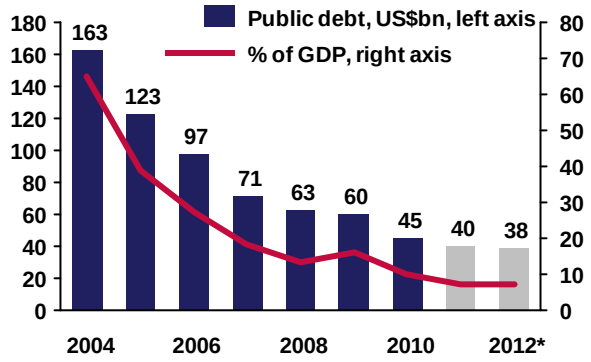
SAMA has continued to reduce public debt, partly to help stimulate private sector lending

The government has used its budget surpluses to pay down public debt, which has fallen from US$163bn in 2004 to US$45bn in 2010. Given its ample reserves and oil revenues, there is little need for the government to hold a substantial amount of debt.

The debt reduction policy was sustained following the financial crisis, despite a budget deficit in 2009 and a relatively small surplus in 2010. This policy reduced the extent that banks could invest surplus liquidity in government debt and may have made alternatives, such as lending to the private sector, more attractive.

We expect the government to continue reducing debt in 2011-12, given our forecast for a budget surplus averaging 12% of GDP per year. Stimulating bank lending to the private sector remains a priority—most stimulus measures introduced in 2009 are still in place. SAMA is therefore unlikely to change its policy of limiting government debt issuance—it is currently only issuing short-term treasury bills.

Fig 6.4 Public Debt (2004-12)



Source: SAMA, *QNB Capital forecasts in 2011-12

Bottom line: the government can spend big, reduce debt and still accrue reserves

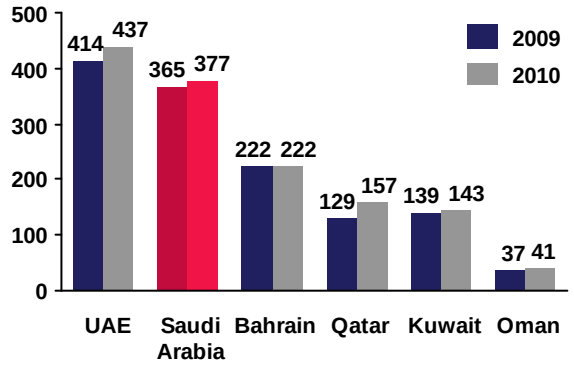
Overall, despite massive additional spending measures and reducing public debt, the government is still able to accrue international reserves. Holdings of foreign exchange and foreign securities rose at an annual rate of 20% to US$473bn in the first four months of 2011, thanks to high oil prices (Fig 4.2 in Section 4A).

7. Banking Sector

A. Overview

Although Saudi Arabia is the largest economy in the GCC, its banking sector is slightly smaller than the UAE (Fig 7.1). Development in the UAE has tended to rely more heavily on debt financing, particularly in Dubai, than in Saudi Arabia, where the government and banks are more cautious.

Fig 7.1 GCC Total Banking Assets (2009-10)
(US$bn)

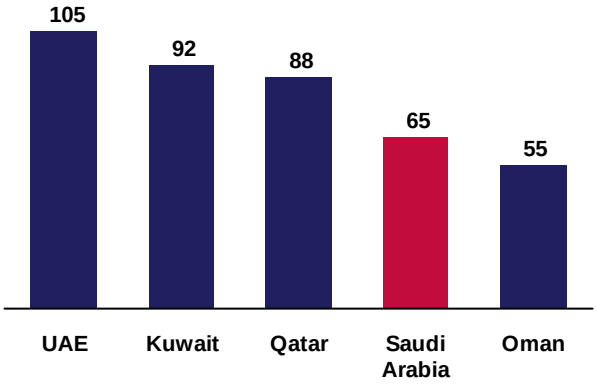


Source: Central banks

Low loan penetration means there is room for growth in credit

The Saudi banking sector is underpenetrated. In 2009, total loans amounted to 65% of GDP, compared with 105% in the UAE (Fig 7.2). A number of factors have kept commercial bank lending below potential in the Kingdom, including delays in passing a mortgage law (Section 3C). This leaves room for growth going forward. It is important to note that specialised credit institutions (SCIs), with assets of US$101bn (Section C), play a far more significant role in Saudi Arabia than in other GCC countries. If SCI lending was included, loan penetration in Saudi Arabia would have been 78% in 2009.

Fig 7.2 GCC Loan Penetration (2009)
(Loans as % of GDP)



Source: Central banks

Prudent oversight has kept the banking sector well protected

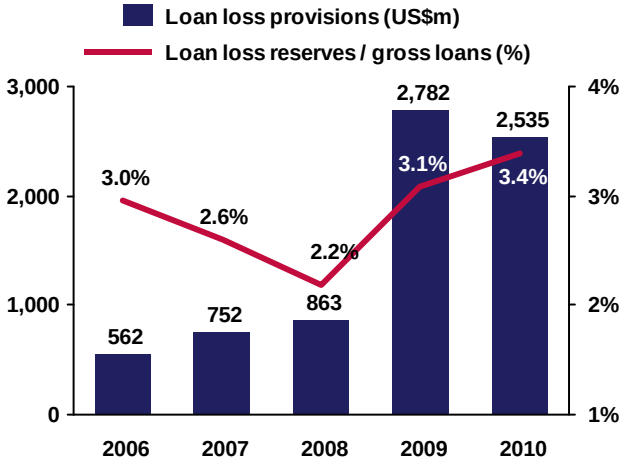
SAMA has taken a proactive role in the supervision of the banking sector. It has implemented international standards, such as Basel II[63] in 2008, and expects Saudi banks to maintain their leading position among international financial institutions that also apply these standards. Saudi banks had a capital adequacy ratio of 16.5% in 2010, according to the IMF, compared with the Basel II requirement of 8%. These factors ensured that the banking sector was well protected during the 2008 global financial crisis.

Non-performing loans and loan-loss provisions increased after the financial crisis

Nonetheless, like most countries, non-performing loans did increase in 2009 in the aftermath of the financial crisis. They rose from 1.4% of total loans in 2008 to 3.4% in 2009. Much of this increase was the result of exposure to two large Saudi corporate defaults[64]. It was also a consequence of the broader economy feeling the squeeze of the global economic slowdown and the indirect effects of lower oil prices in 2009.

This forced banks to increase their annual loan loss provisions. In 2009, the amount of additional provisions taken by Saudi banks for losses related to loans more than tripled to US$2.8bn (Fig 7.3). These new provisions reversed the previous downward trend in the proportion of loan loss reserves to gross loans. The reserves ratio rose from 2.2% in 2008 to 3.1% in 2009 and to 3.4% in 2010.

Fig 7.3 Loan Loss Provisions (2006-10)



Source: Bankscope and individual bank statements

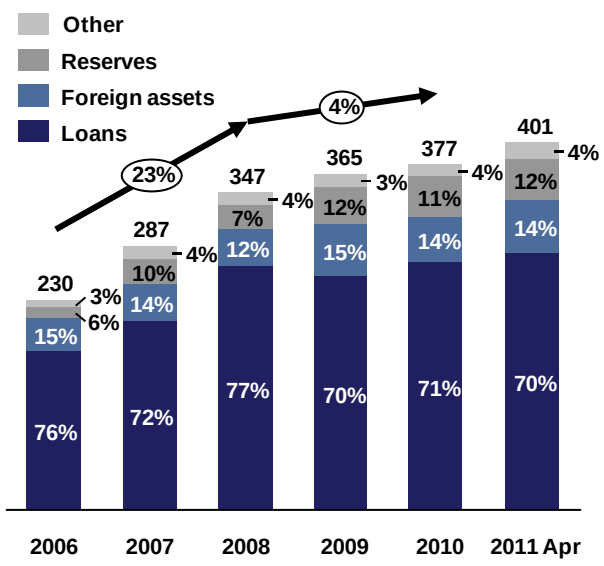
[63] Basel II is a set of international banking recommendations for regulators to use as guidance for their risk and capital management requirements
[64] Two major Saudi corporates, Ahmad Hamad Al-Gosaibi and Brothers and the Saad Group, defaulted on their debts in 2009, and impacted the financial services sectors in the region

B. Bank Performance

Strong credit growth has been a key driver of commercial bank asset growth

The **assets** of commercial banks have grown at a CAGR of 13% from 2006-10. This growth was significantly stronger from 2006-08, when it reached 23%, than from 2008-10, when it was 4% (Fig 7.4). **Loans** are the largest component of assets and were a key driver of growth with a CAGR of 24% from 2006-08. This strong credit growth spanned the private and public sectors, driven by the expansion of the entire economy.

Fig 7.4 Commercial Bank Assets (2006- Apr 2011)
(US$bn, end-period, CAGRs shown)



Source: SAMA

Commercial banks were largely focused on the domestic economy from 2006-08, and so foreign assets grew comparatively slowly, at a CAGR of 8.9%. This helped protect the sector from foreign contagion during the global financial crisis. Reserves growth was also strong from 2006-08, at a CAGR of 37%.

Although loans contracted in 2009, government support contributed to an increase in total assets

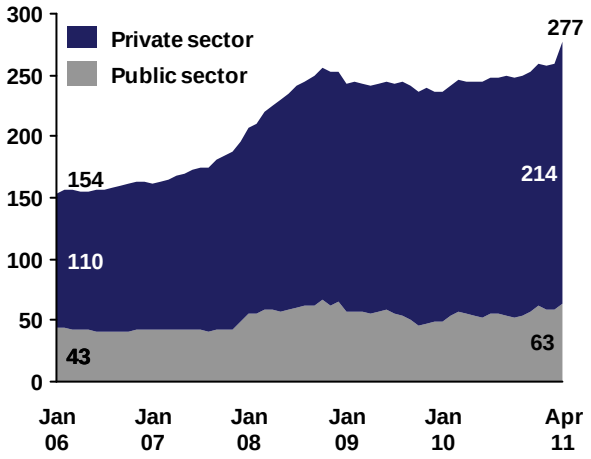
The financial crisis and global slowdown led to greater caution amongst banks and a slowdown in demand for loans. This caused loans to contract by 6.1% in 2009. Private sector credit stagnated and public sector credit contracted by 25%, from US$65bn to US$49bn, as the government paid down loans to support the banking system (Fig 7.5).

SAMA took a number of steps to support banks:

- US$3bn in deposits were injected into the banking system
- Interest rates were cut from 1.5% in December 2008 to 0.25% in June 2009, in line with cuts in US rates
- The cash reserve requirement on demand deposits was reduced from 10% to 7%

The liquidity injection, along with increased caution among banks and less demand for credit, led to an accumulation in foreign assets and reserves in 2009 (Fig 7.4). Reserves grew by 65% and foreign assets by 37% in 2009, leading to growth in total assets of 5.2%, despite the contraction in lending.

Fig 7.5 Commercial Bank Lending (Jan 2006-Apr 2011)
(US$bn)



Source: SAMA

Lending has recovered in 2010-11

In 2010, the banking sector recovered as banks regained confidence and increased lending to the private sector. Consumer credit expanded by 11% in 2010 and lending to companies grew by 8.6%. Lending to the public sector also recovered, growing by 14%. From the beginning of 2010 until April 2011, total assets and its components have grown at the following annualised rates:

- Total assets at 6.4%
- Reserves at 4.8%
- Loans at 8.7%

With a number of major project financing deals expected, including around US$2.9bn of lending from local banks for two oil refineries (Section 3B), loan growth is likely to be sustained during 2011.

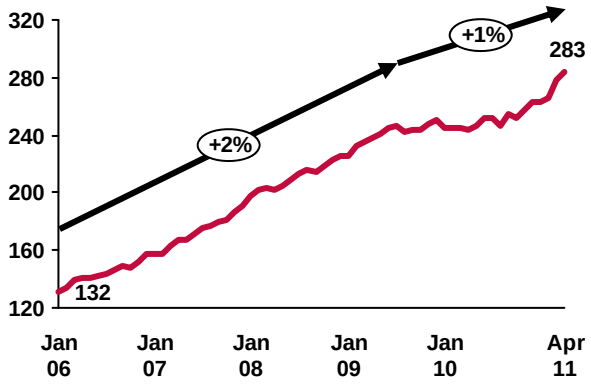
Short-term deposits do not create a problematic funding gap

On the other side of the balance sheet, total commercial bank **deposits** were also affected by the financial crisis (Fig 7.6). Deposits account for around 70% of the banks' total **liabilities**. Deposits grew steadily at a CAGR of 20% from the beginning of 2006 until mid-2009, when they stabilised as economic activity slowed down and private sector depositors became more wary of potential

issues in the banking system. The private sector accounts for around three quarters of deposits and the public sector accounts for the remainder. Government deposits in the commercial banking system grew strongly at a CAGR of 15% in 2006-10 and contracted by 6.5% in 2010, as the government increased its deposits with SAMA. Growth in total deposits reached 7.8% in the first three months of 2011 (equivalent to an annualised growth of 25%), driven by the recovery in confidence and economic activity.

Short-term demand deposits accounted for 54% of total deposits in 2010. However, as 59% of loans are for a period of less than one year, there is not a significant funding gap resulting from differing maturities of loans and deposits.

Fig 7.6 Commercial Bank Deposits (Jan 2006-Apr 2011)
(US$bn, CAGRs shown)



Source: SAMA

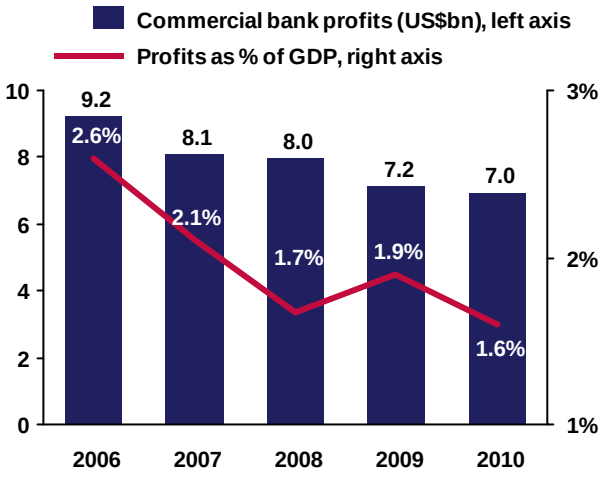
A series of events have led to a decline in commercial bank profits every year since 2006

Profits of commercial banks have declined since 2006 (Fig 7.7) as a series of shocks have undermined profitability.

In 2005, SAMA became concerned at the rapid growth of personal lending, which was thought to be driving a stockmarket boom. In response, SAMA imposed restrictions on consumer lending, including a cap on debt-service payments to one-third of the borrowers' salary. This acted as a break on loan growth, reducing bank interest income. The stockmarket bubble burst in 2006 and trading volumes also collapsed, lowering brokerage income for banks. Finally, during 2007-10, banks took increasing provisions for loan losses as the financial crisis unfolded.

With increasing economic and financial activity in 2011, this may be the first year of commercial bank profit growth since 2006. Total profits at the commercial banks in the first quarter of 2011 were 10% higher than in the first quarter of 2010. The US$130bn of new stimulus packages announced by the government in early 2011 (Section 6B) will also provide a substantial boost to banking activity.

Fig 7.7 Commercial Bank profits (2006-10)
(US$bn)

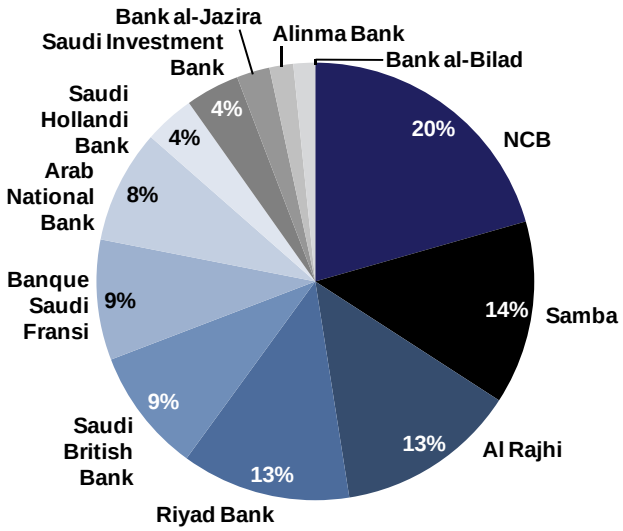


Source: SAMA

C. Structure of the Sector

There are 12 **local commercial banks**, which are all majority-owned by Saudis. National Commercial Bank (NCB) is the largest bank in terms of assets (Fig 7.8).

Fig 7.8 Market Share of Local Banks by Assets (2010)



Source: Bankscope

Four local banks are fully Sharia compliant and the others have Islamic windows

Four of the local banks are fully Sharia-compliant **Islamic banks**:

- Al Rajhi
- Bank al-Bilad
- Alinma
- Bank al-Jazira

These banks account for 19% of market share by assets.

Saudi law, including the law that governs the banking sector, is Sharia-compliant. In order to comply with these regulations, conventional banks that operate in the Kingdom offer Islamic financial services through "Islamic windows".

The local banks account for around 98% of commercial bank assets in the Kingdom. This means **foreign banks** only represent 2%. As at May 2011, SAMA has issued 11 licenses to foreign banks to operate in the Kingdom:

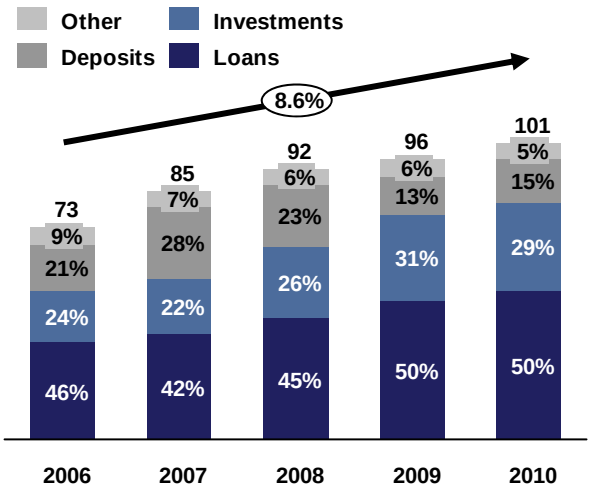
- Gulf International Bank
- Emirates NBD
- National Bank of Bahrain
- National Bank of Kuwait
- Bank Muscat
- Deutsche Bank
- BNP Paribas
- JP Morgan Chase
- National Bank of Pakistan
- State Bank of India
- TC Ziraat Bankasi

Foreign ownership in commercial banks is capped at 60%, although investment banks can be fully foreign-owned.

Government lenders have assets worth 28% of commercial banking sector assets

There are also five government-owned **SCIs**, which are responsible for supporting different areas of the economy. At the end of 2010, the assets of the SCIs were US$101bn, 27% of the size of the commercial banking sector.

Fig 7.9 Assets of Specialised Credit Institutions (2006-10)
(US$bn)



Source: SAMA

Overall assets of the SCIs have grown steadily at a CAGR of 8.6% from 2006-10 (Fig 7.9). In 2009, their lending and investment activities increased while their deposits[65] decreased. This was part of the government strategy to counteract the effects of the financial crisis, particularly the slowdown in commercial bank lending, by providing loans and investments to stimulate the economy.

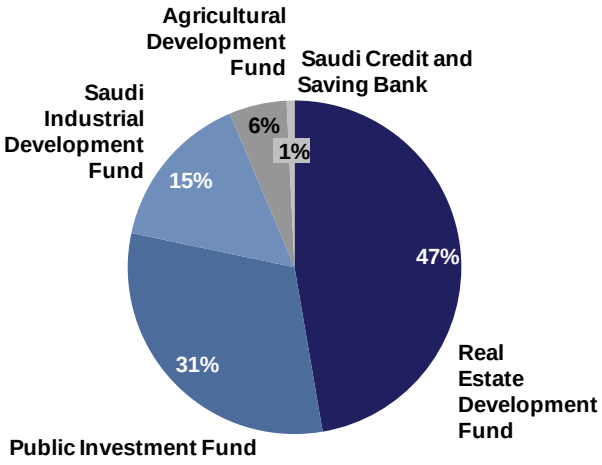
Table 7.1 SCI Net Lending (2010)

SCI	2010 Net Lending (US$m)	Loan/Investment Type
Public Investment Fund	2,214	Major projects in the Kingdom such as power and railway projects
Saudi Industrial Development Fund	1,032	Private industry and new and existing factories
Saudi Credit and Saving Bank	230	Interest-free loans to small businesses and citizens with limited incomes
Real Estate Development Fund	221	To increase the supply of housing
Agricultural Development Fund	- 26[66]	Agricultural equipment
Total	**3,671**	

Source: SAMA

Data for 2010 show that deposits at SCIs increased as a proportion of total assets while loans and investments decreased. This suggests that there has been a reversal of the previous trend as the growth in SCI activity has slowed. However, absolute net lending (new loans less debt repayments) rose by US$3.7bn in 2010 with the Public Investment Fund accounting for most of this increase (Table 7.1).

Fig 7.10 Loans of Specialised Credit Institutions (2010)
(% share)



Source: SAMA

[65] These are deposits held by SCIs at local banks and are therefore recorded under assets on the SCI balance sheet

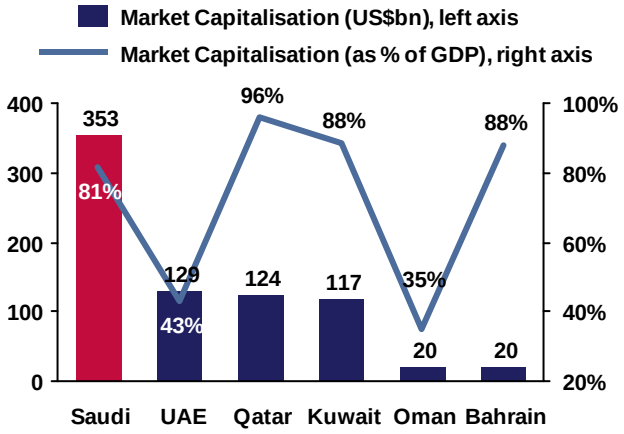
[66] As the government has been withdrawing support from the agriculture sector, the Agricultural Development Fund has had a higher level of debt repayments than new disbursements, leading to negative net lending

8. Equity Market

The Saudi stockmarket is the largest in the GCC but there is room for growth

The Saudi bourse, the Tadawul, is by far the largest stockmarket in the GCC (Fig 8.1). Its equity market capitalisation was US$353bn at the end of 2010, equivalent to 46% of total regional capitalisation of US$764bn. Nonetheless, there is room for the Saudi stock exchange to grow—in 2010, its market capitalisation accounted for 81% of GDP, compared with 96% in Qatar.

Fig 8.1 GCC Market Capitalisation (2010)



Source: Various stock exchange websites and annual reports

The equity market includes 146 stocks and is fairly liquid. However, activity is limited in other asset classes. There are only two exchange traded funds (ETFs) and seven sukuks (Islamic bonds). The traded value of sukuks was less than 0.1% of the equity traded value in 2010.

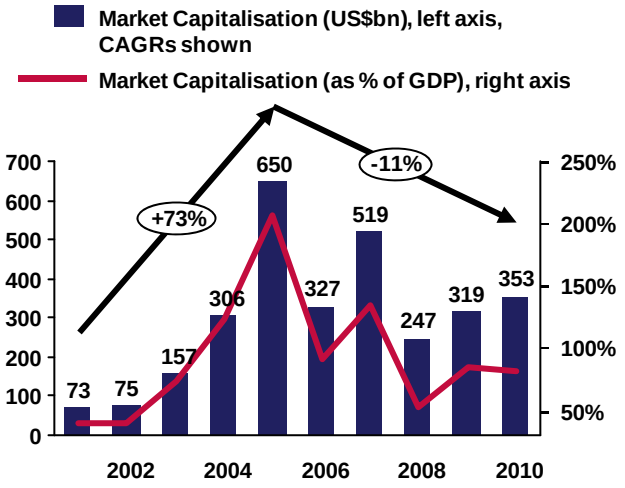
Market capitalisation is growing but volatile, owing to a high proportion of retail investors

During 2001-2010, Saudi Arabia's market capitalisation rose at a CAGR of 19% from US$73bn to US$353bn (Fig 8.2). This was primarily driven by economic growth, increasing interest in the stock market and new listings. However, the growth of the market has not been smooth. Market capitalisation was US$650bn at the end of 2005, before a stockmarket crash in 2006 when market capitalisation plummeted by 50% to US$327bn. This was followed by another boom in 2007 and bust in 2008 following the financial crisis. The market has made a steady recovery in 2009-10. Market movements tend to track oil prices, which have risen, boosting the exchange.

The volatility is partly a consequence of the dominance of retail investors with limited experience in the market. The Saudi exchange, like some of its regional peers, has attracted a significant number of new retail investors, particularly through a series of large initial public offerings (IPOs) of stakes in major public companies between 2003 and 2006. Saudi individuals accounted for 88.3% of transactions in April 2011, domestic companies 4.5%, Saudi mutual funds 2.2%, and foreign investors 5%. In comparison, on large mature bourses such as those in London or New York, institutional investors make up over 80% of traded value. Restrictions on foreign investment have been an important factor in limiting institutional presence on the Saudi stock exchange.

Fig 8.2 Saudi Market Capitalisation (2001-10)

(end-year)



Source: Tadawul market reports

Many retail investors borrowed to speculate on the bourse during the 2001-05 boom. This helped drive a number of equities to unreasonably high valuations, and resulted in a sharp correction in 2006.

Saudi Arabia was second only to London in terms of IPO issuance in 2008

Saudi IPO activity remained strong after the 2006 crash—there were 27 IPOs in 2007 and 13 in 2008. The Tadawul had the fourth largest value of IPOs in 2008 after New York, London and Shanghai, with a total value of around US$10bn. This has supported the growth of market capitalisation. The IPO pipeline has been helped by major public sector offerings and by a number of new insurance companies coming to market, which is a regulatory requirement for their establishment.

Following the financial crisis, the number of IPOs fell further to 11 in 2009 and nine in 2010. However, there is some scope for this trend to be reversed. The equity market is currently an attractive route for small private companies, which have been struggling to borrow from risk-averse banks (Section 7).

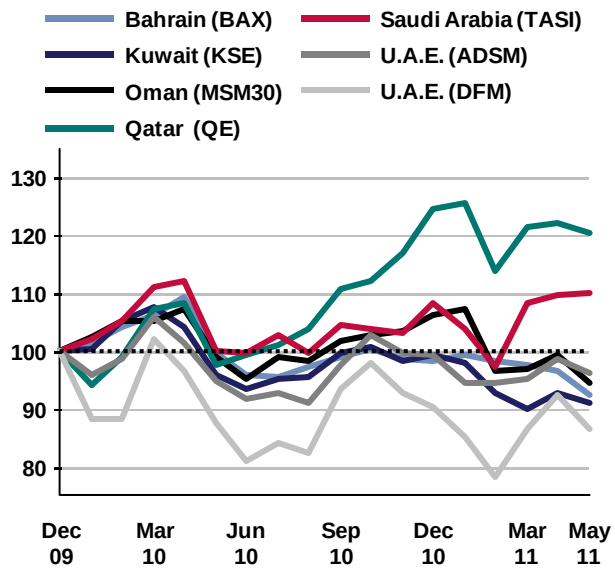
Saudi's TASI index is the only GCC index to have made gains in the first five months of 2011

In 2011, regional unrest negatively impacted a number of stockmarkets. However, the Tadawul has largely recovered from its initial losses. At the end of May 2011, the market capitalization had increased by 1.4% to US$358bn. The Tadawul All Share Index (TASI) is the Saudi bourse's primary index. It is the only GCC stockmarket index to have made gains in 2011, as at the

end of May 2011, when it was up by 1.7% for the year. This is primarily because of the high level of oil prices, which are a key determinant of investor confidence in the Saudi economy and stockmarket. The stockmarket received a boost from an estimated US$169bn of public spending initiatives announced in February and March 2011 (Section 6B). The only stockmarkets to have made gains since the end of 2009 are Saudi Arabia and Qatar (Fig 8.3).

Fig 8.3 GCC Stockmarket Performance (2010-11)

(Monthly index based to end-Dec 2009)



Source: Stock exchange websites

Trading values have declined since 2006 after SAMA put lending limits in place

The traded value on the Tadawul rose rapidly during the stockmarket boom and crash in 2001-06. However, it has declined every year since the peak of US$1.4trn in 2006, falling at a CAGR of -38% to US$202bn in 2010 (Fig 8.4).

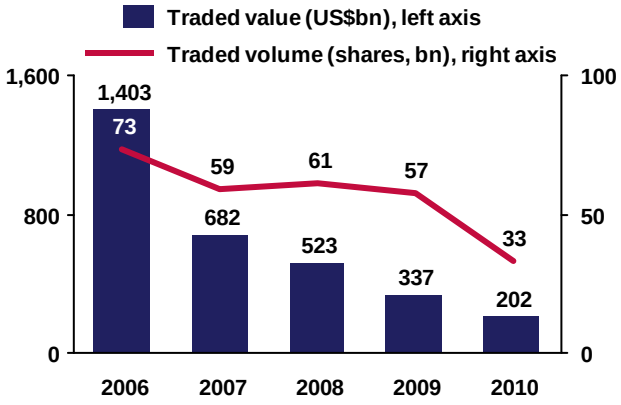
One of the main reasons for the decline was the imposition of lending limits by SAMA at the end of 2005. These restricted personal loans to three times monthly salaries. Many investors had been borrowing to invest in the stockmarket. The cutting of credit lines left many investors short of capital and has contributed to the steady decline in activity.

The opening up of the market has failed to stem the decline in trading activity

Direct investment in the Tadawul was formerly restricted to Saudi nationals. Foreign residents in the Kingdom were permitted to invest in 2006. In December 2007, the Tadawul was opened up to other GCC nationals. In August 2008, non-GCC foreigners were permitted to invest in stocks, indirectly, through swap arrangements with local, approved intermediaries.

The opening up of the market has not been sufficient to stem the decrease in trading activity to date. Many GCC investors prefer to diversify their holdings outside the region. Also, the swap agreements for non-GCC investors do not grant the purchaser voting rights. Additionally, most IPOs are still restricted to Saudi investors. Nationals accounted for 93.1% of traded value in 2010. GCC citizens made up 3.2% of the traded value, non-GCC Arabs accounted for 1.7% and other foreign investors accounted for 2%. Although foreign investment remains relatively small, it has grown quickly from zero in 2008 to reach US$14bn in 2010. Foreign investors showed reasonable interest in the Kingdom's capital markets, even during difficult market conditions.

Fig 8.4 Volume and Value of Shares Traded (2006-10)



Source: Tadawul

Seasonality is important to regional markets, particularly in Saudi Arabia

It is notable that seasonality plays an important role in regional markets. For the past two years, summer and Ramadan (which will coincide for the next few years) tend to be slow periods, and hence market activity declines drastically. Similarly, there can be a pick up before the summer. In May 2010, the total traded value was more than US$27bn, while in August-September (when Ramadan and Eid took place) the total traded value was less than half of that level. We can expect a similar pattern in 2011.

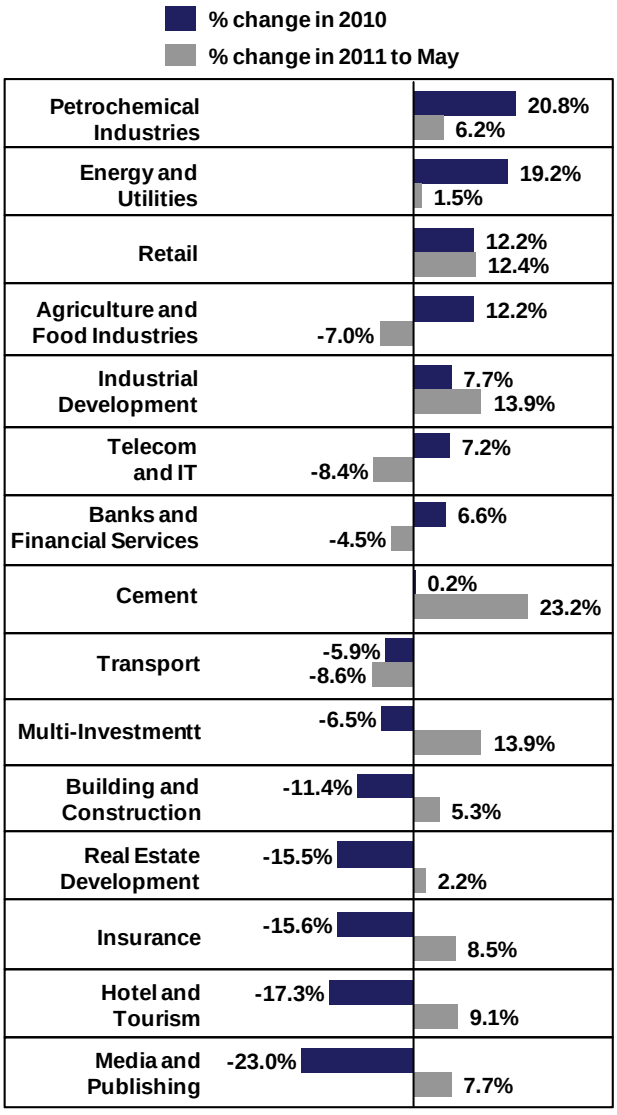
Petrochemicals, utilities and finance drove stockmarket gains in 2010

In 2010, the TASI rose 8.2% from 6,122 to 6,621, and it has gained a further 1.7% in the first five months of 2011. The petrochemicals sector has led the gains, up 21% in 2010 and 6.2% in the first five months of 2011, significantly outperforming the TASI (Fig 8.5). The sector accounted for 37% of the TASI capitalisation at the end of 2010 (Fig 8.6).

The majority government-owned petrochemicals giant, SABIC, has the largest market capitalisation in the TASI with 25% of the total. Its value rose 27% during 2010 and

so it was the main driver of stockmarket gains. So far in 2011, SABIC has performed slightly below the average for the sector, increasing by 2.4% in the first five months. The petrochemicals sector in Saudi Arabia has benefited from high international oil prices as these boost the export prices for its outputs, while domestic inputs remain relatively cheap. Petrochemicals also made up the largest portion of traded value, accounting for 38% of the total.

Fig 8.5 Tadawul Sector Performance (2010 to May 2011)



Source: Tadawul

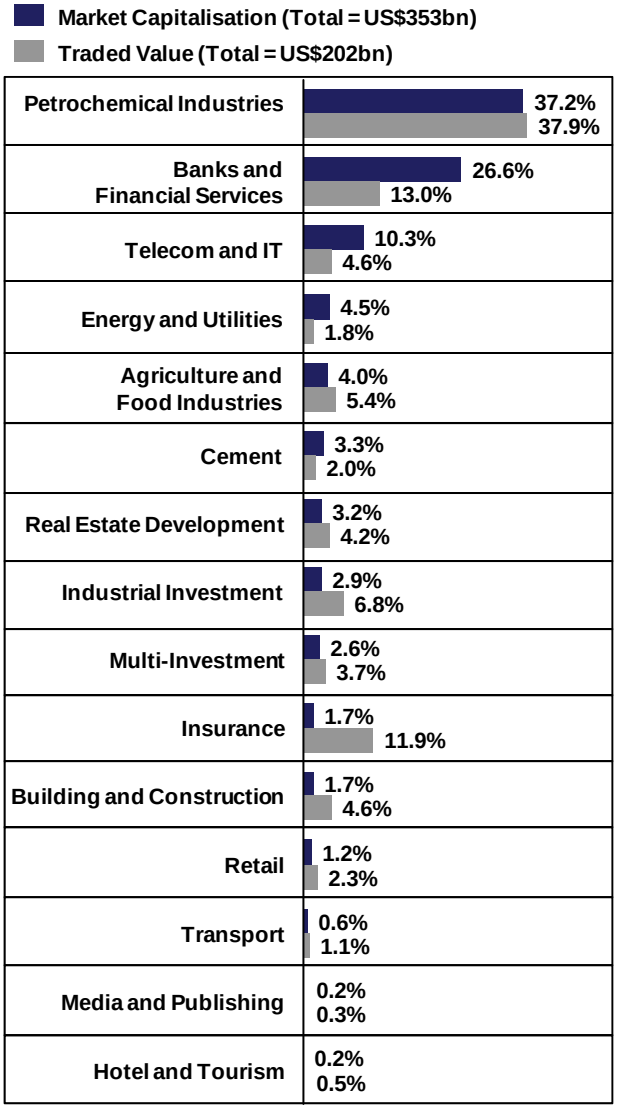
The banking and financial services sector has the next largest market capitalisation on the TASI after petrochemicals, accounting for 27% of the total. The Islamic bank, Al Rajhi, is the second largest company by market capitalisation with 9% of the total in May 2011. The country's largest bank, NCB, is not yet listed on the exchange, although a steady flow of reports have emerged regarding a potential IPO. The sector accounted for around 13% of traded value in 2011, less than half of its share of market capitalisation, suggesting that investors are likely to buy and hold banking stocks.

The gains in 2010 in petrochemicals and banking and energy were offset by underperformance in other sectors, mainly services based. However, these sectors have less weight in the index, hence the overall gain in 2010.

The top gainers on the Saudi exchange in 2010 were insurance companies. These companies were all newly established in 2010. A regulatory requirement for the incorporation of insurance companies is that they carry out an IPO for at least 30% of their capital. The popularity of IPOs means they are heavily oversubscribed and new equity issues tend to trade well above their offer price.

Fig 8.6 Market Capitalisation and Traded Value (2010)

(US$bn)



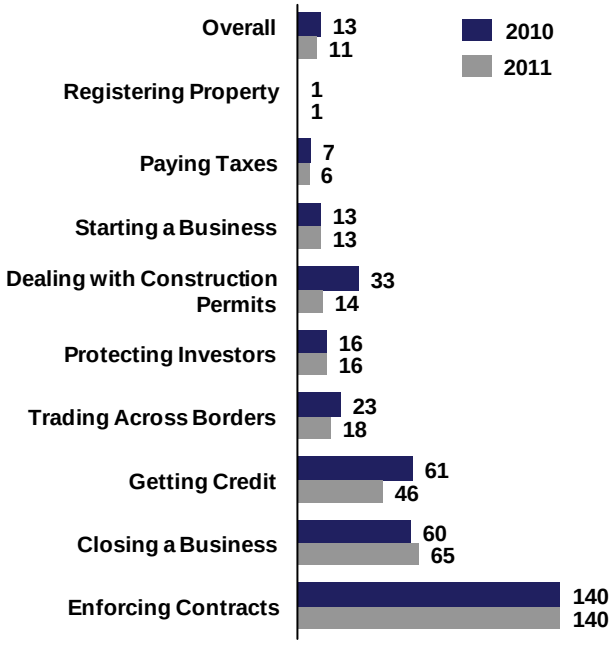
Source: Tadawul

9. Business Environment

Saudi Arabia has risen 56 places since 2005 in the World Bank's Doing Business rankings

Saudi Arabia ranked **11th out of 183** economies in the World Bank's Doing Business 2011 report (Fig 9.1). This was a two place improvement on its rank in the previous year. Although, the Kingdom narrowly missed out on its goal of reaching the top ten in this year's rankings, it has made unprecedented progress up the rankings, from 67th in 2005. The Kingdom's accession to the World Trade Organisation in 2005 and a series of reforms, some deliberately tailored to the index's key indicators, have driven the improvement. It is now the top ranked Middle East country, ahead of Bahrain, which is ranked 29th.

Fig 9.1 World Bank Doing Business Ranks (2010-11)
(Rank out of 183)



Source: World Bank Doing Business

Much of the improvement in rankings in 2011 was a result of streamlined processes in dealing with construction permits with the number of procedures cut from 17 to 12. This should help ease blockages that have slowed progress with capital investment projects. There was also a significant improvement in its ranking for getting credit, as a result of a legal amendment that made secured lending more flexible and allowed out-of-court settlement in the event of a default. The improvement in the trading across borders ranking was the result of a new container terminal at the Jeddah Islamic Port. The Kingdom's progress up the rankings was held back by its score for closing a business. On average, it takes 1.5 years and the recovery rate is 37% of the estate value.

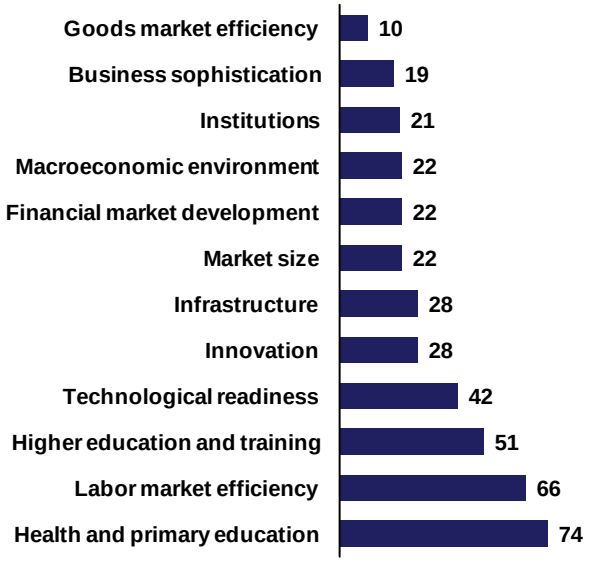
Saudi Arabia ranks 1st in the world for registering a property, a process which typically takes two days. The Kingdom underperforms in enforcing contracts, which typically involves 43 procedures, takes 635 days and costs 28% of the claim. Although the time taken was reduced by 145 days in 2010, this was not enough to improve the ranking in this area. A process of codifying Sharia judgements to create a basis of legal precedent is being implemented and should improve transparency.

Meanwhile, the Global Competitiveness Report 2010-2011, produced by the World Economic Forum (WEF), ranked Saudi Arabia **21st out of 139** countries. This was a significant improvement from 28th position out of 133 countries in 2009-10. The higher rankings were mainly due to improvements to the institutional framework, more confidence from businesses in the security situation and stronger corporate governance.

Economic openness boosts the Kingdom's competitiveness

The Kingdom ranked particularly well in terms of the efficiency of its goods market category. This is mainly a consequence of the openness of the economy, the low-tax environment and strong consumer demand. The country underperforms in health, education and labour market efficiency, but these areas continue to be a focus of government attention.

Fig 9.2 Competitiveness Ranks by Category (2010-11)
(Rank out of 139)



Source: World Economic Forum, Global Competitiveness Report

The WEF carries out a survey of businesses as part of its competitiveness assessment. It found the most problematic factors for doing business were:

- Restrictive labour regulations
- Access to financing
- Inadequately educated workforce
- Inefficient government bureaucracy

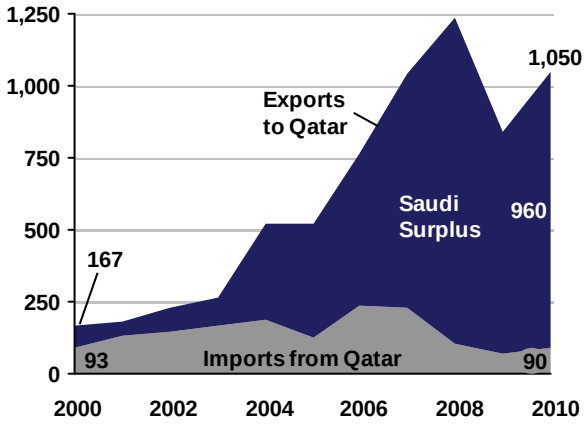
10. Qatar's Activities in Saudi Arabia

Electrical equipment, iron and steel and petrochemicals dominate Saudi-Qatari trade

Bilateral trade between the two countries accounts for 0.4% of Saudi Arabia's overall trade, according to IMF data, and 1.4% of Qatar's overall trade.

Saudi Arabia has a trade surplus with Qatar, which has grown from US$73m in 2000 to US$960m in 2010 (Fig 1.1). Exports from Saudi Arabia to Qatar grew at a CAGR of 20% from US$167m in 2000 to US$1.1bn in 2010. Meanwhile, imports to Saudi Arabia from Qatar are almost unchanged at US$93m in 2000 and US$90m in 2010.

Fig 10.1 Qatar-Saudi Trade (2000-10)
(US$m)



Source: IMF, Direction of Trade Statistics

Electrical machinery and equipment is the largest single category of Saudi exports to Qatar at 24% of the total in 2009, according to the Qatar Statistics Authority. The majority of this is likely to be re-exports, as few of these goods are produced in Saudi. This category has grown at a CAGR of 59% since 2001, driving much of the increase in the Kingdom's trade surplus with Qatar.

The majority of the remainder of the trade between the two countries is in the categories of **iron and steel** and **plastics**. Saudi Arabia imports basic iron and steel products from Qatar (this accounted for 49% of imports in 2007 but dropped to 27% in 2008). It also exports more developed articles of iron and steel to Qatar (accounting for 14% of exports in 2009). There is a similar bilateral trade profile in plastics. In 2008, 48% of Saudi imports from Qatar were plastics. In the same year, 8.3% of Saudi exports to Qatar were plastics. Expanding petrochemicals sectors in both countries have driven the increase in trade in plastics, which grew at a CAGR of 27% from 2001-08.

Qatar imports US$163m of **food items** from Saudi Arabia. This is 58% dairy products, 22% beverages and 20% live animals. As the Saudi government withdraws from its heavy subsidisation of the agricultural sector, these imports are unlikely to grow significantly in the future.

Qatari companies have a limited presence on the ground in Saudi Arabia

There are only a handful of major Qatari companies with a presence in Saudi Arabia, including those described below.

Currently, there is only one Qatari bank with activities in Saudi Arabia. The Islamic bank, Masraf al-Rayan, took a 20% stake in a Saudi Islamic consumer finance company, Kirnaf Investment and Instalment Company (KIIC), in 2007. In 2009, the company became operational with US$160m of capital. KIIC specialises in personal finance, such as home and car finance, and also in equipment and merchant finance for SMEs. It currently operates in Riyadh and plans to establish 45 branches throughout the Kingdom's cities and regions.

Doha-based **Al Fardan Jewellery** was first established in Saudi Arabia in 1993. It now has seven stores across the Kingdom, four in Riyadh, two in Jeddah and one in Khobar.

In May 2011, **Qatar Airways** announced a 71% increase in the number of its flights to Saudi Arabia. It is adding four flights a week to Medina, a destination for religious tourism in the west of the Kingdom, is doubling capacity to Riyadh and Jeddah, and is increasing capacity to Dammam.

The presence of some major Saudi construction companies in Qatar, including El Seif Engineering and Contracting and the Saudi Binladen Group, may also help to build commercial bilateral ties.

The Qatar-Saudi Joint Co-ordination Council was established in 2009 to strengthen bilateral ties between the two countries. It has met three times, most recently in March 2011 in Saudi Arabia at a meeting chaired by the Saudi Crown Prince and the Qatari Heir Apparent. Its work is focused on developing ties between the two countries in a variety of spheres, including trade and investment. Such efforts at cooperation may lead to stronger business relations in the future.

Appendices

Appendix A: Key Refinery Projects

Jubail Refinery: A JV between Aramco and Total for a 400k b/d refinery on the Gulf coast. Completion is expected in 2013. Total costs will exceed US$10bn.

Yanbu Export Refinery: A 400k b/d refinery with total costs of US$10bn-12bn. ConocoPhillips pulled out of a JV with Aramco in 2010 to develop this refinery. In April 2011 an MOU was signed with Sinopec for the joint development of the project. Completion is expected in 2014.

Jizan Refinery: A US$7bn 400k b/d refinery on the Red Sea coast. The project was initially intended for private sector ownership, but it failed to attract bidders. It is therefore being developed by Aramco and an initial design tender has been awarded. Completion is expected in 2016.

Petro Rabigh Refinery: This JV between Aramco and Sumitomo was completed in 2009. It is an integrated petrochemicals plant and refinery. Throughput at the refinery is 400k b/d of crude oil.

Appendix B: Key Petrochemicals and Fertiliser Projects

Jubail, SABIC: This 400k tonnes/year (t/y) facility has reached the front-end design and engineering stage and is expected to begin operations in 2013-14.

Ras al-Zour: Production is expected to commence in the third quarter of 2011 of 3m t/y of fertiliser. The project is using phosphates, sulphur and natural gas from al-Jalamid, in the north of the country, and transporting them to Ras al-Zour via a new “minerals railway”. There is an existing fertiliser plant in Ras al-Zour that already producers 3m t/y.

Petro Rabigh: A US$10bn JV between Aramco and Sumitomo, was completed in 2009. It is situated in a large industrial development north of Jeddah, Rabigh, on the Red Sea Coast. It utilizes 400k b/d of crude oil and 1.2m t/y of gas to produce around 18m t/y of refined petroleum products and 2.4m t/y of petrochemicals. Around 75% of the refined products and 90% of petrochemicals are exported. A US$7bn expansion of production at the facility is currently under study and tenders for the work are expected to be issued in 2011 with completion in 2014.

Jubail, Aramco: Saudi Aramco has entered into a JV with Dow Chemicals for a large petrochemicals facility in Jubail. The project has been underway for some time. Rising costs may have delayed progress—initial estimates put costs at US$10bn in 2005, but these spiralled to US$30bn plus in 2007-08. A change of planned location in 2010, from Ras Tanura to Jubail, and a drop in raw materials prices may have helped move the project forward and current costs are estimated at US$20bn. Production is expected to begin in 2015 and will be around 8m t/y of petrochemicals, although a final investment decision has not yet been taken.

Appendix C: Key Power and Water Projects

Ras al-Zour: This US$3.9bn SWCC project is the largest ongoing power and water project in the Kingdom. It includes a 2,400 mw power station combined with a 1m cm/d desalination plant, which will be the largest in the world once completed. Generated electricity will be shared: Maaden will receive 1,350 mw for a aluminium smelter JV with Alcoa; the Saudi Electricity Company (SEC) will distribute 1,000 mw through the national grid; and the remaining 50 mw will go to other industrial uses.

A large government-owned entity, Marafiq, has been created to help with boosting power generation capacity (a selection of Saudi Arabia’s largest state companies owns more than 99% of Marafiq. The entities are the Royal Commission for Jubail and Yanbu, Saudi Aramco, SABIC, and the Public Investment Fund. Some large private companies are also involved, including ACWA Power, Gaz de France; and the GCC-owned Gulf Investment Corporation is also involved). Marafiq currently has two large projects underway:

- **Jubail**: A US$3.4bn, 2,745 mw gas-fed power plant
- **Yanbu**: A US$3.4bn 850 mw oil-fed power plant with completion expected in 2014

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Key Indicators

	2006	2007	2008	2009	2010	2011	2012
Population							
Total (m)	24.0	24.7	25.5	26.3	27.1	**28.1**	**29.0**
Growth (%)	3.1	3.1	3.1	3.1	3.1	**3.6**	**3.2**
GDP							
Nominal GDP (US$ bn)	356.6	384.9	476.3	375.8	434.7	**548.0**	**548.7**
Oil sector	192.4	210.5	288.3	179.0	**226.6**	**323.2**	**309.5**
Non-oil sectors	164.2	174.4	188.0	196.8	**208.1**	**224.8**	**239.2**
Nominal GDP growth (%)	12.9	8.0	23.8	-21.1	15.7	**26.1**	**0.1**
Real GDP growth (%)	3.2	2.0	4.2	0.2	3.8	**7.0**	**4.4**
Oil sector growth (%)	-0.8	-3.6	4.2	-6.7	**0.5**	**7.7**	**1.3**
Non-oil sector growth (%)	5.1	4.6	4.3	3.7	**5.1**	**6.0**	**5.6**
Fiscal indicators (% of GDP)							
Revenue	50.4	44.6	61.6	36.2	45.1	**50.0**	**47.3**
Expenditure	29.4	32.3	29.1	42.3	38.4	**35.8**	**36.9**
Balance	21.0	12.2	32.5	-6.2	6.7	**14.2**	**10.5**
Public debt	27.3	18.5	13.2	16.0	10.2	**7.3**	**7.0**
Current account (% of GDP)							
Balance (US$ bn)	98.9	93.3	132.3	21.0	75.3	**149.2**	**130.5**
(as % of GDP)	27.7	24.2	27.8	5.6	17.3	**27.2**	**23.8**
Trade balance	41.3	39.1	44.5	28.0	37.1	**43.2**	**39.4**
Exports	59.1	60.5	65.8	51.1	57.4	**62.3**	**58.9**
Imports	17.7	21.2	21.1	23.0	20.2	**19.0**	**19.5**
Services balance	-9.9	-12.1	-13.8	-17.4	-14.9	**-12.0**	**-11.7**
Income balance	1.1	1.7	1.9	2.3	1.6	**1.2**	**1.3**
Current transfers balance	-4.7	-4.4	-4.8	-7.4	-6.4	**-5.1**	**-5.1**
International reserves	-	-	-	109.1	102.4	-	-
External debt	11.9	19.7	17.5	23.8	20.3	-	-
Industry indicators							
Oil production (m bpd)	9.2	8.8	9.2	8.2	8.4	**8.9**	**9.1**
Saudi crude price (US$/barrel)	63	70	92	62	78	**105**	**99**
Raw gas production (bn cu ft/day)	8.2	7.9	8.3	10.2	11.2	**11.8**	**12.4**
Monetary indicators (%)							
Consumer price inflation	2.2	4.1	9.9	5.1	5.3	**6.1**	**4.4**
Foods and beverages	5.3	7.0	14.1	2.0	6.3	**5.8**	**4.5**
Rent, water and fuel	1.1	8.1	17.5	14.2	9.4	**8.0**	**4.0**
Wholesale price inflation	1.1	5.7	9.0	-3.0	4.3	**10.2**	**2.0**
Interbank deposit rate	-	4.9	3.3	0.9	0.7	-	-
Broad money growth	19.3	19.6	17.6	10.7	5.0	**16.6**	**14.9**
Exchange rate US$:SR (avg)	3.75	3.75	3.75	3.75	3.75	**3.75**	**3.75**

Source: SAMA, CDSI, MEP, **QNB Capital estimates and forecasts**

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Editorial closing date: 4th June 2011

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