

SABB Notes

- ▶ 2007 had the fifth budget surplus in a row despite a 60% decline over 2006
- ▶ 2007 budget expenditure was the highest ever in the country's economic history
- ▶ 2008 budget continues its focus on education and healthcare
- ▶ Government debt falls down to 19% of GDP from 119% in 1999

And the boom continues...

High revenues, robust budget, growth

12 December 2007

Dr. John Sfakianakis
Chief Economist

Tel: +966 1 276 4602
Email: johnsfakianakis@sabb.com

This and other publications can be downloaded from: www.sabb.com

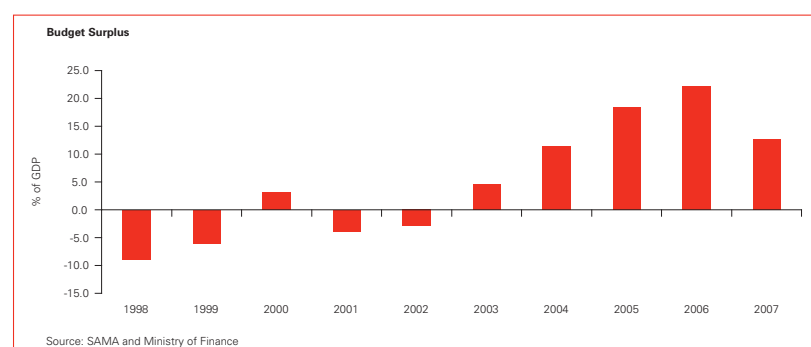
Disclaimer

These notes should be read in conjunction with the concluding Disclaimer, which forms part of them.

2007: A new set of records

On December 10, 2007, the budget for fiscal year 2008 was announced; the largest in the economic history of Saudi Arabia. Saudi Arabia's budget is the largest in the GCC and is more than three times the total fiscal spending of the UAE. The government continues to increase spending in support of its development programme, but adheres to fiscal prudence in an environment of rising inflation, high money supply and robust oil revenues. As a result, actual spending in 2007 increased by 12.7%. Per capita GDP rose to SR 57,570 (\$ 15,352); the highest since 1981 when the country's population was 9.8 million compared to nearly 25 million at present.

The budget surplus of Saudi Arabia is more than twice as big as Lebanon's 2006 GDP and is equal to the 2007 invested assets of the Qatar Investment Authority (QIA). In adherence to the policy followed during this second boom, part of the higher-than-anticipated revenue was used to lift spending above the budgeted level. Although the budget surplus fell by 62% since 2006, it is still at a very comfortable rate of SR 178.5bn (\$ 47.6bn) compared to SR 289.7bn (\$ 77.2bn) in 2006. The bulk of the surplus was used to accumulate foreign assets at the central bank (SAMA) and to reduce debt. In addition, funds have been set aside for the Real Estate Development Fund



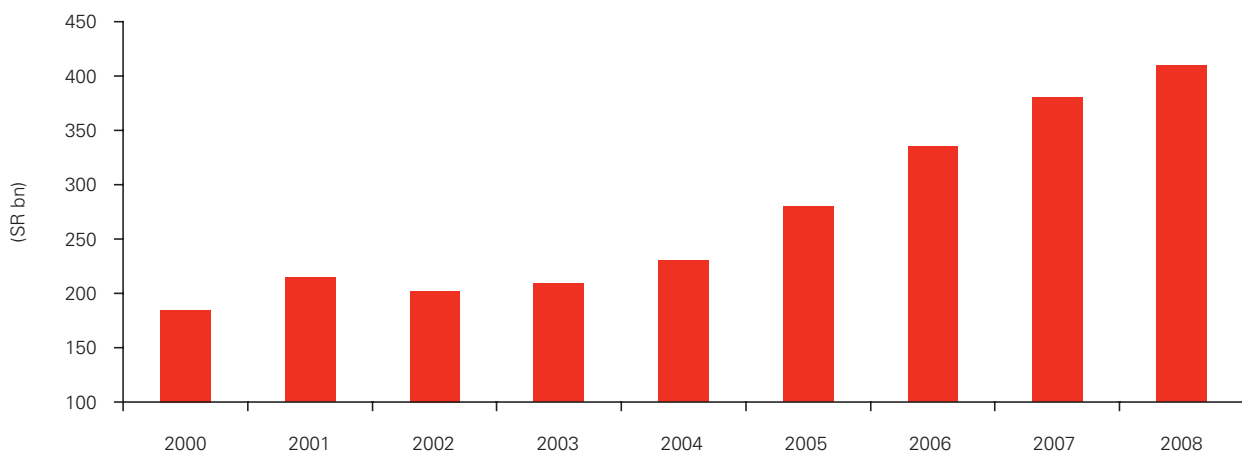
which provides much needed house purchase loans, usually to first time home-owners. Last year's budget gave a capital boost to the Public Investment Fund, but this year's focus is clearly to support the vast, yet increasing, housing needs of the local population.

2007 was a year of healthy fiscal performance as oil export revenues could hit a historic high once again according to preliminary estimates. A previous record was already set in 2006 in which oil export revenues were 16.5% above the total recorded in 2005. In regional terms, the size of the Kingdom's preliminary oil export revenues for 2007 is staggering: more than 118% of the UAE's GDP in 2006 and four times bigger than the size of Qatar's GDP during the same year.

A spending boost

A budget surplus of SR 178.5bn (\$ 47.6bn) was announced for 2007 compared to SR 289.7bn (\$ 77.2bn) recorded in 2006. Spending reached SR 443bn (\$ 118.1bn) over revenues of SR 621.5bn (\$ 165.7bn). The surplus was around five times bigger than the one in 2003, when the economic boom started. The 2007 budget was based on projected revenues of SR 400bn (\$ 106.6bn) and expenditures of SR 380bn (\$ 101.3bn). Spending in 2007 increased by 12.7%, compared to 17.3% increase in spending in 2006 and 21.4% spending rise in 2005. The slowdown in spending could be intended to combat inflation but it could very well be related to the supply bottlenecks in the economy, resulting from the boom, as a large chunk of government spending is construction related and the construction sector is facing expansion constraints related to mainly labour issues. The boosted revenue, due to a considerable excess in targeted oil receipts, allowed spending to grow beyond the budget. The bulk of the surplus was used to increase central bank foreign assets and repay debt in line with a policy adhered to during the second oil boom of the Kingdom.

Budgeted Spending (2000 - 2008)



Source: SAMA and Ministry of Finance

Strong economic performance

Preliminary data show that economic performance remained healthy in 2007. Real GDP growth slowed to 3.5% from 4.3% in 2006 owing to a fall in oil production in the first seven months of the year. Oil production picked up after July from around 8.55 mbpd to its current level of 9 mbpd. We could see a slight shift in real GDP as the final national account statistics are produced in months ahead. Non-oil private sector growth was 5.9% compared to 6.4% in 2006. Starting from a low base of 0.4% in 2005, inflation rose from 2.2% in 2006 to a 12-year high of 3.1%, but we expect further inflationary pressures to build up in the economy in 2008.

A growing budget surplus

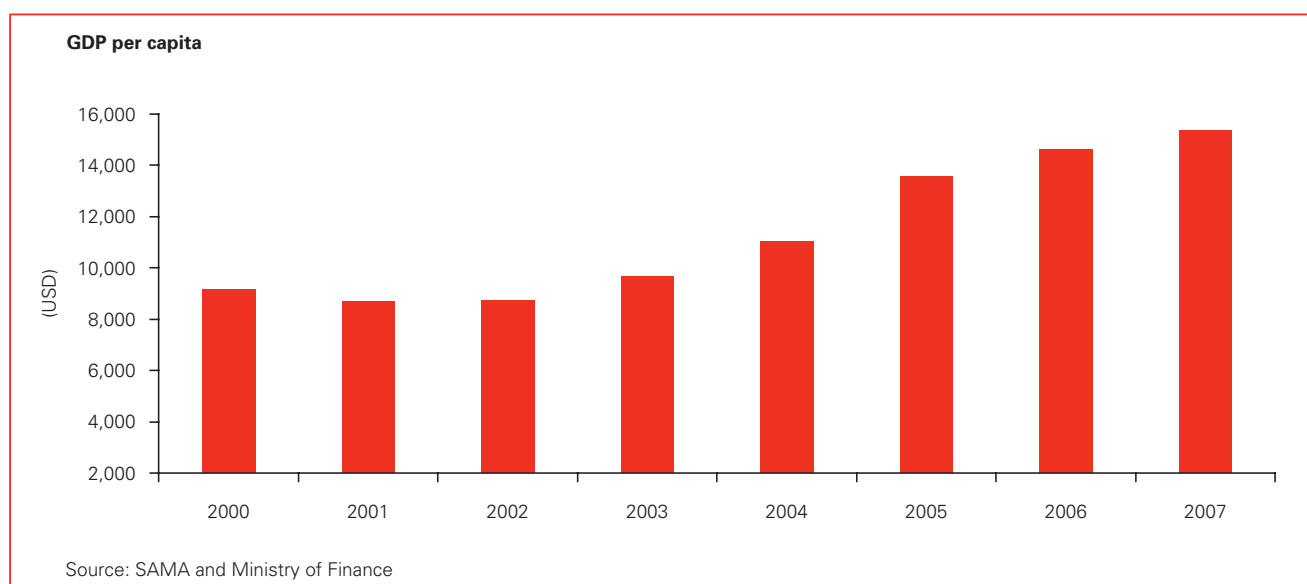
For 2008, spending is budgeted at SR 410bn (\$ 109.3bn) compared to revenues of SR 450bn (\$ 120bn), resulting in a projected surplus of SR 40bn (\$ 10.6bn) which is much higher than the projected surplus of SR 20bn (\$ 5.3bn) in the 2006 budget. Our preliminary forecast is that actual expenditures and revenues will exceed their budgeted levels and another budget surplus is more than likely to happen.

2007: Fiscal strength

The 2007 surplus is the third largest surplus in the country's economic history. The bulk of the surplus was used to accumulate foreign assets at the central bank (SAMA) and to reduce debt.

Paying off public debt is another important step for the Kingdom's healthy fiscal position. Paying off government debt reduces the government's financing costs and increases the pool of finance available to banks, and which can be deployed to support needed projects. The government set aside SR 53.5bn (\$ 14.2bn) to pay off government debt. Although some SR 109bn (\$ 28.8bn) in government debt were paid off in 2006, the government in 2007 was more careful. In addition, funds have been set aside for future capital projects and to increase the capital of the Public Investment Fund which provides loans to industrial, agricultural and infrastructure projects.

As oil prices continue to have an essential impact on the Kingdom's state of fiscal health, since nearly 90% of government revenues come from oil, we continue to expect robust oil prices for 2008. Hence, we anticipate Saudi Arabia to continue to enjoy budget surpluses at least until

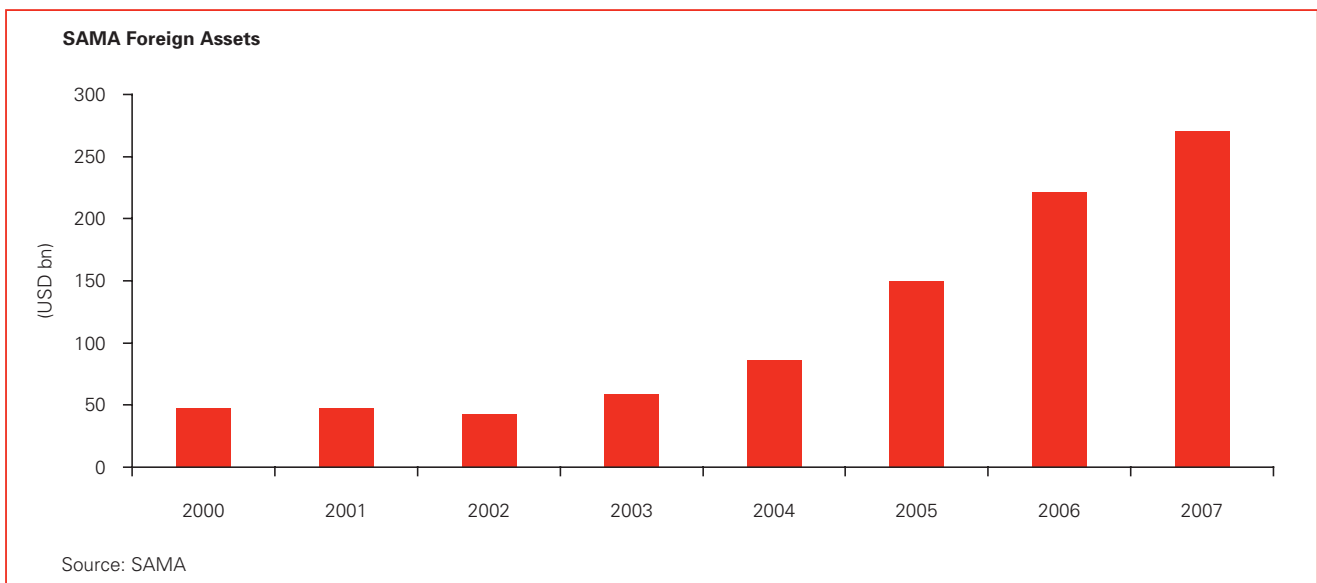


2010. Revenues would continue to be strong but would fluctuate during this period as oil prices move in both directions, and spending would continue to rise above 12% over the forecast period.

The 2008 budget envisages revenue of SR 450bn (\$ 120bn) which is a conservative estimate compared to the actual revenue we preliminary forecast for the coming year. Over the past six years, budget revenue projections have been outperformed by more than three quarters each year. The practice of setting conservative budget revenues resulted from the days of fiscal imbalance, high government debt and no surpluses – characteristic of the 1980s and 1990s. Certainly, this is a prudent practice that will continue for many years to come. The 2008 budget is based on \$ 45 per barrel for Saudi oil and 9.5 million barrels of daily production.

Double-digit spending growth

Actual expenditure exceeded planned spending by 16.5%, in line with the historical trend. Supplemental spending included funds for projects at the Kingdom’s two Holy Mosques (Mashair), subsidies, an allocation to cover higher student numbers and an increase in scholarships, and the 13th month salary. Based on import data for 2006, we estimate that the recently announced rice subsidy is estimated to cost around SR 1.2bn and the milk powder another SR 1.3bn for the state’s coffers. In September, the government announced an increase on barley, corn and soya seed subsidies. At SR 443bn, actual spending was 13.5% greater than in 2006. This makes 2007 the fifth consecutive year of double-digit spending growth. Government expenditure last year was more than two-thirds greater than it was in 2002. Nonetheless, with revenues 71.3% above the budget forecast, the additional spending was easily covered.



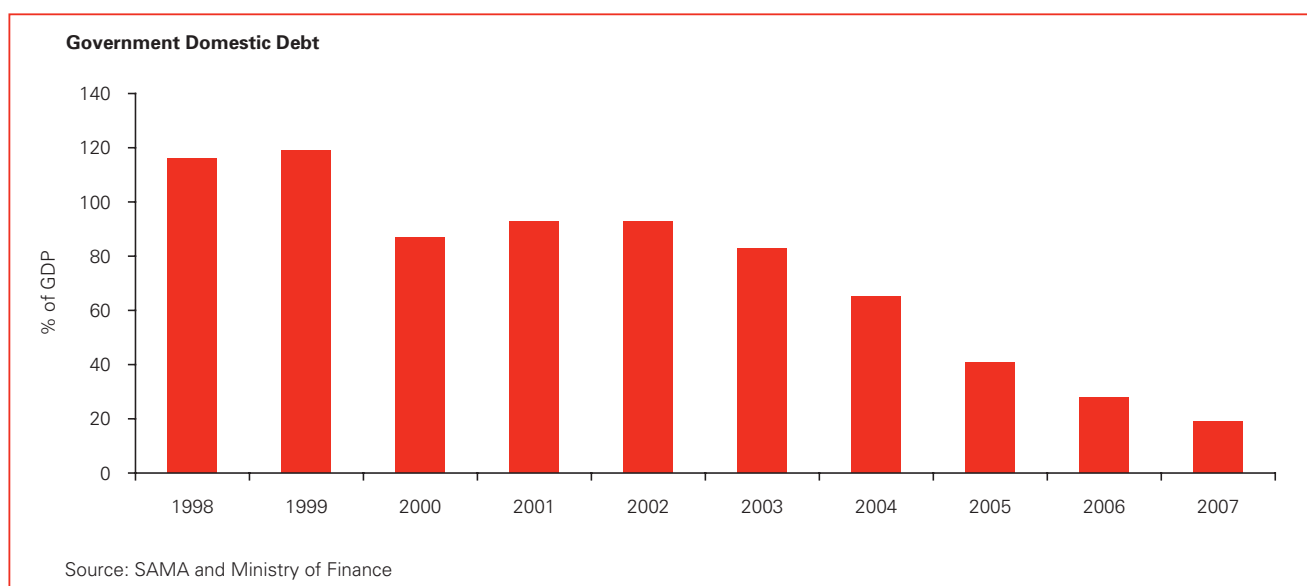
¹ Every three years, the government has a 13th month payroll obligation because the pay period coincides with the lunar and Hijri calendar while the government’s fiscal year is based on the Gregorian calendar. The Hijri year is 11 days shorter. Hence, the 2007 budget has accounted for the 13th month payroll which will be disbursed in 2008.

Foreign assets rise

According to the latest data, SAMA's foreign assets have increased by 22.5% by October 2007 – compared to 47% over 2006 – to reach a total of SR 1.01 trillion (\$ 271bn). The average growth of SAMA's foreign assets per month for 2007 is SR 18.6bn (\$ 4.98bn). Central bank foreign assets should surpass SR 1.05 trillion (\$ 280bn) by yearend as the 2007 foreign asset figures will show in the February 2008 report. They have risen more than fivefold since 2003 to provide nearly 24 months of import cover which had fallen due to an increase in imports in 2007. Overall, SAMA's assets provide ample budgetary cushion against oil price weakness and can support the Riyal's peg to the USD. SAMA's foreign assets are almost equal to the total assets of the domestic banking sector (SR 1.021 trillion).

Reducing government debt

Government debt, all of which is domestic, has been reduced to SR 268.6bn (\$ 71.6bn) from SR 366bn (\$ 97.6bn) at the end of 2006. The repayment of debt, combined with strong economic growth, has allowed a substantial improvement in the government's debt position. Debt now stands at 19% of GDP compared to 28% in 2006 and a peak of 119% of GDP in 1999. At a time of mounting inflationary pressure in the economy, the government had to make sure that it pays down some government debt without injecting more money supply into an over money-supplied system. The decline of government debt to GDP is noteworthy but its decline is also due to an increase in total GDP. As the size of the economy grew, government debt in relation to GDP shrank further. Most of the remaining debt is held by the two large pension funds: GOSI and the Public Pension Agency. We expect that the government will continue to pay off its debt at a gradual pace. As the economy continues to grow, total government debt to GDP will naturally shrink even further.



2008: A Budget with Robust Revenues and Controlled Spending

The 2008 budget is set to provide an added spending stimulus in line with the government's plan, while remaining fiscally prudent. For 2008, spending is budgeted at SR 410bn (\$ 109.3bn) compared to revenues of SR 450bn (\$ 120bn), resulting in a projected surplus of SR 40bn (\$ 10.6bn) over SR 20bn (\$ 5.3bn) in 2006. Although budgeted expenditure is below actual spending in 2007, we anticipate an overrun corresponding to the historical pattern. The 7.9% increase in projected spending between 2007 and 2008 is cautious compared to the growth in revenues and suggests that the government is not over-extending itself in the current period of high oil prices. Moreover, the government's projected differential between expenditures and revenues, widened by SR 40bn in the 2008 budget compared to SR 20bn in the 2007 budget, is indicative of the government's assessment that revenues will continue to be robust, yet spending will be controlled as inflation is on the rise.

Social and physical infrastructure

As with recent years, spending plans prioritise qualitative improvements to social and physical infrastructure. Emphasis is also placed on capital programmes that would generate employment opportunities and help the country enter a sustainable growth phase. Capital spending for 2008 is budgeted at SR 165bn, up by 17.8% on the budgeted level for 2007, but we will not be surprised if actual spending

somewhat declines in 2008 to address price pressures in the wider economy. Capital spending in 2007 was budgeted up by 11%. Historically, capital spending has hovered around 18% of total spending, and more than 85% of budgetary expenditure is directed to current expenditure (salaries). A 15% public sector salary increase would cost the state an extra SR 45bn per year. Attentive to the needs of the Kingdom, the focus of the 2008 budget is on education and healthcare.

1. Education and manpower development is allocated SR 105bn compared to 96.7bn in 2007, an increase of nearly 8.5% compared to an 11% increase between 2006 and 2007. Capital spending in this sector is budgeted to rise by a staggering 34.4% in 2008 compared to 17% in 2007. Spending is spread across all levels of education, but particular attention is paid to primary and secondary education with some 2,074 new schools in addition to 4,352 schools under construction. In attempt to develop regional economies, much needed budgetary support continues to be provided to The University of Northern Border Region (bordering Iraq), as well as added spending on technical and vocational training. The implementation of the National Plan for Science and Technology called for a significant boost of SR 8bn as the country pushes forward to increase its capacity in these two fields.

2. Health and social affairs spending will be increased by 12.4% in 2008 to reach SR 44.4bn. The bulk of the increase appears to cover the cost of staffing the large number of hospitals and healthcare centres. More than 80% of the medical staff consists of expatriates. Some eight new hospitals will begin to be built in addition to the 79 already under construction.

3. Water, agriculture and infrastructure will receive SR 28.5bn, with 73% of that money going towards capital spending. Of this total, SR 13.3bn is allocated to water, sewerage and desalination projects. In addition, the industrial cities of Jubail and Yanbu, as well as other industrial and agricultural projects, will receive SR 7.6bn.

4. Transportation and telecommunications are allocated SR 16.4bn. With Saudi Arabia's paved road network being one of the most modern in the region, financing has been dedicated for new roads totalling 7,300 kilometres – besides the 24,000 kilometres of roads under construction. Development of ports, airports, railways and new postal services are also planned.

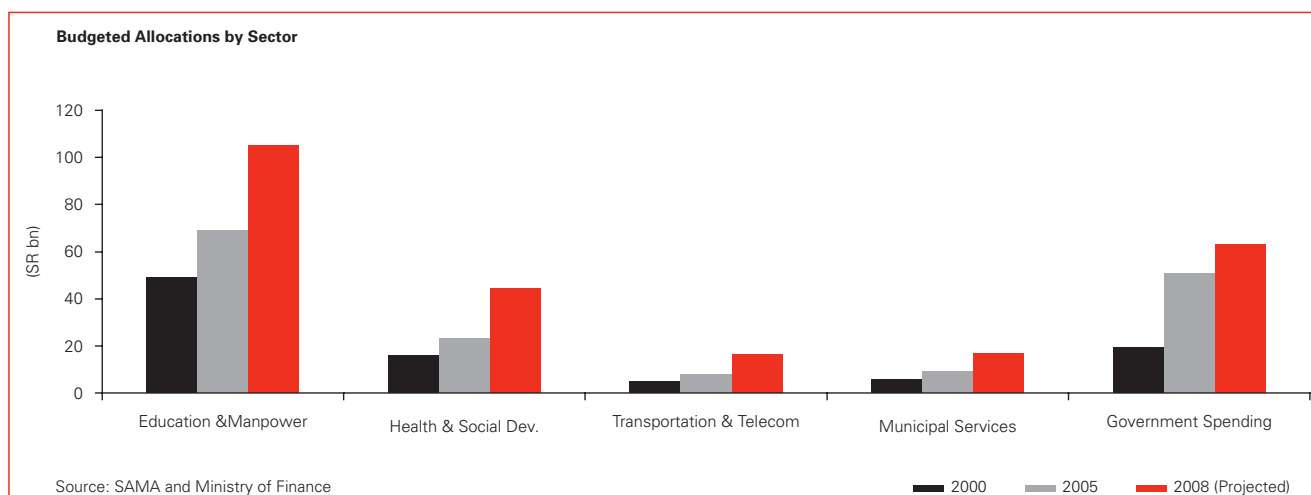
5. Municipality services will receive SR 17bn compared to SR 15.5bn in 2007. New capital spending will total SR 14bn compared to SR 11.1bn in 2007. Various inter-city roads are planned, as well as bridges, road lights and city cleaning projects.

Revenues

Revenues for 2008 are budgeted at SR 450bn. Almost 90% of this total is likely to be derived from oil. The 2008 budget is based on a price of \$45 per barrel of Saudi oil per day at an average 2008 production of 9.5 million barrels per day. We anticipate that Saudi Arabia will increase production further throughout 2008. While oil prices have eased from around \$ 100 per barrel, we are not entirely convinced that prices would subside in 2008. However, SABB forecasts that actual oil revenues will be well above the budgeted total for 2008, giving enough fiscal breathing space.

Budget allocation

The highest budgetary allocation was for Saudi Arabian Airlines which received SR 17.4bn, an 11.3% increase. The Royal Commission for Jubail and Yanbu had the second biggest appropriation of SR 5.5bn, an increase of 21.9% followed by the Saline Water Conversion Corporation. Higher education received noticeable increases as well: King Saudi University received SR 3.6bn, followed by King Abdulaziz University which received SR 2.4bn. The smallest increase among the tertiary institutions was for King Fahd University for



Petroleum and Minerals which received a 4.7% increase or SR 822mn. The newly founded Human Rights Commission and the General Commission for Housing received funds to begin their operations (See Annex).

2007: Macroeconomic Performance

The budget contained the government's preliminary figures for macro-economic performance for the year in terms of real and nominal GDP, inflation, current account surplus and broad money supply

Real GDP growth

Preliminary real GDP growth was estimated at 3.5%. This is lower than the rate recorded in 2006 because of a decline in oil production of around 5.5%. Non-oil private sector growth also eased at 5.9% over 6.4% for 2006. The decline in non-oil growth could be due to lower productivity, bottlenecks in the economy as well as labour shortages. However, non-oil private sector growth is strong and above trend. Non-oil industrial growth was at 8.6% supported by the expansion in the petrochemical and cement sectors. Transport and communication witnessed the highest growth rate within the private sector, growing by 10.6%. Mobile telephony penetration rates are constantly increasing – currently around 78% – keeps rapidly increasing. The wholesale and retail have performed better this year partly due to a rise in consumer confidence following a slowdown in 2006 due to the stock market crash.

Nominal GDP growth

Nominal GDP growth reached 7.1% as oil prices remained robust, yet very volatile, through 2007. Nominal GDP reached 1.41 trillion (\$ 376bn), making Saudi Arabia not only the biggest economy in the GCC but the biggest in the Middle East.

Consumer price inflation

Consumer price inflation reached 3.1% up from 2.2% in 2006. This is a 12-year high. However, inflation is much lower than any other country in the GCC and much lower than the double-digit inflation figures in Qatar and the UAE. We continue to believe that inflation is mostly locally generated and not imported. Rents are rising, pushing inflation higher. Supply bottlenecks, wage inflation as well as simple speculative hikes by retailers are pushing prices up. We do not believe that a revaluation will help fight inflation in this environment of demand-pull inflation. Moreover, the build-up of inflation cannot be fought with salary hikes since this will help fuel further inflation. Salary hikes should be followed with commensurate productivity improvements which are not likely under tight labour market conditions.

Current account surplus

The current account surplus reached SR 344.4bn (\$ 95.5 bn) compared to the SR 371bn (\$ 98.9bn) in 2006. For 2007, we expect that Saudi Arabia's current account surplus will be one of the top five in the world, in line with last year's performance. Although a full breakdown is not provided, it can be assumed that higher imports could account for a slightly

lower current account surplus. Oil export receipts appear to have increased by 7.2% to a preliminary estimate of SR 754.4bn (\$ 201.1bn). Although oil production fell, oil prices went on an unexpected bull-run for part of the year. Oil receipts will be officially released later next year. Non-oil exports also performed extremely well, increasing by 25% to SR 106.8bn from SR 85.5bn in 2006. We believe that the increase was mainly due to a rise in the value and volume of exports. With the region booming, the value and volume of construction materials, agriculture and food products as well as petrochemicals helped increase non-oil exports to a historic high. A revaluation would have been unfavourable to non-oil exports. Imports grew by a strong 20.5% in 2007 – a higher rate than the 17% recorded in 2006 – to reach SR 288.3bn.

Broad money supply

Broad money supply (M3) expanded by 13.5% in 2008 compared to 11.8% over the 10 months to the end of October. Money supply should grow strong on the back of 19.3% growth for 2006. The strong growth in money supply is commensurate with rising inflation. Also, high money supply is simply due to the boom that the country is witnessing. During the slow years of the 1990s, money supply grew by approximately 6-7%.

2008: A Forecast of Strong Performance

We expect another year of strong performance in 2008. Consumer spending is picking up as optimism rises. We anticipate oil production to increase in 2008 which will translate into higher real GDP growth. The current account balance

will slightly drop but it will remain extremely healthy. Inflationary pressures are more likely to build up in 2008 than go down. This is more of a temporary challenge rather than a long-term problem. We expect inflation to begin slowing down in 2009. Going forward, our preliminary forecast for 2008 is as follows: real GDP of 5.7%, nominal GDP 9.1, and inflation 4.2%.

Finally, forecasting in an oil based economy is not simple. Predicting oil price movements and production include many unpredictable factors. Very few were those who predicted the rise in oil prices to around \$ 100 per barrel as oil markets behave in a very volatile manner. Hence, we predicted oil prices to behave less robustly in 2007, distorting our forecasts for nominal GDP, government revenues, budget surplus, oil exports and current account surplus. We were very close in estimating real GDP growth; we forecasted a growth rate of 3.7% compared to the official rate of 3.5%. However, we were wrong on our real non-oil private sector growth assumptions. We had predicted a 7.5% growth rate for the 2007 non-oil private sector, which was significantly higher than the 5.9% that was announced earlier. Our inflation forecast for 2007 was very close to the announced figure. Our government spending forecast was SR 444.6bn with the announced figure being SR 443bn. In addition, our budget surplus estimate of SR 159.7bn was close to the announced figure of SR 178.5bn.

2007 Preliminary Results

	2007 Actual	2007 SABB forecast
Real GDP (% change)	3.5	3.7
Nominal GDP (% change)	7.1	-2.2
Inflation (%)	3.1	3.6
Current Account Balance (SR bn)	344.0	244.0
Government Spending (SR bn)	443.0	444.0
Government Revenues (SR bn)	621.0	574.0
Budget Surplus (SR bn)	178.5	159.7
Oil Exports (USD bn)	201.0	175.0

Source: World Bank and IMF

Annex – Budget Allocations to Semi-Autonomous Institutions

Description	2002	2003	2004	2005	2006	2007	2008	(SR Million)
								2008 % change
Saudi Arabian Airlines	10,966	11,280	12,580	13,595	15,663	15,632	17,400	11.3
General Sea Ports Authority	464	455	437	466	548	683	827	21.1
Grain Silos and Flour Mills Org.	425	451	457	506	632	682	915	34.1
Saline Water Conversion Corp.	2,234	2,245	2,350	2,256	2,978	3,926	5,053	28.7
Royal Commission for Jubail and Yanbu	2,173	2,273	2,439	2,729	4,015	4,579	5,584	21.9
General Org. for Military Industries	711	716	774	793	870	925	1,063	15.0
King Abdulaziz City for Science and Tech.	519	504	516	520	599	705	858	21.7
Saudi Red Crescent Society	249	295	340	418	510	587	630	7.4
General Saudi Railways Organization	303	145	143	421	730	795	824	3.6
Saudi Arabian Standards Org.	81	87	98	105	124	141	156	10.5
Telecommunications & IT Authority	70	80	100	185	300	280	300	7.1
Saudi Arabian General Investment Authority	64	80	80	83	98	142	104	-27.0
Supreme Tourism Council	79	125	150	157	185	222	347	56.3
Saudi Geological Survey	120	111	111	117	148	148	146	-1.1
Institute of Public Administration	224	203	202	200	248	268	288	7.6
Technical Education	1,509	1,540	2,004	2,488	3,309	3,412	3,434	0.6
King Saud University	2,268	2,403	2,420	2,608	3,117	3,189	3,698	16.0
King Abdulaziz University	1,456	1,538	1,500	1,602	1,903	1,895	2,468	30.2
Imam Muhammad bin Saud University	1,257	1,250	1,170	1,223	1,500	1,629	1,866	14.5
King Faisal University	723	773	867	994	1,273	1,335	2,165	62.2
King Khalid University	407	422	469	599	662	763	1,399	83.3
King Fahd University for Petroleum and Minerals	540	574	622	681	781	785	822	4.7
Umm Al-Qura University	711	745	673	754	993	999	1,493	49.4
Islamic University	281	288	310	317	407	407	431	5.9
Pension Fund	14,812	29,480	32,730	-	-	-	-	-
Qassim University	-	-	309	378	659	710	1,096	54.4
Taif University	-	-	122	178	303	367	775	111.2
Taiba University	-	-	178	257	345	404	890	120.3
Jizan University	-	-	-	-	151	220	541	146.1
Jouf University	-	-	-	-	130	190	459	141.8
Hail University	-	-	-	-	135	155	481	210.2
Tabuk University	-	-	-	-	-	104	364	250.2
Baha University	-	-	-	-	-	101	324	220.5
Najran University	-	-	-	-	-	113	320	183.2
Northern Border University	-	-	-	-	-	-	316	
Girls University	-	-	-	-	-	1,123	1,358	20.9
Food and Drugs Administration	-	-	-	-	96	129	220	70.5
Saudi Postal Organization	-	-	-	-	1,329	1,469	1,516	3.2
Civil Aviation Organization	-	-	-	-	2,737	3,063	4,764	55.5
King Faisal Specialist Hospital	-	-	-	-	2,519	2,691	3,364	25.0
Human Rights Commission	-	-	-	-	-	-	52	-
General Commission for Housing	-	-	-	-	-	-	69	-

Disclaimer

This report is prepared for information only. Where the information contained in this report is obtained from outside sources, SABB believes that information to be reliable. However, SABB does not guarantee its completeness or accuracy. The opinions expressed are subject to change without notice and SABB expressly disclaims any and all liability for the information contained in this report.

The report only contains general information. It should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe to any investment. The specific investment objectives, personal situation and particular needs of any person have not been taken into consideration. Accordingly, you should not rely on the report as investment advice. Neither SABB nor any of its affiliates, their directors, officers and employees will be liable or have any responsibility of any kind for any loss or damage that may be incurred as a result of the information contained in this report.