



Euro crisis and its impact on Saudi Arabia

- Global markets have entered a period of extreme volatility, as the fallout from debt problems in the eurozone has raised concerns about slowing economic growth and caused an abrupt change in investor sentiment.
- Markets have focused on other factors as well such as the prospect of new financial regulation, Chinese government policy to slow growth and heightened political risk in South Korea and Thailand, even though new economic data throughout the world generally points to the recovery gaining traction.
- Current events pose nowhere near as serious a threat to the global economy as the financial crisis triggered by the failure of several massive financial institutions that culminated in the collapse of Lehman Brothers in September 2008.
- Over the short term, movements in the euro are likely to be volatile and driven by investor sentiment. Over the longer term, many factors point to a weakening of the euro.
- Oil prices have plunged, but at current levels they are closer to what the Saudi Oil Minister has called the “perfect price” of \$75 per barrel than they were at the start of the month. We think it unlikely that oil will drop below \$60 per barrel for a prolonged period.
- The idea that global growth is likely to slow later this year as government stimulus is unwound is not new and is already built into our forecasts. We therefore continue to expect economic growth in the Kingdom to rise, the budget to return to a surplus and project the TASI at the end of the year at 7,400.
- The direct impact of slower growth in the eurozone on the Kingdom’s exports is minor and a weaker euro should lower inflation. However, falling oil and share prices are hitting sentiment and, if sustained, could dent growth and lead to a downward revision of our forecasts.
- The Saudi banking sector has been little affected by global events and we still anticipate a pick-up in local bank lending over the remainder of the year. Accessing finance from foreign banks is likely to become more difficult.

TASI in 2010



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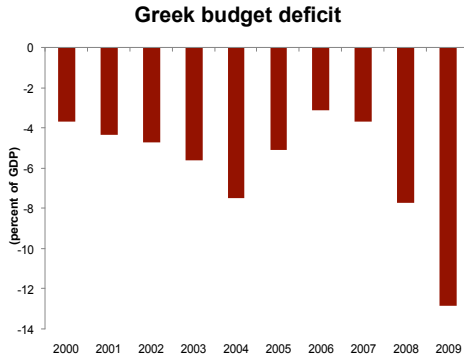
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What has happened in the eurozone?

The eurozone has been the focus of market attention. Budgetary problems in Greece have spiraled into a debt and currency crisis that has sucked in other European countries and tested the key political relationships at the core of the regional single currency. The problems in Greece emerged last year when a new government revealed the data on the budget released by its predecessor had significantly understated the size of the deficit. Financial markets became concerned about Greece's ability to issue all the debt necessary to finance its deficit, driving up the rate of interest the Greek government was required to pay to borrow and raising the risk that Greece would default on its debt.

Although Greece is one of the smallest countries in the eurozone (accounting for just 2.6 percent of the region's GDP) a default would be a huge problem for the region. In addition to shattering confidence in the single currency, it would put market pressure on those countries with similar debt and budgetary characteristics, notably, Portugal, Spain and Ireland. A default would also have serious repercussions for eurozone banks, which hold €49.2 billion (\$62 billion) of Greek debt (€35.1 billion of which held by French and German banks). Therefore, despite a "no bailout" clause in the EU treaty, the EU and the IMF agreed a €110 billion rescue plan.



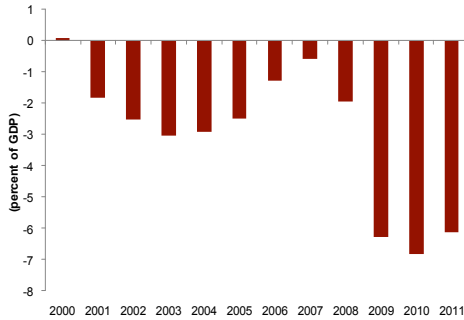
Comparative economic data (2009)

Country	Nominal GDP	GDP growth	Budget deficit	Credit Rating	
	(\$ billion)	(%)	(% of GDP)	Moody's	S & P
Eurozone					
Austria	381.9	-3.6	3.6	Aaa	AAA
Belgium	470.4	-3.0	5.8	Aa1	AA+
Cyprus	23.6	-1.7	6.1	Aa3	A+
Finland	238.1	-7.8	2.4	Aaa	AAA
France	2,675.9	-2.2	7.9	Aaa	AAA
Germany	3,352.7	-5.0	3.3	Aaa	AAA
Greece	330.8	-2.0	12.9	A3	BB+
Ireland	227.8	-7.1	11.4	Aa1	AA
Italy	2,118.3	-5.0	5.3	Aa2	A+
Luxembourg	51.7	-4.2	1.1	Aaa	AAA
Malta	8.0	-1.9	4.1	A1	A
Netherlands	794.8	-4.0	4.9	Aaa	AAA
Portugal	227.9	-2.7	9.3	Aa2	A-
Slovakia	88.2	-4.7	6.3	A1	A+
Slovenia	49.2	-7.3	6.1	Aa2	AA
Spain	1,464.0	-3.6	11.4	Aaa	AA
Others					
UK	2,183.6	-4.9	10.9	Aaa	AAA
US	14,256.3	-2.4	12.5	Aaa	AAA
Saudi Arabia	369.2	0.1	3.3	Aa3	AA-

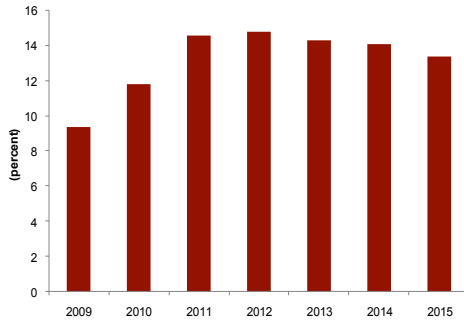
The bond markets deemed this insufficient and renewed their attacks on the affected countries. Soon after, the EU and IMF agreed a €750 billion package of loan guarantees to enable the Greek government,



Eurozone budget balance
(2010 and 2011 are IMF projections)



Greek unemployment rate
(IMF projections)



and others that need to, to be able to borrow without paying the high prices demanded by the bond market. A key risk to the introduction of the package was overcome on May 21 when it was approved by the German parliament.

The size and structure of the package has eased concerns about a debt default. Instead, investors immediately focused on the tough economic policy measures envisaged in the plan. Sharp spending cuts and increased taxes are essential to reduce the budget deficit, not just for Greece, but for nearly all countries in the eurozone. According to the IMF, every country in the eurozone ran a budget deficit in 2009; for 8 of the 16 members it was greater than 6 percent of GDP and in the case of Ireland, Spain and Greece, it exceeded 10 percent of GDP. The total budget deficit for the region last year was 6.3 percent of regional GDP, up from 2 percent of GDP in 2008. Even allowing for some policy adjustment this year, the IMF expects the total budgeted deficit for the eurozone to widen to 6.8 percent of GDP this year and to remain above 6 percent of GDP in 2011.

Budget deficits ballooned over the past year as government revenues fell in line with the recession and government expenditure was raised. In order to reverse the growth in the deficit, tax revenues need to be increased and spending lowered, policies that will restrict already weak economic growth. In the case of Greece, under the economic program that accompanied its first bailout, growth is forecast to fall in real terms by 4 percent in 2010 and 2.6 percent in 2011 and the unemployment rate will not peak until 2012 at 14.8 percent. By 2015 it will still be much higher than it was in 2009. Even though in most cases these policies have yet to be fully implemented, worries about their impact have hit consumer and corporate confidence and led to widespread demonstrations. Eurozone consumer confidence fell at the second highest rate in almost 20 years in May.

In addition to concerns about the outlook for economic growth, recent events have highlighted weaknesses in the institutional structures and political resolve that underpin the single currency. The weaknesses include, weak enforcement of economic and fiscal rules, policy differences among even the largest EU countries and the lack of a central fiscal body and cross-border fiscal transfers.

Formally, countries whose budget deficit exceeds 3 percent of GDP are subject to financial sanctions, but these are rarely enforced and provide little incentive to tighten policy. Greece exceeded the deficit target for 9 years between 1999 and 2009; Italy did six times and France, Germany and Portugal did on four occasions.

The bailout packages run contrary to a commitment not to bailout economies. Requiring the European Central Bank (ECB) to buy government bonds, despite earlier pledges from the ECB not to, possibly undermines of the bank's independence. Furthermore, despite highlighting the need for eurozone governments to work together to address the region's problems, there have been clear tensions between the region's dominant economies, Germany and France. France appeared ready to push through the package of loan guarantees with little German support, and last week the German government unilaterally banned "naked short selling" for certain assets, including some bank stocks and government bonds (under this practice, an investor sells an asset that they do not own). The way this decision was taken highlights the difficulty in reaching



agreement quickly in a crisis when the decisions are in the hands of region-wide bodies rather than national governments.

These issues point to the lack of sufficiently empowered centralized institutions and most crucially, the lack of a centralized fiscal authority. The US dollar successful serves a large and diverse US economy because there is a system that enables funds to be transferred among states through Federal government spending. No such system exists in the EU. Indeed, it is proving difficult for tax payers to accept that their payments will be used to support other countries that have been profligate with their incomes and have more relaxed working conditions. Instituting a large formal regional tax collection body with rights to redistribute tax revenues across the EU appears essential to the proper functioning of the euro, but currently seems far too politically contentious to be realistic.

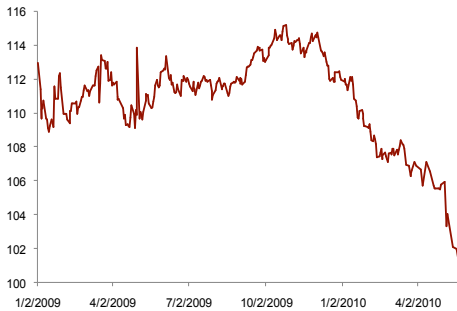
In this environment the euro has fallen sharply. Against a trade-weighted basket of the currencies of the region's main trading partners, the euro is down by 9.5 percent so far this year and by 4.2 percent since the end of April. Against the dollar, the falls have been greater, by 14.3 percent and 7.7 percent, respectively, with the euro falling to a four-year low in the middle of last week, before recovering slightly. The underperformance of the euro against the dollar, and a rise in the prices of US government bonds, shows that at times of risk aversion investors will buy dollars and safe dollar assets even if the fundamentals of the US economy are not that strong.

Over the short term, movements in the euro are likely to be volatile and driven by investor sentiment. Despite all the current problems in the eurozone, the single currency actually strengthened last week. Given the risks the single currency faces, we expect the euro to be on a volatile downward trend over the next few months.

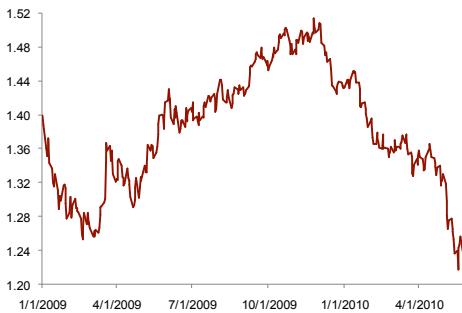
Over the longer term, many factors point to a weakening of the euro. The EU may be the only region in the world that experiences a double dip recession, since its return to growth has been weak (eurozone GDP grew by just 0.5 percent in year-on-year terms in the first quarter) and austerity measures will dampen economic performance. Interest rate differentials will no longer favor the single currency, as it now seems that the ECB is unlikely to raise rates for some time. The ECB, with a mandate to control inflation, has persistently kept interest rates higher than in the US, where the Federal Reserve is mandated to control inflation and sustain growth. In a pair of currencies such as the dollar and the euro, the actual difference in interest rates and the expected changes in this differential play an important role in influencing currency moves. Given the economic weakness in Europe, the Fed may raise interest rates before the ECB, a move that would probably contribute to further euro weakness.

Institutional and political problems will continue to weigh on the euro, particularly as tougher fiscal policy has the potential to cause social unrest. Furthermore, the current problems are undermining the euro's growing role as a reserve currency, so central banks around the world may be less inclined to build up their holdings of euros. Another deep structural issue that will not soon be fixed is the lack of competitiveness of several countries within the eurozone. This has been caused by rigidities in labor markets that have prevented wages from adjusting. In the absence of a currency peg many countries would address this by currency devaluation, but inside the

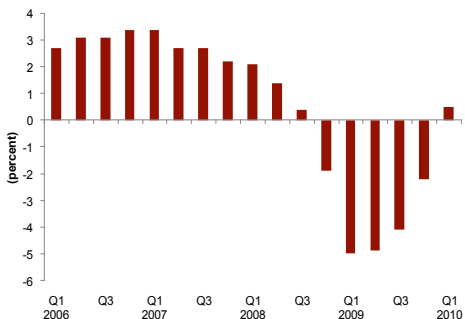
Trade-weighted euro exchange rate



Dollar/euro

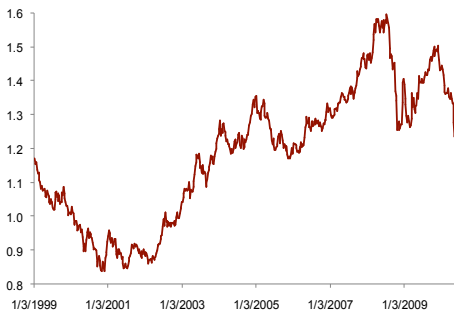


Real eurozone GDP growth





Dollar/euro



single currency tackling it requires tough internal reforms.

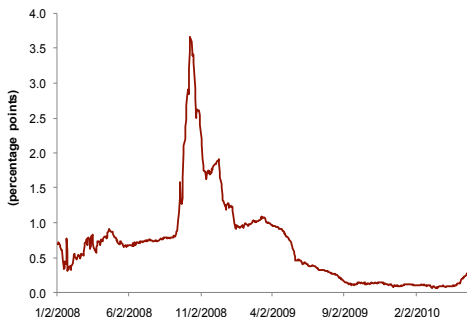
It was less than a year ago that analysts were predicting a long-term fundamental weakening of the dollar, and sentiment in the currency markets can change quickly. Providing it is orderly, many eurozone governments would welcome the weakening of the euro as it would improve export competitiveness. While close to a four-year low, the euro is still above its average against the dollar since it was launched in 1999, of 1.18, and around where many analysts consider fair value. The most likely path forward is that the euro continues to weaken as EU policy actions remain fragmented and not fully reassuring to the markets. However, we do not think that the eurozone will break apart given the strong political support that the currency still commands.

Not another global financial crisis

Recent events provide a severe test for the global economic recovery and clearly have the potential to derail the momentum that has built up. However, they are nowhere near as serious a threat to the global economy as the financial crisis triggered by the failure of several massive financial institutions that culminated in the collapse of Lehman Brothers in September 2008. It is true that for some of the variables most important to the Kingdom, the initial reaction has been sharper. In the three weeks since the end of April, the TASI has dropped by 16.1 percent and the oil price (WTI) has fallen by 24 percent. In contrast in the first three weeks after the Lehman collapse, the TASI fell by 3.9 percent and WTI was just 1.7 percent lower.

Yet on a global basis the fallout has been far less dramatic. In the immediate post-Lehman period central banks across the world were compelled to make huge injections of liquidity and several major financial institutions were bailed out or nationalized. In the US alone, the value of various stimulus and financial sector support packages ran to several trillion dollars, and a number of other countries introduced huge government programs. In contrast, so far no country has stepped in to aid their financial system or economy outside of the eurozone.

Libor/OIS spread



The key difference is that bank balance sheets are in much healthier positions than they were in September 2008 and central banks are much better positioned to deal with any problems. After Lehman, money markets froze, with virtually no lending between banks, let alone to private sector borrowers. This has not been the case recently. A key measure of financial sector stress and bank caution about lending to other banks is the spread between three-month Libor and the three-month overnight indexed swap rate. This currently stands at around 30 basis points, compared with over 350 basis points in September 2008. Other indicators of financial risk such as bond spreads and credit default swaps are similarly a long way below their post-Lehman levels, aside from those of the EU countries most directly affected.

Rather than being a potentially new crisis for the global economy, the events in the EU are actually a new phase of the stresses that have affected the global economy over the past few years. In essence, the private sector debt of individuals with large mortgages and banks with excessive leverage has been replaced by high levels



of government spending and debt incurred to prevent a global depression after the Lehman collapse.

How is this affecting the rest of the world?

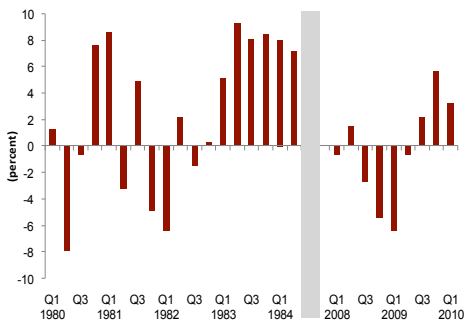
Concerns about a likely slowdown in economic growth are not confined to Europe. Throughout the world questions are being raised about the health and sustainability of the recovery. Any renewed recession in the EU would be felt globally as the region is a huge market for imports. Total imports into the EU were \$2.1 trillion in 2008, with China, the US and Russia the main origin of these imports, accounting for 14 percent, 13 percent and 12 percent, respectively. Aside from the direct channel, the current problems hitting Greece highlight that other economies will face similar periods of austerity in order to restore their public finances to a sustainable position. More generally, the abrupt reversal of sentiment means that markets are now focusing on bad news even when it is being outweighed by good news and strong data.

US consumer confidence
(Conference Board measure)



This is particularly the case in the US, where recent data showing that the recovery appears to be picking up pace has been largely ignored by the markets. Employment grew at its fastest rate since February 2006 in April, retail sales for the same month were up by 0.4 percent, double analyst's expectations, manufacturing output was 1 percent higher, again above the consensus forecast, and consumer confidence in May was at its highest since March 2008. This data all suggest that the consumer is developing some momentum and could help to propel the economy as the stimulus programs unwind.

US real GDP growth
(quarterly annualized)



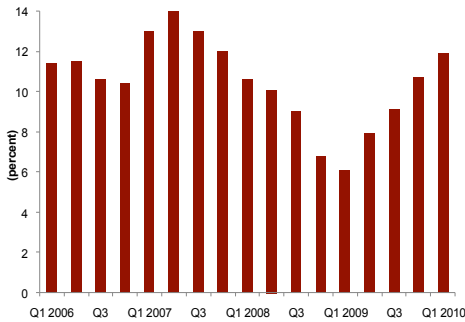
What is now affecting market sentiment is concern about the pace and strength of the recovery. It is certainly a lot weaker than to the recovery from the 1980-1982 recession (the longest post-war recession to date). As the chart to the left shows, after that recession finished, five quarters of growth of over 6 percent (on a seasonally adjusted annualized basis) quickly followed and growth in the third quarter of the recovery was 9 percent. In contrast, the recovery through 2009 and 2010 has so far been sluggish, with growth in the third quarter of the recovery of just 3.2 percent. This relative lethargy is despite huge government spending and exceptionally low interest rates.

It is the inevitable unwinding of these stimuli that make it likely that growth in the US will slow in the second half of the year. Although interest rates will remain very low, other stimulus measures will be ending. In addition, recent gains due to the rebuilding of company inventories will cease to be a major contributor to growth, low capacity utilization will restrain investment and deleveraging will continue. Furthermore, with the unemployment rate close to 10 percent and businesses still facing difficulties accessing credit, the challenges facing the US economy remain large.

Asia has recorded by far the strongest economic performance of any region since the financial crisis. Partly, this was because its banks were much less affected than those elsewhere and the need for stimulus was less. Also, it was a result of the huge demand coming from the Chinese economy, which grew by 8.7 percent last year and was up by 11.9 percent in seasonally adjusted annualized terms in the first quarter of 2010.



Chinese real GDP growth
(quarterly annualized)



While the Chinese economy continues to perform strongly (retail sales and industrial production were both up by around 18 percent in year-on-year terms in April), there are concerns that the easy availability of bank credit has caused excessive asset price inflation, particularly for real estate. The Chinese government has taken various steps to cool the property market (such as increasing bank reserve ratios and thereby reducing the amount available to banks to lend) that have so far had little effect. Markets are worried about the prospect of further actions, which could hit economic growth and demand for commodities. Sentiment in Asia has also been hurt in the last week or so by elevated political risk in Thailand (stemming from domestic unrest) and the Korea peninsula.

Other emerging markets will be unable to avoid being affected by a slowdown in the developed economies in the second half of the year. The clearest effect of a renewed slowdown would be through a reduction in demand for emerging market countries' exports. Lower commodity prices are also likely to bite. We think the emerging economies will continue to outperform developed economies through this year and next, but it is clear that their growth would be stronger if the large global economies were doing better.

Reform of financial regulation

Investor pressure on the euro has strengthened the political momentum for tougher financial regulation. Markets have become concerned that overly restrictive regulation could harm the recovery, the efficiency of financial markets and the profits of financial institutions. The German government's ban on naked short selling is linked to a broader push for tighter regulation that could include taxes or levies on financial institutions and transactions. The new UK government has made banking sector reform its top policy priority and last week the US Senate passed a financial sector reform bill aimed at preventing a repeat of the global financial crisis. This needs to be squared with an earlier bill passed by the House of Representatives, with it likely that a final document will become law later in the year. There is likely to be an effort to harmonize financial sector reforms within the G20, where Saudi Arabia is a member.

The major components of the US legislation are to:

- move derivatives trading onto exchanges;
- limit "proprietary trading", the amount of trading that commercial banks can do with their own capital;
- create a bankruptcy process for non-bank financial institutions (such as AIG or Lehman Brothers) and banks previously considered "too big to fail";
- create a Council of Regulators responsible for "macro-prudential" regulation (monitoring large risks that could affect the overall financial system, such as the widespread growth of subprime mortgages) as opposed to "micro-prudential" regulation (monitoring the health of individual banks);
- create a new consumer protection agency to monitor financial products' suitability.

We do not think that the proposed reforms would result in dramatic change for Saudi banks if they were implemented in the Kingdom. Indeed, as SAMA is already focused on macro-prudential issues, it is unlikely that many changes would be necessary. Although Saudi banks hold some derivatives, such as credit default swaps, which



may move to trading on exchanges, their holdings are not significant enough for this change to have an impact. Limitations globally may be placed on speculative participation in the oil futures market, a goal the Kingdom seeks as a way to reduce oil price volatility.

Greater clarity in the legal code for bankruptcy of bank and non-bank financial institutions and new laws for the regulation of certain non-bank financial institutions, such as leasing companies, may be accelerated. But as the Saudi banking system and regulatory environment is already cautious and prudent and the Kingdom has never witnessed a bank failure any change is likely to be marginal. We do not see curbs being placed on foreign banks that would restrict their lending into Saudi Arabia. This is currently being affected by bank risk appetite, but not by new global financial rules.

What is happening in the markets?

Although many forecasters, including ourselves, had anticipated that the global economy would slow in the second half of this year and remain subdued into 2011 for many of the reasons outlined above, the reaction in markets has been sharp, with some major falls recorded. For the markets in the eurozone, this was not surprising. While issues with Greece had been apparent for some time, the rapid spreading of these problems caught the markets by surprise. For markets elsewhere, the main cause of the decline has been a shift in investor sentiment.

We had thought for some time that many markets were above where they should be given the fragility of the global recovery. Based on some valuation criteria, developed and emerging stock markets were looking expensive, and had indeed been correcting since early this year. Furthermore, given the prevailing economic conditions, it did not seem reasonable for oil prices to be above \$86 per barrel, as they were at the start of the month. Once it was clear that the worst of the recession had passed, many investors quickly priced in a strong recovery and momentum lifted many asset prices to beyond the levels justified by the fundamentals. Now that the events in the eurozone have reminded investors about the weakness of the fundamentals, markets have abruptly adjusted.

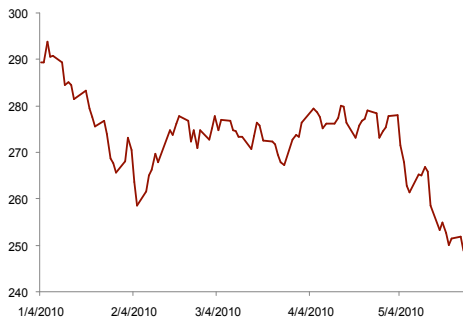
The table on the next page shows the performance of stock markets and exchange rates throughout the world, both over the last month and for the year to date. It shows that all of the featured stock markets have fallen in the past month and for the year to date. Not surprisingly the largest faller this year is Greece, followed by China, where investors have been rattled by moves to control credit growth. Over the past month, large emerging markets have performed worse than EU countries, owing to the threat the eurozone problems pose to global growth and a general reduction in investor appetite for risk.

Greater risk aversion is clearly evident in recent currency moves. The only currency to have strengthened against the dollar over the month is the yen, the leading global safe haven. Unlike the stock markets, the bulk of the weakening of the euro and most other currencies so far this year occurred before the last month. This was because the pressures on the currency have been building over the year whereas the stock markets were more affected by the likely broader economic fallout as the crisis intensified. Aside from the euro, moves in other currencies on the following table have not been

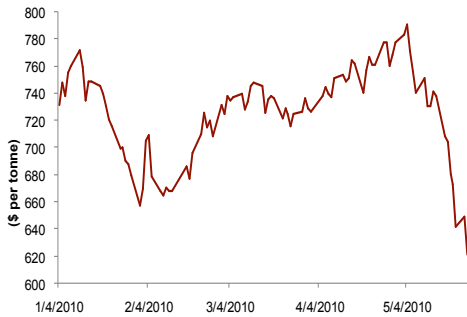




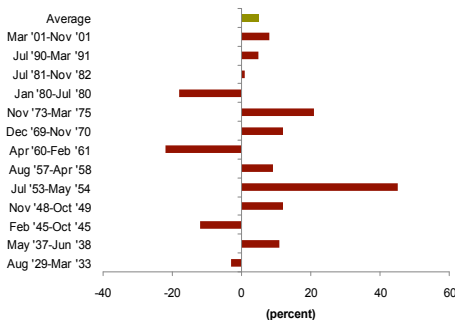
Reuters commodity price index



Naphtha price
(naphtha for delivery to Japan)



Change in S&P 500 after past recessions
(second year after market low)



that great, reflecting stronger economic fundamentals in many key emerging markets than in the eurozone.

Stock market and exchange rate performance
(as of May 25)

	Stock market (% change)		Exchange rate (versus \$, % change)	
	Year to date	Last 30 days	Year to date	Last 30 days
US	-3.7	-11.4	0.0	0.0
Japan	-9.6	-14.6	3.0	4.0
Germany	-4.8	-10.5	-14.3	-9.1
UK	-8.7	-14.1	-12.6	-9.1
France	-15.4	-16.7	-14.3	-9.1
Greece	-29.9	-14.7	-14.3	-9.1
Saudi Arabia	-5.9	-16.4	0.0	0.0
Dubai	-12.9	-10.6	0.0	0.0
Egypt	-6.3	-20.8	-3.2	-2.1
China	-17.4	-20.1	0.0	0.0
Brazil	-13.7	-14.1	-5.8	-5.6
Russia	-14.0	-23.6	-3.2	-7.8

Recent price moves have been sharpest for commodities. The Reuters commodity price index has fallen by 10 percent since the end of April. Prices for products where demand is heavily dependent on the health of the global economy have generally fallen further. Oil prices have fallen by 24 percent over the past month, petrochemical prices are down, with naphtha 20 percent lower, and aluminum prices are down by 14 percent. Gold prices have risen over the past month, hitting a series of all-time highs in euro terms. In dollar terms, the gain of 2.4 percent is fairly subdued given recent events.

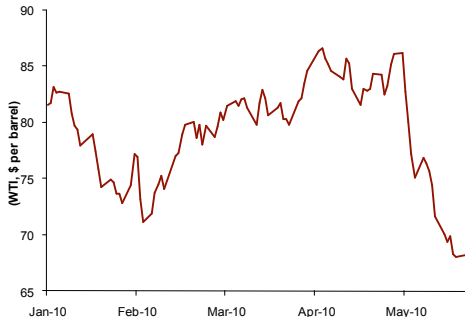
Global stock markets, exchange rates and commodity prices are likely to remain under pressure over the next few months as investors monitor events in the eurozone and economic data until there is greater clarity on the outlook for growth in the global economy. A chart we have used in several previous reports is reproduced on the left. It is based on research from Capital Economics which shows that in the second year after hitting a cyclical low, the US S&P 500 rises on average by only 5 percent. For this cycle the low point in the S&P 500 was in March 2009 and after very strong gains during the first year of recovery, recent market moves suggest that the historical trend may be replicated, with low returns in 2010. Nonetheless, as investors become surer about the course of the recovery, country-specific prospects will resume their importance and markets with sounder fundamentals, such as the Kingdom, should outperform.

What does this mean for Saudi Arabia?

We think that the Saudi economy should withstand what is happening in the global economy. We had anticipated a slowdown in global growth in the second half of the year and though the movements in asset prices have been dramatic, based on our view of the fundamentals we are not changing our forecasts. This does not mean that the Kingdom will be unaffected by what is happening



Oil price



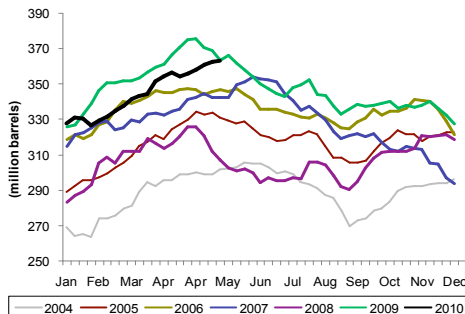
in the global economy and global markets. Falling oil and share prices are hitting sentiment and if sustained could dent growth and lead us to revise our forecasts. The direct impact of slower growth in the eurozone on the Kingdom's exports is manageable and a weaker euro should help by lowering inflation.

The most immediate and potentially significant impact on the Saudi economy and stock market is through the oil price. Oil prices (WTI) have dropped from \$86.2 per barrel on May 3 to \$65.2 per barrel on May 26, a 24 percent fall. Several factors have contributed to this downward pressure on oil prices. These include the eurozone's troubles, China's efforts to slow its economy, rising inventories of crude oil around the world, the strengthening dollar and declining stock markets.

As we have described above, it seems likely that economic growth, and therefore the demand for oil, will slow. This will probably be most pronounced in Europe, which accounts for around 18 percent of global oil demand. Concerns about a slowdown in China are also hitting the oil market. Although China accounts for less of global oil demand than Europe, at 10 percent, it is the fastest growing source of oil demand. Nearly 40 percent of the 1.6 million barrels per day increase in global demand projected by the International Energy Agency (IEA) for 2010 is expected to come from China.

The continued rise in inventories, at a time when demand may fall, is also becoming a worry for the markets. Commercial inventories of crude oil have risen for the past few months in a number of major oil consuming countries, particularly the US, leading to speculation that gasoline prices in the US could drop during the summer driving season, rather than the usual increase. Commercial inventories in the OECD are now sufficient to cover over 60 days of future demand, according to the IEA, compared to a five-year average of around 55 days. There was a particularly sharp increase in crude oil inventory levels in April.

Oil inventories in the US

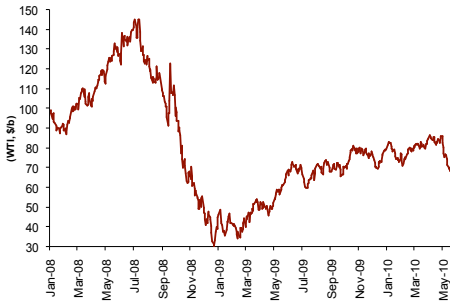


With demand prospects subdued and inventories rising, the ample cushion of excess oil production capacity is also weighing on oil prices. Global spare capacity is around 6 million barrels per day, nearly all of which is in Opec countries (around 4.2 million barrels per day of this is in Saudi Arabia). The Kingdom's stated oil policy is to maintain about 2 million barrels per day of unused capacity to cushion supply shocks that occur from time to time. We think it would take a decline in spare capacity to below 3 million barrels per day for spare capacity to support higher oil prices, and given the weak recovery in demand, this seems unlikely for some time.

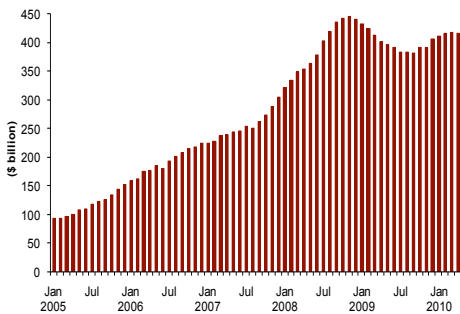
In addition to concerns about physical demand for oil, investment demand has fallen in line with the strength of the dollar and the declines in global stock markets. For much of the past few years there was a strong inverse correlation between oil price movements and the dollar; when the dollar weakened, oil prices strengthened. A certain amount of that correlation can be explained by oil, which is mostly sold in dollars, maintaining its real value against fluctuating currencies. In the past year, this correlation with the dollar has weakened and oil prices have moved more in line with major stock markets, rising when the stock markets go up and vice versa. This change seems to reflect investors using oil as a play on the health of global economy. In the last few weeks the dollar has strengthened and stock markets have weakened, a potent combination working to



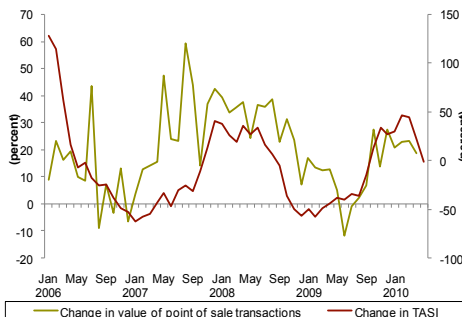
Oil price



SAMA net foreign assets



The TASI and consumer spending



pull oil prices down.

After oil prices plunged to just over \$30 per barrel in early 2009 in the aftermath of the worst of the financial crisis, they were quick to rebound to above \$60 per barrel and have been above this level for nearly a year. Despite all the forces currently aligned against oil prices, we think it unlikely that they would drop below \$60 per barrel for a prolonged period and if they approached this level it would be likely to spur Opec into action, by at least tightening compliance with existing production quotas, if not formally lowering production quotas. Again, as we have mentioned above, we were fully expecting lower growth in the global economy in the second half of 2010, and this is factored into our forecast that WTI will average \$75 per barrel this year. Despite the falls over the past month, the average WTI price for the year is still comfortably above that level, at \$79.3 per barrel. We do not see enough change in the fundamentals of the global oil market to revise our forecast.

While the decline has been sharp, at their current level of \$65 per barrel, oil prices remain closer to what the Saudi Oil Minister has called the “perfect price” of \$75 per barrel than they were earlier in the month. At the current price and current production levels of around 8.1 million barrels per day, Saudi Arabia remains well ahead of the \$53 per barrel level needed to satisfy this year’s budget. We therefore do not expect any pullback on the strong stimulus spending the government is undertaking this year. Even if oil prices drop further, the government retains a huge stock of foreign assets that it will draw down to finance spending. SAMA’s net foreign assets have risen for most of the year and stood at \$414 billion at the end of April.

Falling oil prices have been a major contributor to the plunge in the TASI over the past few weeks. Although we do not think that lower oil prices will affect the government’s commitment to its spending program, they do hurt the competitiveness of the petrochemicals sector, which has been the worst performer on the TASI so far in May. In addition, lower global economic growth will hit demand. The psychological impact of falls in global stock markets has also damaged investor sentiment and recent days are reminiscent of the depths of the global financial crisis in late-2008, when local fundamentals had little impact on the moves in the TASI. We maintain our view that based on the fundamentals, a fair value for the TASI at the end of the year is 7,400, a 28 percent rise from the current level.

The evolution of the TASI is important to track in examining how the ongoing volatility will impact on the Kingdom’s economy. Given that the bulk of Saudi nationals are exposed to the stock market and that movements in the value of their investment portfolios have an important influence on their spending decisions, the falls in the past few days could well hit consumer spending. The chart on the left shows that there is a close relationship between the annual change in point of sale transactions (the closest proxy available for retail sales) and the annual change in the TASI, and illustrates that a slowdown in spending is likely if the TASI does not quickly rebound (the May observation on the chart is based on the closing value of the TASI on May 25).

We assume that the movements in oil and share prices will have a larger potential to trigger a downgrade to our forecasts than problems caused by direct trade linkages. Greece accounted for 0.7



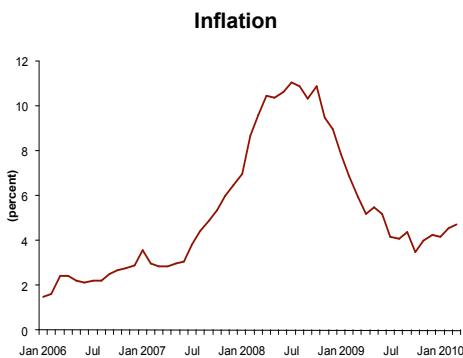
percent of total Saudi exports in 2008 and just 0.2 percent of non-oil exports in 2009. Greece, Portugal, Spain and Ireland combined were the destination for less than 3 percent of total exports and below 1 percent of non-oil exports in the same years.

The EU is the Kingdom's largest trading partner. But unlike every other large trading partner, the Kingdom recorded a trade deficit with the EU in 2008 (latest data) owing to the high level of imports. The EU is the destination for around 11 percent of exports (worth \$33 billion in 2008) and 9 percent of non-oil exports (worth \$2.7 billion in 2009). Slower growth may well reduce demand for these exports, but with trade dominated by oil and oil prices expected to hold up, it will not have a notable impact on the Kingdom. Exporters of non-oil products to the EU will probably face lower demand and prices and the weaker euro will reduce the riyal value of earnings by Saudi companies from sales in the EU.

Main trading partners
(SR billion)

	Destination of exports			Source of imports		
	2007	2008	2009 ¹	2007	2008	2009
EU	97	124	10	110	126	109
US	147	196	3	46	59	51
Japan	134	179	1	30	35	27
China	60	105	9	33	48	41
Korea	74	102	1	15	19	16
GCC	71	83	42	14	19	18

¹Non-oil exports



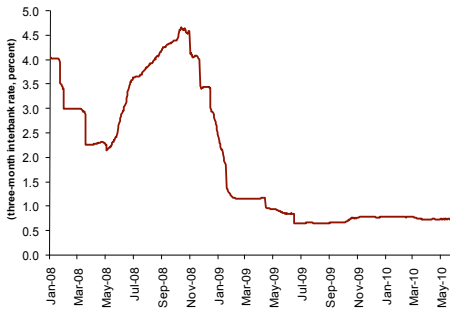
Nonetheless, given the large proportion of imports that come from the EU, a weaker euro will on balance be beneficial to the Kingdom. Around 25 percent of imports into Saudi Arabia are sourced from the EU. The weaker euro means that these products will be cheaper in riyal terms for importers and therefore probably to consumers as well, reducing inflation. Lower commodity prices will also have a dampening impact on inflation, though food prices, which are the largest component of the cost of living index, are not down by that much. In most cases, imports from the EU do not compete directly with locally produced products, so local companies are unlikely to be too badly hit by cheaper imports.

We do not think there will be an impact on local bank lending. The slowdown in lending has been a key factor hampering economic performance over the past 18 months. Saudi banks have minimal exposure to Greece and to those other European countries that markets think could default on their debt. The lack of discomfort in the local financial sector is reflected in interbank interest rates (the rates banks pay to lend to one another). Interbank rates soared as liquidity dried up in the second half of 2008 and shortly after the collapse of Lehman Brothers the three-month interbank rate peaked at 4.67 percent (267 basis points above the reverse repo rate). In contrast, the three-month interbank rate has remained unchanged since the middle of March and is currently just 0.73 percent (48 basis points above the reverse repo rate). We therefore continue to forecast a gradual increase in growth in local bank lending to the private sector this year.

Accessing finance from foreign banks is likely to become more difficult. In particular, many European banks will be concerned about



Three-month Saibor



their exposures to the troubled eurozone members and so are expected to be less forthcoming in extending credit. However, foreign bank lending to the Kingdom has been subdued over the past few years due to greater risk aversion and problems at local private sector businesses and Dubai World. Even though creditors have agreed on a restructuring of the debts of the latter, we do not see this prompting a return to greater lending in the current environment. Tougher market conditions also mean that investors will demand higher rates on new bond and sukuk issues and could compel companies in the process of issuing debt or considering IPOs on the stock market to hold back until the environment improves.



Key data

	2003	2004	2005	2006	2007	2008	2009	2010F	2011F
Nominal GDP									
(SR billion)	804.6	938.8	1182.5	1335.6	1442.6	1781.6	1384.4	1554.0	1680.1
(\$ billion)	214.6	250.3	315.3	356.2	384.7	475.1	369.2	414.4	448.0
(% change)	13.8	16.7	26.0	12.9	8.0	23.5	-22.3	12.2	8.1
Real GDP (% change)									
Oil	17.2	6.7	6.2	-0.8	-3.6	4.2	-6.4	3.9	3.9
Non-oil private sector	3.9	5.3	5.8	6.1	5.5	4.8	2.5	3.8	4.4
Government	3.1	3.1	4.0	3.1	3.0	3.7	4.0	3.6	3.4
Total	7.7	5.3	5.6	3.2	2.0	4.3	0.1	3.8	4.0
Oil indicators (average)									
WTI (\$/b)	31.1	41.5	56.6	66.1	72.3	99.7	62.0	75.0	80.0
Saudi (\$/b)	26.9	34.7	49.5	60.5	68.1	93.4	60.5	71.3	74.8
Production (million b/d)	8.8	9.0	9.5	9.2	8.7	9.2	8.1	8.3	8.5
Budgetary indicators (SR billion)									
Government revenue	293	392	564	674	643	1101	505	626	672
Government expenditure	257	285	346	393	466	520	550	603	621
Budget balance	36	107	218	280	177	581	-45	23	51
(% GDP)	4.5	11.4	18.4	21.0	12.2	32.6	-3.3	1.5	3.0
Domestic debt	660	614	475	366	267	237	225	220	215
(% GDP)	82.0	65.4	40.2	27.4	18.5	13.3	16.3	14.2	12.8
Monetary indicators (average)									
Inflation (% change)	0.6	0.3	0.7	2.3	4.1	9.9	5.1	4.5	3.4
SAMA base lending rate (% , year end)	1.75	2.50	4.75	5.20	5.50	2.50	2.00	2.25	3.00
External trade indicators (\$ billion)									
Oil export revenues	82.0	110.4	161.6	188.2	205.3	281.0	162.6	192.6	200.4
Total export revenues	93.0	125.7	180.4	210.9	233.1	313.4	189.6	221.8	231.9
Imports	33.9	41.1	53.8	63.0	81.5	100.6	81.6	88.2	97.0
Trade balance	59.1	84.6	126.6	147.8	151.6	212.7	108.0	133.6	135.0
Current account balance	28.0	51.9	90.0	98.9	93.3	132.3	26.5	45.3	41.9
(% GDP)	13.1	20.7	28.5	27.8	24.3	27.9	7.2	10.9	9.4
Official foreign assets	97.1	127.9	195.5	273.4	359.8	502.0	461.1	496.7	530.1
Social and demographic indicators									
Population (million)	22.0	22.5	23.1	23.7	24.2	24.8	25.4	26.1	26.9
Unemployment (male, 15+, %)	8.2	8.5	8.8	9.1	9.0	8.8	8.5	8.2	8.0
GDP per capita (\$)	9745	11112	13640	15041	15868	19151	14550	15871	16675

Sources: Jadwa forecasts for 2010 to 2011. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.



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