FOR AGENDA

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September 17, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Saudi Arabia—Staff Report for the 2001 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2001 Article IV consultation with Saudi Arabia, which is tentatively scheduled for discussion on Wednesday, October 10, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Saudi Arabia indicating that they do not consent to the Fund's publication of this paper.

Questions may be referred to Mr. Iqbal (ext. 38924) and Mr. Hussein (ext. 36757).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, September 25, 2001, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

SAUDI ARABIA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Saudi Arabia

Approved by P. Chabrier and J. Seade

September 14, 2001

- The consultation discussions were held in Riyadh during May 16–30, 2001.
- The staff team comprised Messrs. Iqbal (Head), Thai, Hussein, Okogu, and Megarbane (all MED), and Mr. Iden (MAE). Mr. Chabrier participated in the policy discussions.
- The Saudi representatives were Dr. Ibrahim A. Al-Assaf, Minister of Finance and National Economy; Sheikh Hamad Al-Sayari, Governor of the Saudi Arabian Monetary Agency (SAMA); the Vice-Minister and Deputy Ministers of the Ministries of Finance and National Economy; Industry; Petroleum and Mineral Resources, and Planning; the Vice-Governor and the Deputy Governor of SAMA; and other senior government officials. The mission also met with representatives of commercial banks; the Chairman of the Riyadh Chamber of Commerce and Industry; and with officials of the Cooperation Council for the Arab States of the Gulf (GCC). Mr. Al-Turki, Executive Director of Saudi Arabia, participated in the meetings.
- Saudi Arabia accepted the obligations of Article VIII, Sections, 2,3, and 4 on March 22, 1961.
- Saudi Arabia has accepted the Fourth Amendment of the Fund's Articles of Agreement.
- The authorities have agreed to issue the Public Information Notice (PIN) following the conclusion of the consultation process.
- The principal authors of this report are Messrs. Iqbal, Thai, and Hussein.

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EXECUTIVE SUMMARY

Current setting

Responding to the adverse impact of the fall in oil prices 1998, Saudi Arabia intensified the implementation of the strategy, which aims at broad-based structural reforms under a tight fiscal program to accelerate non-oil growth, generate employment opportunities, and reduce vulnerability to oil price shocks. This strategy encompasses an expanded role of the private sector and foreign investment, reduction in the domain of the public sector, and opening up of the natural gas sector under the existing liberal exchange and trade system.

In 2000, Saudi Arabia's macroeconomic position strengthened dramatically, reflecting the recovery of oil prices and structural reforms under a prudent macroeconomic stance. Real GDP growth turned sharply positive, the budget registered a notable turnaround to a surplus of around 3.5 percent of GDP and government domestic debt fell. The external current account surplus rose to about 9 percent of GDP, and SAMA's net foreign assets increased to the equivalent of about ten months of prospective imports. In 2001, a number of additional reforms have so far been undertaken including a sharp reduction in import tariffs, restructuring of state enterprises, and the introduction of the major Gas Initiative. The fiscal and external current account surpluses are expected to remain large. Based on the oil price expectations, the staff's medium-term forecast suggests that, under the ongoing policies, real non-oil GDP growth will accelerate, but fiscal and external current account deficits will re-emerge starting in 2003.

Staff appraisal

- The staff supports the authorities' strategy to address the dual challenge of accelerating non-oil growth and reducing vulnerability to oil price fluctuations.

- Several areas where further efforts would reinforce the authorities' strategy include: (a) a speedy public sector restructuring and privatization; (b) a further expansion in the domain for foreign direct investment; (c) a further early widening and deepening of the financial sector through development of new instruments and the capital market; (d) labor market reforms to increase the elasticity of substitution for the Saudi Arabian workforce; and (e) structural strengthening of the budget through generation of higher non-oil revenue and strengthened expenditure management to reverse the debt dynamics.

- Important progress has been made toward greater transparency and dissemination of economic data. Areas where further work would be particularly helpful include national accounts, consolidated public sector accounts, and employment and wage data. Early steps toward the adoption of the General Data Dissemination System (GDDS) would be beneficial.

I. BACKGROUND AND RECENT DEVELOPMENTS

1. **Following the sharp deterioration in Saudi Arabia's financial position in 1997-98 on account of the fall in oil prices, the Saudi authorities initiated a major shift in their economic strategy**. In contrast to previous years, when a combination of financing and adjustment was used to address terms of trade shocks, the new strategy aimed at implementing a broad-based structural reform agenda to reduce vulnerability to oil price shocks and accelerating non-oil growth in a sustained fashion to generate employment opportunities for a rapidly growing Saudi Arabian labor force. Under this strategy, investment would be increased through expanding the role of the private sector, including foreign investment, under a competitive market environment; the domain of the public sector would be reduced; and the large, but hitherto, virtually untapped non-associated natural gas sector would be opened up. A number of steps have already been taken under the guidance of the Supreme Economic Council (SEC) to restructure and privatize the large state enterprises to undertake legal and institutional reforms in order to strengthen the role of the market to further liberalize rules governing foreign capital inflows and thus, improve the business climate.[1]

2. In concluding the 2000 Article IV consultation on October 6, 2000, Directors noted that the strong recovery of world oil prices, efforts to contain expenditure, and strengthen structural reforms had improved the fiscal position, increased growth, and enhanced confidence. They encouraged the authorities to build upon these measures to lessen the economy's vulnerability to oil price fluctuations. Directors emphasized that the authorities' commitment to strengthen and broaden the process of structural reforms would promote investment, expand the role of the private sector, and lay a strong foundation for faster growth, thereby generating employment opportunities. These efforts would benefit from a further strengthening of the fiscal position. Adherence to a prudent monetary policy, a sound and well-supervised financial system, and a credible commitment to the exchange rate peg were commended. While noting progress in improving Saudi Arabia's database, Directors encouraged the authorities to make decisive progress in strengthening it further, including through participation in the Fund's General Data Dissemination System (GDDS).

3. **There has been a dramatic improvement in Saudi Arabia's macroeconomic and financial position since 1999. However, the authorities are confronted with the dual challenge of accelerating growth in a sustained fashion to address unemployment**

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[1] The SEC, which was established in 1999, is headed by Crown Prince Abdallah bin Abdul Aziz and is composed of key economic ministers. It coordinates and expedites policy formulation and implementation of economic reforms.

pressures and durably reduce vulnerability to oil price fluctuations.[2] Moreover, in the period ahead, the global economic slowdown and the possible weakening of oil prices will affect the economy. Recognizing the narrow window for action provided by the relatively higher oil prices, the authorities have intensified their reform effort while maintaining a generally prudent macroeconomic stance. The consultation discussions were, therefore, focused on steps to address this dual challenge.

4. **Although oil prices recovered sharply in the second half of 1999, the overall economic situation remained weak.** Total real GDP declined slightly as crude oil production was curtailed by 8 percent and the real non-oil GDP grew modestly, while the consumer price index fell further by 1.3 percent (Table 1, Figure 1). Reflecting the increase in oil prices and expenditure cuts, the d budget deficit fell but government domestic debt remained high at the equivalent of 117 percent of GDP and interest payments reached 5 percent of GDP.[3] While the external current account registered a sharp turnaround to a small surplus in 1999, the Saudi Arabian Monetary Agency's (SAMA) net foreign assets fell further to the equivalent of about eight months of imports as large capital outflows were registered (Table 3, Figure 3). Although monetary expansion picked up, credit to the private sector grew modestly as the non-oil sector recovery remained subdued (Table 4, Figure 4). Interest rate differentials with the U.S. dollar fell sharply through the year to about 30 basis points at end-1999. The Saudi riyal remained stable following a brief speculative attack in early 1999.

5. **Progress was made during 1999 on establishing the legal and institutional foundations for the private sector-led growth.** Steps were taken to corporatize and restructure the telecommunications company and the electricity sector; the stock market was opened to foreign investors through open-ended mutual funds managed by Saudi banks; and the reform of the tax and customs administration was continued.

6. **In 2000, reflecting the sharply higher oil prices and the maintenance of generally prudent policies, Saudi Arabia's macroeconomic position strengthened dramatically (Figure 5).** Real GDP growth is estimated to have turned sharply positive at 4.5 percent (against a decrease of almost one percent in 1999) mainly due to an 8.5 increase in the oil

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[2] While no firm official data are available on unemployment, it has been estimated to be at least 14 percent of the total Saudi workforce, not all of which is involuntary on account of social and geographic reasons.

[3] Much of the public debt is held by the autonomous government institutions (AGIs). Since operations of these institutions are excluded from the government sector as covered by the analysis underlying the staff report, the size of the debt overstates the burden on the budget. Similarly, to the extent that SAMA's net foreign assets are a subset of total foreign assets (including those of AGIs), they understate the financial strength of the public sector.

sector GDP. Saudi Arabia raised its crude oil output several times in 2000 by a total of 6.5 percent to about 8 million barrels a day. Non-oil GDP growth also recovered moderately to an estimated 2.6 percent as the manufacturing sector maintained its robust growth at 5 percent, mainly on account of the expansion in petrochemicals and other industrial activities. There was also a strong pickup in the construction and private services sectors, which reflected the strengthening of business and consumer confidence. The overall stock market price index increased by 11 percent (Figure 6). Reflecting the improvement in the terms of trade, the real gross domestic income rose by 28 percent.[4]

7. **The budgetary situation also improved dramatically in 2000**. The overall central government budget registered a turnaround of over 10 percent of GDP to a surplus equivalent to 3.5 percent of GDP as oil revenues increased by about 50 percent. In the process, government domestic debt fell to 95 percent of GDP and the ratio of debt service to expenditure declined to 30 percent in 2000. In part, reflecting the improved revenue position, expenditures were allowed to increase by 27 percent over the budgeted level to: (a) settle past late payments to domestic contractors and farmers; (b) provide additional capital allocations to speed up implementation of the approved public sector investment programs; (c) allow larger outlays on operations and maintenance; and (d) permit increased purchases of services and supplies to address the pent-up demand.[5] **In an important step to facilitate market-based pricing of publicly supplied goods and services, electricity rates were adjusted upward.**[6]

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[4] Real gross domestic income (i.e., real GDP adjusted for the terms of trade effects) provides a better measurement of the purchasing power of gross domestic product in an economy that is subject to large movements in the terms of trade. The underlying methodology is described in *Saudi Arabia—Recent Economic Developments and Selected Issues, SM/00/215.*

[5] Expenditure incorporates around SRls 31 billion (4.8 percent of GDP) in settlement of late government payment dues, which if excluded and transferred to financing, reduces the increase in total expenditure over 1999 to about 11 percent, reflecting in large part higher capital outlays. The high level of late payments prior to 2000 is attributable to several factors, such as: (a) the buildup of certificates held by agricultural and industrial suppliers to government ministries and agencies; (b) cases where companies completed projects before the contract duration (e.g., in water desalination), with the Ministry of Finance and National Economy having to catch up on payments due; (c) cases where ministries had decided to delay payments to contractors, who however, sought payments from the Ministry of Finance and National Economy under the original contract; and (d) a number of disputed late payment cases settled by agreement or decisions of the Board of Grievances.

[6] The rollback of about half of the increase in electricity tariff rates in October 2000 reflects the authorities' concern to moderate the adverse effects on vulnerable groups. The increase in

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8. **The external current account surplus rose to the equivalent of 9 percent of GDP in 2000, as oil export receipts rose by about 60 percent.** Non-oil exports also registered an impressive 14 percent increase largely owing to a sharp increase in the value of petrochemical exports. Imports, on the other hand, grew by 8 percent in response to improved business confidence, the anticipated strengthening of the economic recovery, and the improvement in the foreign liquidity position. Improvement in the trade balance more than made up for the deterioration in the services account. With net capital outflows falling by 26 percent, the overall external balance shifted from a deficit equivalent to 5.3 percent of GDP in 1999 to a large surplus equivalent to 5.6 percent of GDP. In the process, **SAMA's net foreign assets rose to the equivalent of 10 months of prospective imports of goods and services.[7] Reflecting these developments, the external vulnerability indicators strengthened further (Table 5).**

9. **The growth of domestic liquidity slowed down.** Net domestic credit fell slightly on account of a sharp fall in the banking sector's claims on the government. However, credit to the private sector rose by over 6 percent, mainly on account of personal and consumer lending.[8] In contrast, there was little strength in short-term business lending, in part, because of the increase in the private sector's own liquidity following the settlement of late government payments. However, in light of the fall in interest rates, longer-term business sector lending was more robust.

10. **The performance of the financial sector remained strong in 2000.** Nonperforming loans fell to about 10 percent of total outstanding loans, and provisioning for such loans rose to 93 percent in 2000 from 84 percent in 1999 (see Appendix IV for details). Bank supervision was further strengthened through the adoption of the International Accounting Standards (IAS) Nos. 34 and 39 for bank accounting purposes, while the risk-weighted capital/asset ratio remained high at 21 percent.[9] Interest rates followed the international

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agricultural subsidies in 2000 reflected a one-time increase in the barley subsidy, which was aimed at cushioning the impact of drought in 1999. Such subsidy was discontinued in 2001.

[7] In addition, net foreign assets of the AGIs rose by 8 percent to 19 percent of GDP.

[8] The sharp increase in consumer lending was driven, in part, by technological as well as legal developments. With these increased sophistication of the payment system, direct deposit of wages has become widespread, which allows automatic repayments of debt. Also, the boom in such lending reflects the introduction of legally binding contracts to service personal loans by means of deductions from electronically deposited wages.

[9] IAS 34 pertains to interim financial reporting and basically specifies the reporting framework of financial reports that are required within the financial year; the reports must be consistent with the annual statements, although these can be more aggregated and summarized. IAS 39, on the other hand, pertains to the "recognition and measurement" of

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trends; the differential with the U.S. dollar declined steadily to 27 basis points by end-2000, which reflected the continued market confidence in the exchange rate peg.

11. **Significant progress was made on the structural front (Box 1).**

- **The new investment law was implemented, which provides a level playing field for both national and foreign investors.** Foreign investors have been allowed 100 percent ownership of business except for about 22 categories on the "negative list", equal access to concessional long-term credit from the Saudi Industrial Development Fund, and authorization to foreign investors to sponsor expatriate workers on their own accord rather than through a Saudi sponsor.[10] Also, the corporate income tax on foreign investment was cut from 45 percent to 30 percent as a first step toward further adjustment under the planned reforms of the income tax law. Domestic corporations, which are not subject to the corporate income tax, pay Zakat at a rate of 2.5 percent of net worth.[11]

- **The Saudi Arabian General Investment Authority (SAGIA) was established** as a one-stop shop for the licensing and processing of foreign investment applications; over the past 12 months, it has issued licenses for about US$10 billion of foreign investment.

- **The Human Resources Development Fund (HRDF) was created**—with financial participation of the private sector—to undertake training of Saudi labor force in skills required by the private sector.

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financial instruments. The provision specifies the standards for initial recognition and subsequent measurement of all financial instruments included on and off balance sheet assets and liabilities.

[10] The "negative list" includes oil production, refining, distribution and transportation, services incidental to electric energy distribution, road and air transportation, audiovisuals, printing and publishing, education (primary, secondary, and adult), pipeline transport, space transports, nursing/paramedical services, real estate commission services, wholesale and retail trade services, auto dealerships, and auto parts outlets, commission agent services, insurance and insurance-related services, public telecommunication services, data and message transmission services, and business network services.

[11] Though a form of the generalized wealth tax, the Islamic direct tax—Zakat—applies to all assets which are capable of producing an economic return, subject to a minimum exemption. By its very nature, Zakat is applicable on wealth rather than on its holder. In Saudi Arabia, foreign corporations are not subject to Zakat.

- A database was established for matching and placement of Saudi workers in the private sector through 37 regional offices in the country.

II. Report on Discussions

12. **The official economic program for 2001 is aimed at continued structural reforms under a tight fiscal policy, in order to accelerate growth. Real non-oil GDP (which accounts for about 66 percent of total real GDP) is estimated to increase to about 4 percent in 2001.** On the other hand, real oil GDP is expected to grow only slightly, on account of the expected stabilization of oil output consistent with the OPEC production decisions. Agreement has also been reached on the implementation of the ambitious Gas Initiative (Box 2).[12] **The fiscal and external current account balances are expected to register surpluses in 2001—though somewhat smaller than in 2000.[13] SAMA's net foreign assets are expected to increase to the equivalent of about one year's imports of goods and services.**

13. **The medium-term outlook remains highly sensitive to variations in the global oil prices.** Moreover, the pace of structural reforms, foreign direct investment inflows, the implementation of the Gas Initiative, and the evolution of the global economy are likely to play a crucial role in determining the medium-term economic developments. Based on the oil price expectations at the time of the mission, under an unchanged policy stance, **the staff's medium-term scenario suggests that growth of real non-oil GDP will accelerate to**

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[12] In 2001, total real GDP growth is expected to decelerate to 2.7 percent on account of stable oil GDP. Real gross domestic income—reflecting the expected drop in oil prices in 2001—would fall by about 2 percent. The cost of living is expected to remain unchanged on account of lower import prices. The recovery in non-oil GDP would be triggered by: (a) the expected increase in private investment following the 20 percent increase in the number of licenses issued for new domestic investments and the 87 percent increase in the authorized capital; (b) an increase in credit to the private sector; (c) the ongoing expansion in the production capacity including in Saudi Arabian Basic Industries Corporation (SABIC); (d) increased demand for intermediate and capital goods imports; and (e) the anticipated foreign direct investment under the Gas Initiative and liberalization under the investment law. Private investment is projected to increase by about 2 percent of GDP.

[13] The June 2001 revisions to the WEO oil price expectations will imply a significantly better financial outturn. Under these assumptions, average oil prices for Saudi Arabia could be US$25.4 per barrel or 5 percent higher than the price consistent with the authorities' expectations in late May 2001, when consultation discussions were held. On the basis of the latest WEO assumptions, fiscal and external surpluses would be larger.

Box 1. Reform Measures Introduced or Under Way

A number of reforms have been introduced in Saudi Arabia since 1999 to enhance the role of the private sector and encourage foreign investment. Other reforms are under consideration or at an advanced stage of preparation. The main developments and relevant stages are itemized below:

Reforms adopted

- Supreme Economic Council established (August 1999)
- Corporatization of the electricity sector (December 1999)
- Foreign investment law (approved in April 2000)
- Sponsorship law (allowing foreign companies to sponsor their expatriate employees, April 2000)
- Saudi Arabia General Investment Authority (facilitating investment process, including the establishment of one-window shop, April 2000)
- Stock market opened to all foreign investors through mutual funds (November 1999)
- Real estate ownership law (allowing foreigners to own real estate except in the two holy cities, May 2001)
- Human Resource Development Fund (training Saudi nationals for the private sector, November 2000)
- Higher Tourism Authority (encouraging domestic tourism, November 2000)
- Telecommunications law and Saudi Telecommunications Authority established (paving the way for ending state monopoly and opening the sector to foreign capital, May 2001) following the corporatization of Saudi Telecommunications Company (STC) (1998)
- Regulations for transfers of employees from the Ministry of Telecommunications to the STC (May 2001)
- Guidelines for publication of economic and financial data (May 2001)
- Reduction of customs tariffs from 12 percent to 5 percent (May 2001)

Fiscal reforms

- Income tax law (under consideration)
- GCC customs unification to be implemented in March 2005. This would lower Saudi tariffs from 12–20 percent to 5.5–7.5 percent (November 1999)
- Strengthening of customs and tax administration (under way)
- Indirect tax (under consideration)
- Excises on luxury goods (under consideration)
- Municipal fees and taxes (under consideration)
- Civil service reform (focusing on restructuring and training to raise productivity, under way)

Reforms awaiting approval from the council of ministers

- Company law (modernization and adaptation of existing regulations)
- Agency law (to remove the requirement for a local agent)
- Capital markets law (to enhance regulation and allow foreign investment in the stock exchange; Stock Exchange Regulatory Commission)
- Insurance law (providing legal framework for insurance activity)
- Competition law (toward establishing a level playing field for Saudi and foreign companies in line with WTO rules)
- WTO accession negotiations in progress, driving trade liberalization:
    - Trademark and intellectual property law
    - Removal of "technical barriers" to trade
- Regulatory agency for electricity
- Labor law (to rationalize employment procedures and increase labor mobility)
- Mining code (to facilitate investment in the hard minerals sector)

Opening up of the oil and gas sector

- International oil companies (IOCs) selected for development of upstream gas sector under the Gas Initiative for use in power generation, water desalination, and petrochemicals (May 2001)
- Signing of preliminary agreements for the Gas Initiative (June 2001)

Box 2. The Gas Initiative

- **Saudi Arabia signed the preparatory agreements with international oil companies (IOCs) on June 3, 2001, which opened the way for the involvement of these companies in the development of the upstream gas sector (with reserves estimated at about 220 trillion cubic meters).** Project proposals had been submitted in 2000 by a number of IOCs for consideration by Saudi Arabia's Supreme Council of Petroleum and Mineral Resources. The winning bids were announced in May 2001 for the three core projects:

    - **Core Venture-1 (CV-1),** ***Exxon Mobil*** is to lead this, the largest venture, covering the South Ghawar fields (other members of the consortium being BP, Shell, and Phillips Petroleum).
    - **CV-2,** covering the Red Sea area, is also to be led by *ExxonMobil* (other members include *Occidental and Marathon* oil companies) and will produce gas in the northwestern part of the country.
    - **CV-3,** led by Shell (with participation by TotalFina, Elf, and Conoco), covers the Shayba fields.

- Under the terms of the agreement, the IOCs are to explore for, and produce, natural gas from their assigned fields, which are thought to contain nonassociated gas. The gas produced would be used in three categories of key downstream projects: CV-1 would be used for electricity generation, water desalination, and petrochemicals; CV-2 would be used for electricity generation and water; while CV-3 would provide feedstock for electricity, water, and petrochemicals. The ventures are projected to add:

    - 300 million gallons of water per day;
    - 2 million tons of petrochemicals per annum to the country's existing capacity; and
    - 4,000 MW of new electricity generating capacity.

- The investment cost of the Gas Initiative, excluding ancillary activities, is estimated to be about US$25 billion over 10 years. In addition, ancillary projects—mainly infrastructure to support the gas projects (including the construction of gas processing and fractionation plants to recover and separate liquids and gas liquid transmission facilities)—are expected to cost even more, thereby, opening up great opportunities for private investors, and would go a long way toward meeting the objectives of promoting the role of the private sector as set out in the Seventh 5-year Plan (2000–05). **Total investments could possibly reach US$45 billion.** The IOCs are required to give priority to local suppliers and contractors as long as they are competitive in price and quality. The authorities expect a sustained investment of at least US$5 billion per annum in the early part of the program.

- The IOCs would be allowed to process and market all associated gas liquids (mainly NGLs and LPG) found in the process of producing the natural gas, but any discoveries of crude oil would be turned over to the government.

- The next phase would involve more detailed specification of the projects, including the physical and commercial scope of the ventures, and are expected to be completed within six months. The procurement, construction, and startup phase will commence in 2002. The legal principles as well as the fiscal and regulatory regimes have been developed.

- The authorities have emphasized that national oil company, ARAMCO, will be a partner rather than a competitor.

4.5 percent in 2003–05. However, fiscal and external current account deficits will re-emerge in 2003, and could rise by 2005 to 4.5 percent and 9 percent of GDP, respectively, (Tables 2 and 3, and Figure 7).[14] To the extent that a part of the rise in the projected external current account deficit will be financed by capital inflows, the loss in SAMA's net foreign assets will be cushioned. It is also expected that capital inflows will generate non-oil exports and strengthen the external position. However, the mission was concerned that the emergence of fiscal deficit would cause public debt to increase, enhance vulnerability to oil price fluctuations, and could weaken growth prospects.

14. **The authorities recognize the medium-term risks and attach the highest priority to accelerating private sector-led growth to generate employment opportunities for the rapidly expanding Saudi workforce and to reduce vulnerability to oil price shocks.** The policies to be implemented for this purpose include: (a) restructuring and privatization of state enterprises; (b) additional steps to expand the role of the private sector; (c) development of the financial and capital markets to promote private sector investment; (d) streamlining of regulations to encourage foreign direct investment; and (e) maintenance of tight fiscal policy in an environment of free exchange and trade system to reduce public debt and to address any weakening of the external balances. The intensified structural reforms will also help improve the fiscal position and facilitate shift in government outlays toward investment. The reinforced political commitment to the ongoing structural reform is likely to speed up the approval and adoption of a number of laws presently under consideration to achieve a fuller operation of market forces, and will facilitate policy implementation.

15. The policy discussions were focused on the authorities' broad strategy and pace of its implementation against the backdrop of the presently comfortable macroeconomic position, and the likely adverse implications of the global economic slowdown and the weakening of oil prices in the period ahead. The authorities intend to build upon their ongoing structural reforms at a pace consistent with their socio-political acceptability and the government's administrative capacity.

A. Oil Policy

16. **The authorities stressed that their oil policy is centered around Saudi Arabia's role as a member of OPEC, and aims, in collaboration with other OPEC members, to stabilize the group's basket crude oil price in the range of US$22–28 per barrel, on the**

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[14] Any greater-than-anticipated weakening of oil prices would widen these imbalances. Staff estimates show that a price path implying US$2 per barrel below the mission's price path would imply increases in the budget and external current account deficits by 2.5 percent and 3 percent of GDP, respectively. However, if the oil prices were to be on the path implied by the revised higher WEO oil prices as of June 2001, these deficits would drop to about 3 percent and 5.5 percent of GDP, respectively, in 2005.

basis of the global supply and demand situation. However, they insisted that producers alone should not shoulder the burden of stabilizing the world oil market and that coordination between oil producing and consuming countries was essential for market stability. In this context, they emphasized that issues pertaining to the production, consumption, investment, and technology in the energy sector should be discussed among all parties through a common platform , such as a permanent secretariat of the Energy Forum, in order to ensure stability and predictability in the international oil market. They noted that the future outlook pointed to a continued growth in world oil demand, which would necessitate dialogue and cooperation for the benefits of producers and consumers.

17. For 2001, the authorities do not expect oil prices to change significantly from the average reached so far; for Saudi Arabia this would imply an average price of about US$24 per barrel (Box 3). However, there could be uncertainties and volatility due to a number of factors, including developments in the refined products markets and refinery bottlenecks. Should there be a long-term reduction or suspension in Iraq's oil output, increased production from other major producers could compensate for the shortfall to maintain price stability. The projected price combined with the likely production level of about 8 million barrels a day, would imply an 8 percent drop in oil export receipts to US$66 billion in 2001.

B. Structural Reforms

Restructuring and private sector growth

18. **The authorities intend to implement restructuring and privatization of large-scale enterprises cautiously in order to avoid unemployment pressures and to moderate price increases** (Box 4).[15] The strategy aims at privatizing management, deregulation, and (finally) privatization. While there is no firm timetable for privatization, the primary focus, in the short run, will be on the corporatization of enterprises and on establishing the regulatory framework for the enterprises (mainly in the electricity, telecommunications, and transportation sectors) in order to prepare the groundwork for their eventual privatization without creating private sector monopolies.[16] The regulatory agencies will establish rules for price adjustments in consultation with producers and consumers and implement guidelines for the entry of competitors. Privatization will be either through a gradual transfer of shareholding to the private sector via the stock market or direct sales to strategic partners—both domestic and foreign. In this regard, during 2001:

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[15] A number of small-scale activities, such as port and municipality services, have already been privatized. Privatization of large enterprises with government share is pursued under various avenues (see Box 4).

[16] Other areas for privatization include water desalination, sewerage, and the Saudi Arabian Airline.

Box 3. Oil Market Developments in 2000 and 2001

Developments in 2000 and impact on prices

- OPEC (excluding Iraq) raised output several times during 2000 by a cumulative amount of 3.7 million barrels per day (mbd) starting from April, in an attempt to restrain the price increases and to enable a rebuilding of stocks. These efforts were supported to varying degrees by non-OPEC producers; Mexico, Norway, Oman, and Russia having cooperated with the OPEC group in the previous year in reducing output following the market collapse of 1998 and early 1999.

- Saudi Arabia's weighted average output for the year was about 8 mbd compared to 7.56 mbd in 1999. As usual, the Kingdom played a key role in engineering the quota changes.

- The average price of the WEO basket of crude oils was 56 percent higher than in 1999, reflecting the effect of robust oil demand (due to a strong world economy), low inventory levels, and speculation due to market uncertainty. The average export price for Saudi oil rose by 56 percent in 2000 compared to 1999.[1]

- Dialogue between major producers and consumers continued in 2000, with the Seventh Meeting of the Energy Forum hosted in Saudi Arabia in November. A wide range of issues affecting the world oil market was discussed, with consensus in many areas. However, there was disagreement as to what the appropriate price of oil should be. A proposal was put forward by Saudi Arabia for a permanent secretariat of the Forum to be based in Riyadh, which is under consideration.

Oil market developments in 2001

- The effect of the output increases in 2000, combined with a slowdown in the world economy, was eventually felt in the form of weakening oil prices from late 2000. The average price of the WEO basket, for example, fell by over 23 percent between November 2000 and mid-January 2001, prompting the pre-emptive quota ceiling reduction of 1.5 mbd (5.6 percent) at the January 17 OPEC meeting. Prices continued to be weak, on account of weakening demand (in line with world economic slowdown), and rising non-OPEC production. This was at a time when Iraqi production was down by about 50 percent in connection with its dispute with the United Nations.

- Evidence of continuing market weakness in February and early March led to further quota reduction of 1 mbd by OPEC at its March 17 meeting, with a promise that more cuts might be undertaken depending on market developments. At present, the OPEC-10 has a total quota ceiling of 24.20 mbd, although there is evidence that the group is exceeding this limit. Saudi Arabia's current quota is 7.87 mbd, bringing its weighted average output for 2001 to 7.99 mbd (assuming there is no further change in quota for the rest of the year). Unlike the January agreement, Mexico signaled its intention to cooperate with OPEC on the March agreement. At the group's meeting on June 5, they decided to leave the production ceiling unchanged. The meeting on July 3, 2001 also left the OPEC production level unchanged.

- The Saudi authorities expect average oil price for Saudi crude in 2001 to be about US$24.2 per barrel.

- The average WEO oil price in June was US$26.97 per barrel, although it was lower toward the end of the month.

- On the basis of the new WEO expectations, the average Saudi export price would decline by only about 5 percent in 2001 compared to 2000.

- The medium-term price outlook for Saudi oil, based on current WEO expectations, shows the price moving in the range of US$23.10–US$19.80 per barrel between 2002 and 2006.

[1] Average of the three WEO crude oils: Brent, Dubai, and West Texas Intermediate (WTI).

Box 4. The Strategy and Progress of the Privatization Initiative

The government has stepped up its privatization efforts in the last few years as part of its reform aimed to promote the role of the private sector in new activities, and mobilize private domestic and foreign investment, especially in the telecommunications, electricity, and water sectors. The Supreme Economic Council (SEC) and the associated Privatization Committee conduct the policymaking and review of privatization initiatives, while the Public Investment Fund (PIF) and the respective ministries carry out the day-to-day implementation. While privatization in the nonutility sectors has involved increasing the private sector's share in government-owned and joint sector companies (through new share subscription, or offering part or all of government shares in the financial market), the privatization strategy in the utilities sectors has involved:

- the corporatization of public entities and the restructuring of their operations with a view to enhance their efficiency in line with market-based prices and costs;
- development of the needed regulatory frameworks and authorities to set the appropriate tariff structure, rate of return on investment, service and quality standards, and rules for private sector participation and competition; and
- the gradual privatization of the public entities through sale on the market of part or all of government shares to the public and/or a strategic partner.

The authorities have preferred to proceed carefully and benefit from other countries' privatization experience in order for the privatization process to attain its professed objectives of enhancing efficiency and private competition. Hence, progress in the process has been constrained by:

- the long lead-time needed to establish the regulatory frameworks for the (few but large) electricity, telecommunications, and transportation sectors to promote private competition (and avoid replacing public by private monopoly); and
- the need to tackle the social issues surrounding the privatization process such as the unemployment pressures owing to labor redundancy, the impact on customers of any needed price and tariff increases, and resistance from vested interests to the loss of current implicit subsidies.

Following the corporatization of both the telecommunication services and the electricity sector, regulatory frameworks and authorities for the two sectors were approved (with those for telecommunications established in mid-2001, while that for electricity is expected to be in place by late 2001). In the electricity sector, government holds an 85 percent share in the corporatized company, which will be gradually sold. In other sectors, the government, with World Bank assistance, has finalized a study to restructure the water sector with a view to rationalize consumption and adjust the tariffs closer to production costs. In petrochemicals, the government plans to divest its share (70 percent) in SABIC gradually. In the transportation sector, following the transfer of the Saudi Ports Authority to private management in 1997, efforts have focused on restructuring the national airline and railroad services with a view toward their privatization. In the financial sector, the government intends to sell its shares in banks (including its 50 percent share acquired in 1999 in the National Commercial Bank) and to engage the private sector (including banks) in the medical insurance business.

- **the corporatization of the large telecommunications company has been completed.** The telecommunications law and regulatory authority came into effect in June 2001, allowing the private sector to participate. The authorities intend to use experience gained in this sector to take steps in other sectors;

- the privatization of the electricity company will be pursued by the planned regulatory authority once the appropriate tariff structure has been established; and

- the government plans to shortly establish regulatory authority for water and sewerage before privatizing corresponding companies or approving new foreign investment projects in these areas.[17]

19. **The reduction in the size of the public sector will be supplemented by steps to promote the private sector through the removal of legal barriers to its expansion and by correction of market distortions.** A number of laws have been passed or are in the pipeline to implement the planned liberalization and the development of a responsive business environment. In addition to the operationalization of the SAGIA and the implementation of the new investment law, which liberalized foreign direct investment, the authorities in 2001 have already taken steps or intend to undertake reforms in various areas to remove remaining barriers to private sector investment. **In early 2001, the real estate law was implemented to complement the investment law.** This law allows non-Saudi residents and companies to own real estate for their housing and business purposes.

20. **A capital market law is under discussion in the SEC and the Shoura Council.** It will provide a framework for new financing instruments, including corporate bonds for private sector investment, and establish an appropriate framework for the deepening and widening of the stock market. It will aim at a privately owned stock exchange managed by an independent Securities and Exchange Commission.[18] **A number of other laws are being considered to improve the transparency of business transactions and to ensure fair competition**. These include: (a) the company law to modernize rules and regulations governing private companies; (b) the agency law to regulate distribution and other franchises; (c) the insurance law providing the framework for insurance licensing and operations; (d) the

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[17] In order to improve resource allocation and reduce costs, the three segments of water use (residential, industrial, and agricultural) will be brought under the newly established Ministry of Water.

[18] The draft law is comprehensive with more than 60 articles encompassing issues such as insider trading, investor protection, as well as listing and disclosure requirements. In addition, it will establish rules for transparency and consumer protection.

competition law which will define and control unfair competition, introduce antitrust regulations, and ensure protection of trade secrets; and (e) the law to guarantee trade marks and intellectual property rights which will also facilitate Saudi Arabia's accession to the WTO.

21. **The mission considered the broad thrust of the strategy as appropriate and noted that the planned progress on a number of fronts would contribute to overall results. However, it felt that this strategy should be underpinned by early concrete action.** For instance, the nascent non-oil economic recovery would benefit from early privatization along with the authorities' plans to reform the legal and institutional framework to establish a well-functioning market economy. In this context, the mission felt that hard budget constraints, combined with an expeditious upward adjustment in output prices, and reduction in implicit subsidies on inputs would improve the efficiency of state enterprises and, thus allow their privatization without undue delay.

Foreign direct investment

22. **A close complement of restructuring and private sector growth is the promotion of foreign direct investment**. The authorities stated that the new investment law and the underlying "negative list" will be implemented flexibly and taxes on foreign companies will be further clarified under an improved new income tax law. SAGIA will continue to encourage foreign capital inflows.[19]

23. **The major Gas Initiative has been approved, which will spearhead the authorities' endeavors to promote foreign direct investment (Box 2).**[20] The beneficial secondary effects will depend upon the extent to which the three core projects will generate opportunities for the Saudi firms and employment for nationals. The authorities are aware that such beneficial effects will entail a further liberalization of the economy to international investments and a widening of the industrial base. The international oil companies (IOCs) participating in the Initiative will be expected to give priority to local contractors and suppliers, provided that their performances and prices are comparable to international

[19] In an attempt to balance the various socio-economic interests, some areas of business activity have been reserved for Saudi nationals. However, the "negative list" is subject to annual revision and some of the excluded areas could be opened up in the future. In February 2001, by excluding gas, power generation, water desalination, and petrochemicals from the "negative list", the authorities indicated their pragmatic approach to foreign direct invest (FDI) inflows.

[20] Saudi Arabia's recoverable gas reserves, which include gas produced in association with crude oil production, presently stand at about 220 trillion cubic meters and is the fifth largest in the world.

standards. The authorities expect that each US$1 billion of investment under this Initiative will directly or indirectly generate up to 2,000 new, mainly highly skilled, job opportunities.[21]

24. The authorities are aware that the upward adjustment of the current relatively low utility rates toward market levels would be crucial for the profitability of the planned downstream projects, particularly for water and electricity. The Supreme Council for Petroleum and Mineral Resources will ensure that gas prices for downstream activities are adequate for investors and that they do not generate additional fiscal burden. The authorities intend to further adjust as soon as possible electricity prices with the aim of eliminating the remaining implicit subsidy.

Financial sector

25. **In order to finance the higher level of private investment, the financial market will continue to be diversified and expanded in the period ahead**. In the view of the staff, this would benefit from the announcement of a timeframe for the implementation of planned reforms. The authorities intend to pursue a three-pronged strategy:

- Cross-border competition in the banking sector will continue to be allowed so as to enhance efficiency. The Saudi banks will be expected to collaborate more closely with international banks, particularly regional banks, including through joint ventures, in order to address the globalized competition.[22]

- Banks will be encouraged to develop new instruments to address the rising demand for private sector financing, including long-term investment banking modes. **This will entail the development of new skills and an appropriate legal framework. Steps have been taken to promote mortgage banking, in part, through the perfection of the underlying securities and their enforcement within the existing legal system. A committee of commercial banks has been established to address these issues.**

- The financial sector will be further broadened and deepened under the proposed capital market law through the expansion of the capital markets, including the reform of the stock market, and the development of insurance.

26. **The banking system is closely supervised, banks conform to international accounting standards, and prudential regulations are generally in accordance with international good practices** (Box 5). While the current minimum capital standards for

[21] Equal to about 3 percent of the jobs that the Saudi economy is projected to generate per year during 1999–2004.

[22] The government will reduce its participation in the banking system including the divestiture of its share in the National Commercial Bank.

Box 5. Main Banking Indicators, 1996–2000

	1996	1997	1998	1999	2000
Banks' capital-asset ratio	10.3	10.0	10.0	10.2	9.6
Banks' risk-weighted capital-asset ratio	22.3	22.5	21.2	21.2	21.0
Ratio of banks' nonperforming loans to total loans	10.9	9.3	8.4	11.4	10.4
Loan provisions as a proportion of nonperforming loans	74	78	83	88	93
Banks' interest rate spread (in percent)	5.4	5.5	5.5	4.5	3.9
Average pretax return on total assets (in percent)	1.6	1.7	1.8	1.5	2.0

Source: Saudi Arabian Monetary Authority (SAMA).

banks are more than met, the authorities are presently evaluating the proposed new capital standards for adoption in 2005.[23] The mission felt that the introduction of limits on foreign exchange exposure and application of a uniform system of loan classification, that ensures more comparability in ratings among banks, would be beneficial in the period ahead as banks expand their lending operations.

Labor market

27. **Recognizing that the government cannot continue to be the employer of last resort and that the unemployment problem can be resolved only through private sector-led growth, the official strategy aims at: (a) the development of skills required by the private sector; (b) flexible implementation of Saudiization; and (c) corrections of labor market distortions.**[24] These steps will increase the elasticity of substitution between national and expatriate workers and permit a more market-oriented remuneration system. At the same time, the government will continue to follow its open, but regulated, borders policy to ensure sufficient supply of labor at competitive wages to the private sector, thus ensuring competitiveness. The following steps will be pursued over the medium term to achieve these objectives:

- The Saudiization process will be pursued with the intention of bridging the gap between the qualifications and wage expectations of the nationals and the requirements of the market, without impairing competitiveness or compromising skill needs.[25] Therefore, the current employment quotas for Saudis under the Saudiization process will be implemented flexibly.

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[23] The SAMA authorities are reassessing their banking supervision against the Basel Core Principles (BCP) using the "Core Principle Methodology." The assessment should be completed by fall 2001. It will include external evaluation, such as involving bank supervision experts from other central banks.

[24] The labor market is segmented, with the private sector heavily relying on the less expensive, better trained, and more flexible expatriate labor, while nationals tend to gravitate mainly toward better-paid administrative positions in the public sector. Authorities consider that the main factors behind the segmentation is the job security and the flexible choice of work location offered by the public sector, as well as to the gap in qualification between the national labor force and the needs of the private sector. In contrast, in small- and medium-size enterprises, that constitute the bulk of the private sector, which cannot offer the same locations flexibility and job security, Saudis represent a very limited share of total employees.

[25] The Seventh Plan (1999–2004) estimates that the Saudi economy will be able to generate 66,000 jobs per year or 40 percent of the growth in domestic labor supply. As a result,

(continued...)

- The existing labor database mechanism will be used more vigorously to match Saudi nationals with jobs in the private sector.

- The government, in collaboration with commercial banks, will provide finance and advice to new Saudi graduates who wish to start their own business.

- **In order to seek a durable structural solution to unemployment pressures, the focus, over the medium-term, will be on education and training to match the required job skills in the economy, improving productivity, and developing an efficient and integrated labor market, which should reduce the differential in wages and benefits between the public and private sectors.** In this context, the Human Resource Development Fund (HRDF) and other government-funded agencies will be used for focused training in technical and vocational skills, which are needed by the private sector. The private sector will also be encouraged to develop its own training facilities.

- **Steps will be taken to ensure that wages progressively reflect labor productivity and, thus, be more market-based. The authorities are also moving toward a mechanism to allow transfer of benefits between the social security system and the pension fund.** This will not only remove a major hurdle to labor movement between the public and private sectors, but could also help to progressively reduce the disparity in benefits and incentives between the public and private sectors.[26]

28. **The mission encouraged the authorities to supplement their strategy with wage restraints in the public sector and a more determined reform of the civil service including reduction in its size and reorganization to improve efficiency, and thus reorient job seekers toward the private sector.** Consideration should also be given to reducing disparities in labor mobility between nationals and expatriates, allowing expatriate workers to move between sponsors and jobs, and revising the overly restrictive dismissal regulations applying to nationals as part of the labor law.

C. Fiscal Policy

29. **Compared to the targeted overall balance, the 2001 budget is expected to register a surplus equivalent to about 4 percent of GDP due to the 15 percent higher-than-projected oil revenues and the continued expenditure restraint.** The expected surplus will

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12.5 percent of the expatriate workforce will need to be replaced by nationals to account for the increase in the national labor force.

[26] At present, accumulated pension rights and other benefits cannot be transferred from one system to the other.

be used to further reduce public debt to 93 percent of GDP and to settle any hitherto unknown late payments.

30. **The mission commended the authorities for maintaining a cautious fiscal policy stance in 2001, despite the increase in oil revenues. It noted that sustained fiscal restraint in the period ahead would be crucial to reduce vulnerability to oil price fluctuations and establish a solid basis for private sector-oriented growth.** It stressed that the significantly improved financial position since 1999 provided the needed environment to expeditiously undertake the more lasting fiscal adjustment and put the public debt on a permanently declining path. As noted, initial staff estimates indicate that fiscal deficits under unchanged policies will re-emerge effective 2003 (Table 2). Such a development will add to public debt, raise debt service payments, limit allocations for capital outlays, and further increase structural rigidity of the budget, thus adversely affecting fiscal sustainability and intergenerational equity. In particular, overall deficit excluding oil revenue will remain high at an average of 26.4 percent of GDP during 2002–05, which highlights the vulnerability to any faster-than-anticipated drop in oil prices over the medium term. These developments will, in turn, possibly weaken private sector confidence and discourage investment, weaken growth and, thus, amplify unemployment pressures.

31. **There was, therefore, the need for an intensified effort to reduce structural rigidity of the budget through**: (a) a durable and early increase in non-oil revenues; (b) reduction and redirection of expenditures away from wages and toward capital outlays; (c) strengthened expenditure management to improve efficiency and avoid building unbudgeted obligations; and (d) adjustment in utility rates toward market levels, which would also encourage investments. An illustrative scenario prepared by the staff to achieve a steady reduction in public debt to about 82 percent of GDP by 2005, would call for the elimination of the overall deficit in 2004–05, with the deficit excluding oil revenues falling from 26 percent in 2001 to about 20 percent in 2005 (Table 6). Such an adjustment would require freezing current expenditures during 2003–05 at approximately the level of 2001 through containment of the wage bill, thus reducing the share of current expenditure in total outlays to 86 percent in 2005 from 89 percent in 2001. Under this scenario, capital expenditures would increase to 14 percent of total expenditures, but total expenditures relative to total GDP would fall to 31 percent from 33 percent in 2001. Non-oil revenues would increase at an annual average rate of about 13 percent, to almost 11 percent of total GDP in 2005 mainly through upward adjustments in fees and charges, higher customs revenues on account of an increase in imports as economic growth picks up, the introduction of the VAT, and improvement in tax and customs administration. Such a fiscal stance, by increasing non-oil revenues and rationalizing expenditures will strengthen the budget structure, and obviate the need for expenditure cutbacks to address the fall in oil revenues, thus reducing vulnerability.

32. **The authorities are determined to avoid the re-emergence of fiscal imbalances. They intend to continue targeting, as a minimum, overall budget balance or small surpluses in the medium term through reductions in the budget deficit excluding oil revenue with the aim of steadily reducing public debt.** While the details of this strategy

are still being worked out, the fiscal plan is broadly in line with the mission's adjustment scenario presented above. The budget for 2002 will be guided by this strategy. Under the existing oil price expectations, the staff forecasts the fiscal account to register a small surplus in 2002. The authorities stressed that any unanticipated fall in oil receipts will, in the short run, be addressed through expenditure restraint. The wage bill will be contained except for education and health, which will have to increase to take account of the rising population pressures and to expand training.[27] Important progress has been made to settle late payments in 2001. **The authorities noted that the late payments were the result of a variety of institutional and legal factors and not necessarily because of lax expenditure controls and stressed that they intend to avoid any buildup of late payments in the future.**[28]

33. **For non-oil revenue generation, a number of initiatives are under consideration.** These include:

- increase in municipality fees and other charges with a view to making municipalities self-financing over the long term;
- applying a revised income tax on non-Saudis with an adequate exemption threshold;
- extension of tax or Zakat to real estate, and imposition of fees on real estate registration and other transactions;
- introduction of a luxury tax on selected imports and competing domestic products;
- increase user charges, including those for water on a sliding scale basis;[29] and
- further improve the collection of revenues, in particular of Zakat and customs, through the ongoing reform of tax and customs administration with Fund technical assistance (Box 6).[30]

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[27] The authorities are looking at different options to reduce expenditures. These include transfer of project implementation to the private sector under the build-operate-transfer (BOT) system in areas such as water desalination, and roads.

[28] Because of the lack of detailed information, the authorities were unable to disaggregate late payments settled in 2000 into appropriate categories. Also, a significant part of such payments was shown as expenditure rather than financing; such a treatment artificially increased expenditures. The authorities intend to treat all such transactions as financing in the future, if they materialize, as required by the GFS guidelines.

[29] It will cover household use, as well as use by the agricultural sector, which is the largest user.

In addition, the authorities expect to use receipts from privatization and royalties from minerals and gas ventures to reduce the public debt stock. The mission noted that an early implementation of planned measures will be crucial to achieving the authorities' fiscal targets, thus, reducing vulnerability to downside oil price risks.

D. Monetary Policy and the Exchange System

34. **Prudent monetary policy, under a rules-based framework similar to a currency board arrangement, in an environment of a liberal exchange and trade system and free capital movement, has ensured maintenance of domestic price stability as well as stability of the pegged exchange rate.** The authorities intend to maintain this policy stance, allowing credit expansion in line with the anticipated increase in the private sector activity in 2001; however, exchange rate stability will remain the anchor. In light of the anticipated pick up in the non-oil economic recovery under a non-inflationary environment, broad money is projected to increase by 7.5 percent in 2001 as compared with less than 5 percent in 2000; credit to the private sector is expected to grow by almost 11 percent as against 6 percent in 2000. In the near-term, SAMA's net foreign assets are expected to remain comfortable, economic activity will be considerably stronger and, given its comfortable liquidity position, the banking sector should be able to accommodate the needed increase in credit demand without weakening the quality of its assets.

35. Interest rate differentials with the U.S. dollar assets contracted further in early 2001 and are expected to remain low, reflecting the market confidence in the peg. The Saudi Arabian riyal, which had appreciated in real effective terms along with the U.S. dollar during 1997–98, registered a real effective depreciation of 4 percent in 1999, in part, on account of negative inflation in Saudi Arabia before appreciating slightly in real effective terms in 2000 as the U.S. dollar appreciated; it has remained broadly unchanged in the first four months of 2001 (Figure 8). Saudi Arabia has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. In addition, capital inflows were further liberalized in 2000 through relaxation of regulations on portfolio and equity flows. **The authorities are determined to maintain the current peg in the period ahead; any deterioration in the external accounts because of lower oil prices would be addressed mainly through a tighter fiscal policy under an open exchange and trade system.**

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[30] A new tax law is presently under consideration, which is envisaged to reduce corporate tax rates but would increase revenues on account of better compliance and a faster growth of non-oil GDP.

Box 6. Tax and Customs Administration Modernization

The modernization of tax and customs administration aims at establishing a more efficient system for the collection of non-oil revenue.

I. Tax administration modernization

The modernization of the Department of Zakat and Income Tax (DZIT), which started in October 1998, has achieved substantial progress, particularly since 2000.

Main measures adopted

- The new organization for the DZIT head office was approved; a new director general appointed in early May 2001; a Large Taxpayer Unit (LTU) established (1999); its organizational structure and operational framework adopted; and a taxpayer identification number (TIN) system prepared.
- Procedures were developed for simplification of tax (including Zakat), filing, and payments, based on self-assessment by taxpayers; audit strategy, selective audit method, and criteria for selecting audit files approved; and the collection of tax revenue through banks started in March 2001.
- Recruitment for new staff began this year and training, especially in audit and enforcement, has advanced.
- The IT infrastructure was updated.

Measures being considered to accelerate the completion of the modernization project

- Adoption of simplified filing and payments procedures; continuation of staff recruitment; acceleration of staff training to administer self-assessment procedures and audit techniques; delegation of more power to the LTU, including transfer of additional taxpayer files (about 1,500) to the LTU; and adoption and implementation of the tax processing package so that the IT system could start the registration of taxpayers and assignment of TIN.

II. Customs administration modernization

The Customs Department (CD) modernization project, adopted in November 1997, aims at collecting revenues effectively, meeting security concerns, and cutting the customs clearing time in order to facilitate trade.

Measures adopted

- Some procedures were simplified and streamlined. These include: adoption of a standard administrative declaration for imports and exports; payment of fees at the last point in the clearance process; customs now open around the clock; and introduction of inspection by X-ray of containers to cut the clearing time.
- Computerization of almost all customs bureaus has been completed, as has introduction of an Electronic Data Interchange system to link data between users and the CD.

Measures being considered to advance the modernization project

- Work has continued on post-clearance controls and audit, risk analysis to minimize security risk, regular cross checking between the manifest of imports declarations and movements of goods in and out of warehouses.
- The IT improvement has also progressed with the adoption of an appropriate customs processing package to support the implementation of the modernized CD.

36. Regarding adherence to the Guidelines for Public Debt Management, the authorities noted that they have a well-defined institutional framework and debt management strategy. The current focus is on raising the required government financing from the domestic market across the maturity spectrum through fixed and floating rate-based debt instruments. The bulk of the debt is in 2–10 year maturities. SAMA and commercial banks are working together to develop a secondary market by addressing issues such as pricing, transparency, primary dealership, and short selling.

E. Trade Policies and Regional Integration

37. **In an important step toward further trade liberalization, the authorities in May 2001 slashed import duties from 12 percent to 5 percent on a wide range of goods, including consumer durables, transport equipment, and other intermediate products.** By reducing import costs for the private sector, discouraging smuggling through other GCC countries, and avoiding under invoicing, this measure will expand domestic trading activity, facilitate re-exports, and improve competitiveness of non-oil exports. The average tariff rate is estimated to fall by more than half to 5 percent on account of the cut in the tariff rate, bringing about a significant reduction in the trade restrictiveness index.

38. **Progress has been made toward accession to the World Trade Organization (WTO).** The Saudi offers on trade mark and intellectual property rights, import licensing, technical barriers to trade (TBT), customs valuation, sanitary and phytosanitary measures, have been well received and bilateral agreements have been signed with 11 countries.[31] However, the process has slowed on account of issues that have been raised by some trading partners. The revised offers of June 1999 will be discussed at the next meeting of the membership committee, perhaps in the fall of 2001. An antidumping law is expected to be approved soon, which will establish a standing committee to deal with antidumping complaints from Saudi Arabian producers as well as from other countries.

39. **Progress has also been made toward regional integration among the member countries of the Cooperation Council of the Arab States of the Gulf (GCC).** These include:

- the establishment of a common currency peg (to the U.S. dollar) has been agreed to in principle and the detailed timetable for a monetary union is under consideration;

- cross-listings of, and trade in, the stocks of companies registered in member countries are allowed, and formal linkages of stock exchanges are being worked out;

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[31] These are: Argentina, Australia, Brazil, Canada, Japan, Malaysia, Mexico, Pakistan, South Korea, Uruguay, and Venezuela.

- GCC nationals have been authorized to invest in land in all GCC countries for a variety of commercial activities, in addition to residential purposes, which have already been allowed;
- a GCC-wide electricity authority has been established to facilitate the interlinking of the grids of various GCC countries; and
- it has been agreed upon to implement the common external tariff (CET) by 2005, and a number of administrative and technical steps have been taken to complete the transition.[32]

40. **In addition, Saudi Arabia has reduced its tariffs by 40 percent so far under the Greater Arab Free Trade Area (GAFTA).** Progress toward the establishment of a free trade zone between the GCC and the EU has remained slow on account of the new issues put forward by the latter; the unresolved EU treatment of GCC exports of petrochemicals, aluminum, and agricultural products; and the requirement of the prior implementation by the GCC of the CET.

III. Statistical and Technical Assistance Issues

41. **Saudi Arabia has made notable progress over the past year in improving data preparation and its provision, including through the internet.** In a major initiative, a new directive on data publication was issued in May 2001, which was designed to require departments and ministries to publish relevant data, including information on GDP, public finance, monetary accounts, and vital statistics on a regular basis. Information provided to the Fund is generally adequate for an assessment of economic developments and to determine Saudi Arabia's medium-term outlook and vulnerabilities. Areas of progress include:

- the timeliness of monetary statistics has been improved, with the result that the monetary survey is now available with a lag of only about one month;
- the timeliness and coverage of data published in SAMA's annual report, quarterly reports, and monthly bulletins have also improved;
- a number of surveys are being conducted by the Central Department of Statistics to obtain a more accurate picture of developments in agriculture and manufacturing, household income and expenditures, and demographic developments, while a more currently-based consumer price index is under preparation;

[32] The CET will have three bands: zero rates on essential goods, 5.5 percent on basic goods, and 7.5 percent on other goods.

- progress is being made under the aegis of a committee in implementing a medium-term program for the compilation of the balance of payments statistics in accordance with the fifth edition of the Balance of Payments Manual (BPM5).

42. Further improvement is needed in the following areas:

- estimation of non-oil GDP based on more current surveys, quarterly indicators of industrial production, employment and wages, and wholesale prices;

- preparation and provision of data on the consolidated public sector (including balance sheets of AGIs and the PIF), and on the structure of government debt which would be essential for the quality of policy formulation;

- provision of more current data on the oil sector; and

- an expeditious and wider dissemination of financial and fiscal data under the new directive, which would be particularly beneficial to the ongoing privatization and promotion of private sector investment, including foreign investment.

43. **Implementation of Fund's technical assistance recommendations and support has improved over the past year, particularly in the area of Zakat and income tax administration**. The continuation of such assistance in the period ahead will be crucial to the preparation of the groundwork for enlarging non-oil tax revenue, including the infrastructure for the implementation of the VAT. The authorities attach high importance to training through continued collaboration with the Fund, and technical assistance to improve national account and balance of payments statistics.

IV. Staff Appraisal

44. **Against the backdrop of the sharp deterioration in the macroeconomic position following the precipitous drop in oil prices during 1998–early 1999, the Saudi authorities intensified the implementation of their broad-based reform program. The program aimed at economic diversification and a sustained acceleration in the growth of non-oil GDP, so as to address the mounting unemployment pressures, and to reduce vulnerability to oil price shocks.** The underlying strategy correctly focused on structural reforms to reduce the role of the government in the economy and promote private sector-oriented growth with a greater role for foreign direct investment under a market-based price and institutional setting. The strategy also focused on pursuing a tight fiscal policy under a liberal exchange and trade system in order to reverse the debt dynamics, contain external imbalances, and ensure macroeconomic stability, thus, underpinning structural reforms.

45. **In 2000, implementation of these policies and the increase in oil prices resulted in a dramatic strengthening of Saudi Arabia's economic position**. Real GDP growth recovered strongly in 2000 to 4.5 percent under a noninflationary environment and the non-oil sector recovery resumed, spurred by renewed business confidence. The external current

account and the fiscal balance registered large surpluses. SAMA's net foreign assets rose sharply and the government domestic debt fell. The performance of the financial sector strengthened further, and interest rate differentials with the U.S. dollar assets contracted reinforcing the continued market confidence in the pegged exchange rate.

46. **The authorities have appropriately persevered with prudent macroeconomic policies and intensified structural reforms in 2001, including a sharp reduction in import duties**. The staff welcomes the concrete coordination of economic policy through the SEC, which has enhanced the effective and simultaneous implementation of interdependent policy initiatives. Notwithstanding the moderation in oil prices, a fiscal surplus is expected in 2001 because of continued restraint on government expenditures, and SAMA's net foreign assets are expected to rise further to the equivalent of almost one year's imports. Growth of real non-oil GDP is projected to accelerate.

47. On the basis of the present outlook for oil prices, and despite the recent global economic slowdown, the staff projects that the continuation of the current economic policies over the medium term will promote capital formation and accelerate non-oil GDP growth. There are tangible signs of increase in foreign direct investment, which along with the agreement to implement the ambitious Gas Initiative, will pave the way for a durable upward shift in economic activity. However, fiscal and external current account deficits will re-emerge from 2003 onward, and the economy will remain vulnerable to the downside oil price risks. Unless addressed effectively, such imbalances will reduce SAMA's net foreign assets and increase government debt with potentially negative effects on growth and the capacity to address unemployment pressures.

48. **The authorities are aware of these risks and intend to intensify structural reforms by establishing a legal and institutional environment conducive for market-based resource allocation and a more central role of the private sector, including foreign investment, in economic activity.** In the view of the staff, areas where further efforts would reinforce the authorities' strategy include: (a) an accelerated public sector restructuring and privatization; (b) a further expansion in the domain for FDI; (c) an early widening and deepening of the financial sector through development of new instruments and institutions to facilitate greater resource mobilization for investment; (d) labor market reforms to increase the substitutability of Saudi workers for expatriate workers; and (e) structural strengthening of the budget to permanently and substantially reduce public debt.

49. **The authorities are determined to pursue state enterprise restructuring and privatization by corporatizing them under a regulatory authority**. The process will benefit from the articulation of a timetable, including steps and modes toward eventual privatization, so that potential investors could plan accordingly. Consideration should also be given to the application of explicit hard budget constraints along with adjustments in input and output prices to eliminate the remaining implicit subsidies over the restructuring period. A safety net mechanism for an orderly adjustment to price and output shocks can provide the

much needed support for restructuring. Concurrently, the widening of the private sector's domain would benefit from a speedy reduction in the areas presently excluded for foreign investors. **In this context, the staff welcomes the authorities' intention to use the "negative list" flexibly under the new investment law.**

50. **The authorities' policy of encouraging cross-border competition and the expansion of the domestic financial market will increase efficiency of the banking system.** In the period ahead, expanded private sector investment will require increased mobilization of resources, a shift toward investment and longer-term credit, and diversified services including insurance and wealth management. In addition, there is a large untapped market for mortgage finance. Resolution of legal constraints to the development of the needed instruments, acquisition of new skills, and closer financial collaboration with the official long-term lending institutions would be particularly beneficial. As a complement to the banking sector, further development of the stock market, including its expansion through more placements, under the planned independent Securities and Exchange Commission, will be particularly beneficial. The deepening and widening of the stock market will likely help mobilize capital and promote privatization while improving the liquidity for owners and businesses, and encourage capital inflows. The deepening of the secondary market in government bonds and development of a market for corporate bonds should also be encouraged. The staff, therefore, urges an early enactment and implementation of the capital market law.

51. **The decision of the authorities to eschew the option of increased government spending to generate employment opportunities for the Saudi Arabian workforce and to take market-based measures is appropriate.** The ongoing structural reforms will accelerate private sector-led growth and thus employment generation, but the problem of potentially large unemployment of the Saudi Arabian labor force will persist for a considerable period. The authorities have quite appropriately chosen to address the problem in the longer-term context by focusing on training and education so as to develop skills, which will be needed by the private sector in the period ahead. This strategy should be supported by measures aimed at bridging the gap between the costs of employing local and expatriate labor. **The pursuit of a more market-based wage policy to ensure that wages reflect labor productivity, combined with wage restraints in the public sector, and a more determined cut in the size of the civil service, would help reorient national job seekers toward the private sector.** The reform of the social insurance system including the extension of the pension system to small enterprises and transfer of rights between the pension and social securities systems would help reduce the incentives for nationals to prefer public sector jobs while bridging the gap in reservation wage between nationals and expatriates. Early enactment and implementation of the new labor law reducing disparities in labor mobility between national and expatriate workers, reforming the existing work permit regulations, and rationalizing rules governing the dismissal of national workers would be particularly helpful.

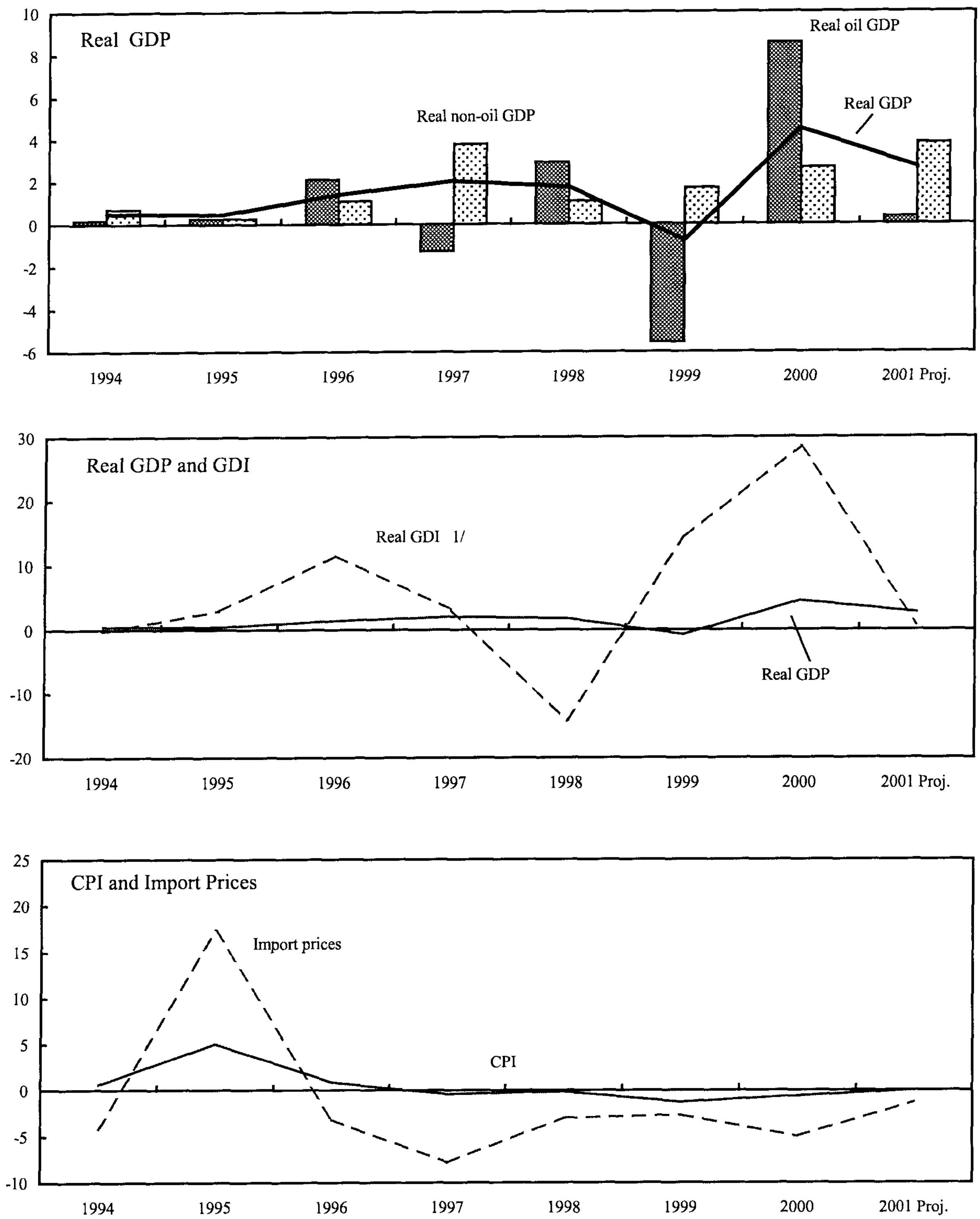
52. **The fiscal position remains sensitive to oil price fluctuations which cannot be addressed in a sustained fashion through expenditure cuts and will benefit from strengthened fiscal management. The staff welcomes the authorities' intention to maintain a cautious fiscal policy stance and to target, as a minimum, overall budget balance or small surpluses in the medium term through expenditure control and non-oil revenue enhancement**. The structural strengthening of the budget to put public debt on a permanently declining path will be crucial to the success of the overall reform strategy. In this context, an expeditious implementation of the authorities' plans to raise non-oil revenues will be helpful in reducing vulnerability to oil price fluctuations. Accelerated reform of tax and customs administration, with the ongoing Fund technical assistance, should pave the way for an early introduction of the indirect taxes and the consolidation of the various fees and charges, thus improving the buoyancy and elasticity of the tax system. Revenue measures should be supported by expenditure restructuring and strengthened expenditure control mechanisms in order to contain current outlays, and shift the composition of expenditures toward investment. Reduction in the wage bill through civil service reform, improvement in efficiency and benefit incidence of social spending, cutback in (and replacement of) implicit subsidies by lower explicit subsidies and transfers, and strengthened expenditure management, will be particularly beneficial. In addition to improving resource allocation and correcting price signals, fiscal consolidation will help reduce debt service burden and, thus, accord greater flexibility to the budget and enhance the ability to address exogenous shocks. The staff is also of the view that a broader definition of the public sector would be beneficial in the formulation of policies.

53. **The staff endorses the maintenance of the pegged exchange rate arrangement under an open exchange and trade system, supported by prudent macroeconomic policies, a strong financial system, and accelerated structural reforms**. It is to be hoped that the remaining bilateral trade issues will be resolved soon to allow Saudi Arabia's accession to the WTO without undue delay. Further progress on economic integration among GCC countries could usefully focus on an early implementation of the common external tariff, avoidance of significant macroeconomic imbalances in member countries, and harmonization of rules and incentives governing FDI and regional capital markets.

54. **Important progress on the development and dissemination of economic data has been made over the past year**. The recent decision to regularly publish economic and financial reports should be viewed as an important step toward greater transparency, and in increasing the scope and periodicity of information available to the market. Areas where further work would be helpful include national accounts, employment and wage data, balance of payments, capital accounts, and the consolidated public sector accounts. Early steps toward the adoption of the General Data Dissemination System (GDDS) would be beneficial.

55. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

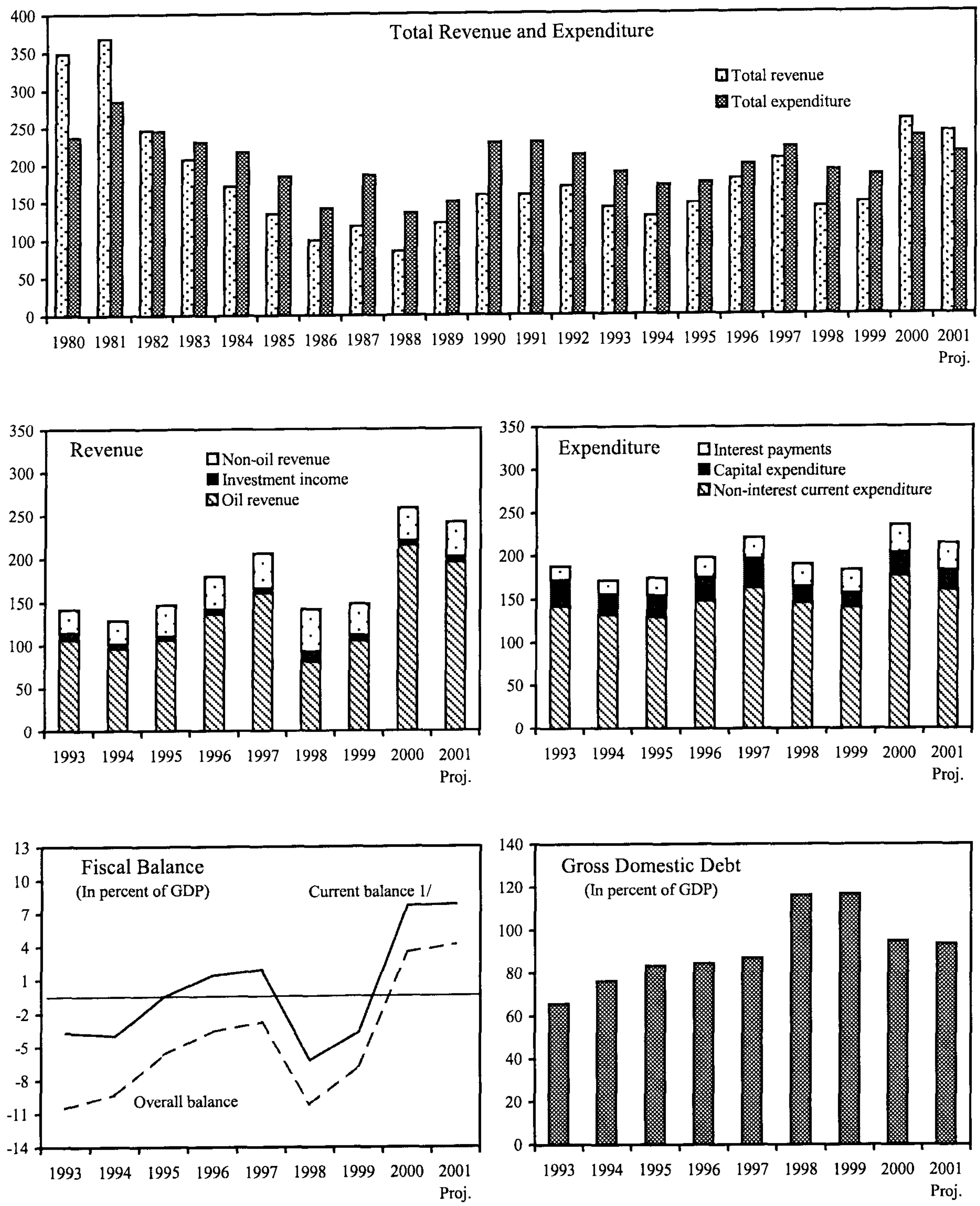
Figure 1. Saudi Arabia: Selected Real Sector Indicators, 1994–2001
(Annual change in percent)



Sources: Data provided by the Saudi Arabian authorities; and Fund staff estimates and projections.

1/ Real GDP adjusted for terms of trade effects.

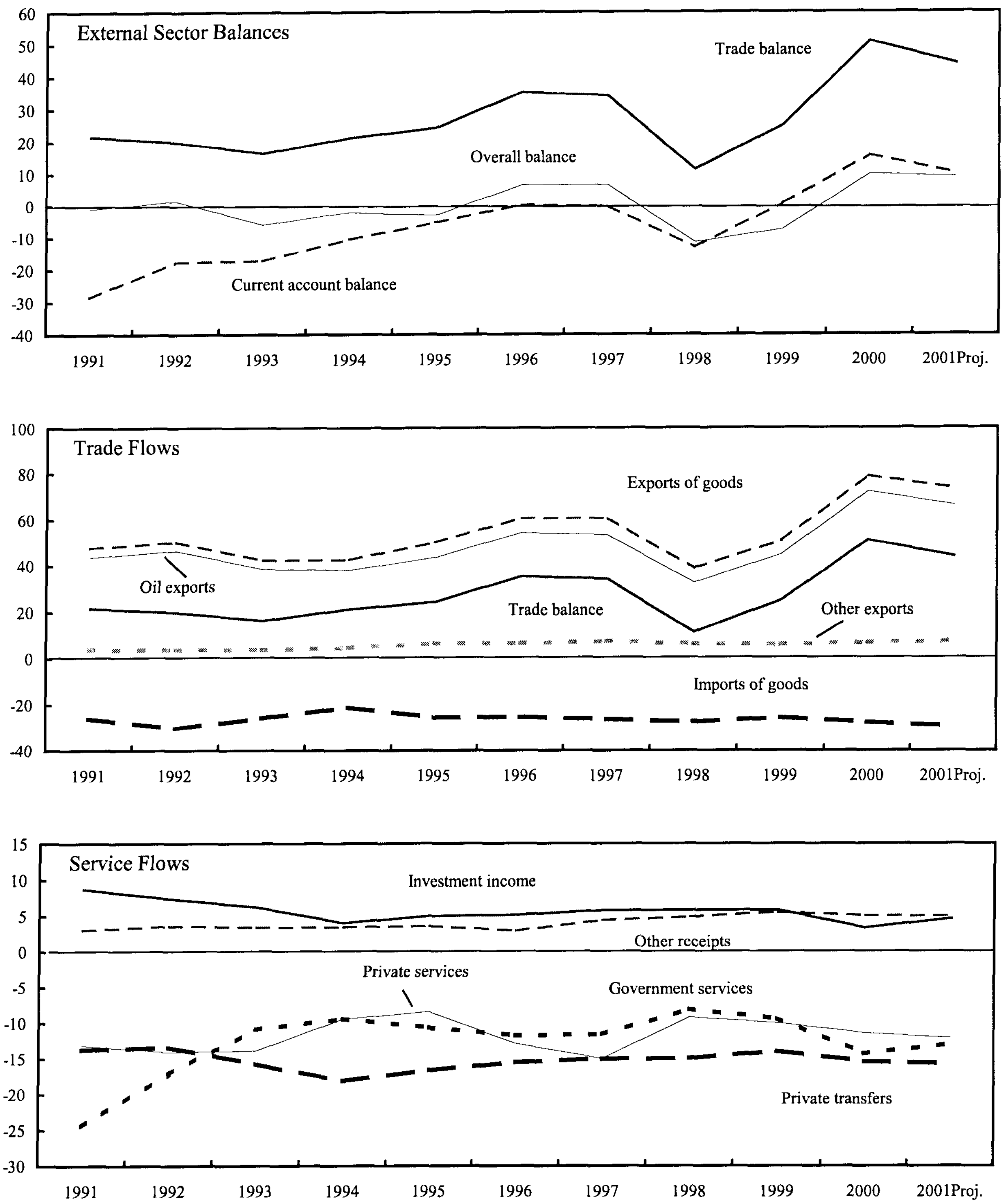
Figure 2. Saudi Arabia: Central Government Fiscal Indicators, 1980–2001
(In millions of Saudi Arabian riyals, unless otherwise indicated)



Sources: Data provided by the Saudi Arabian authorities; and Fund staff estimates and projections.

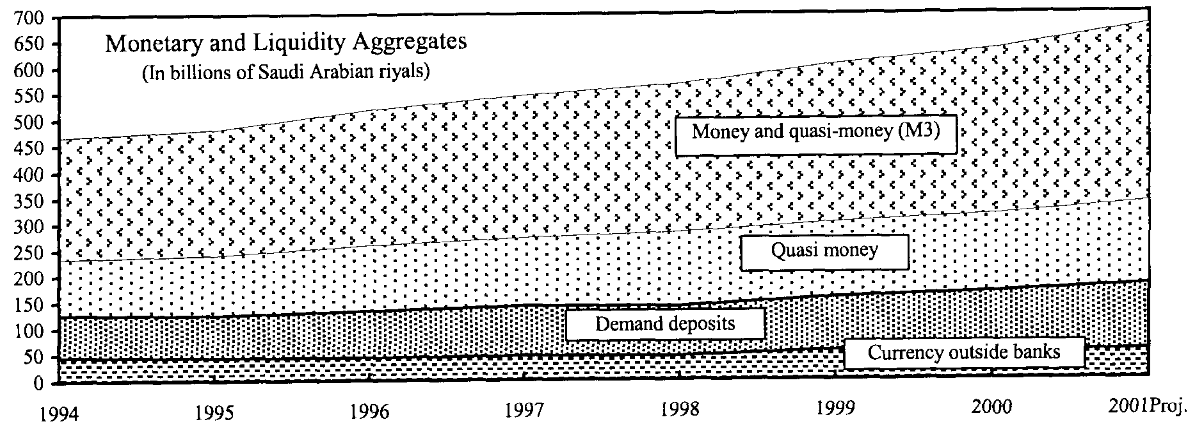
1/ Total revenue minus total current expenditure.

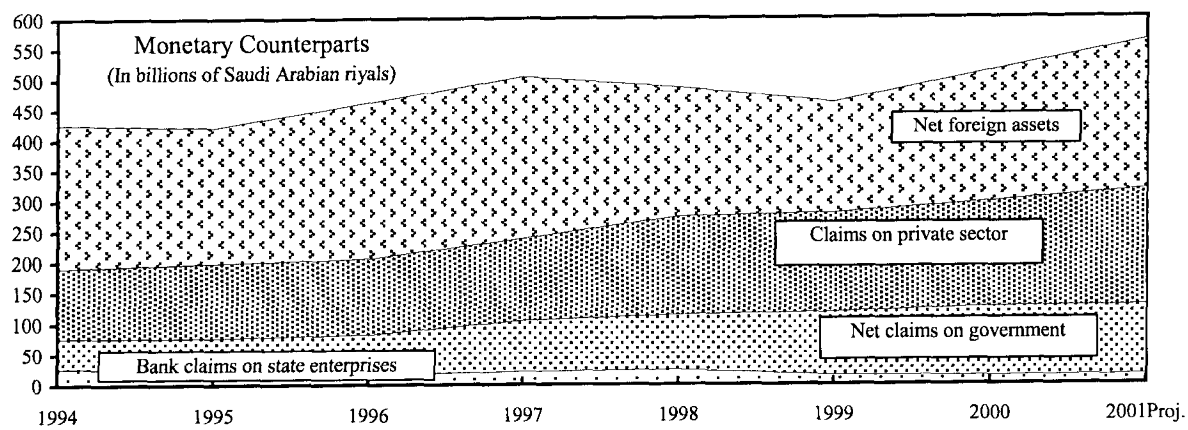
Figure 3. Saudi Arabia: External Sector Developments, 1991–2001
(In billions of U.S. dollars)

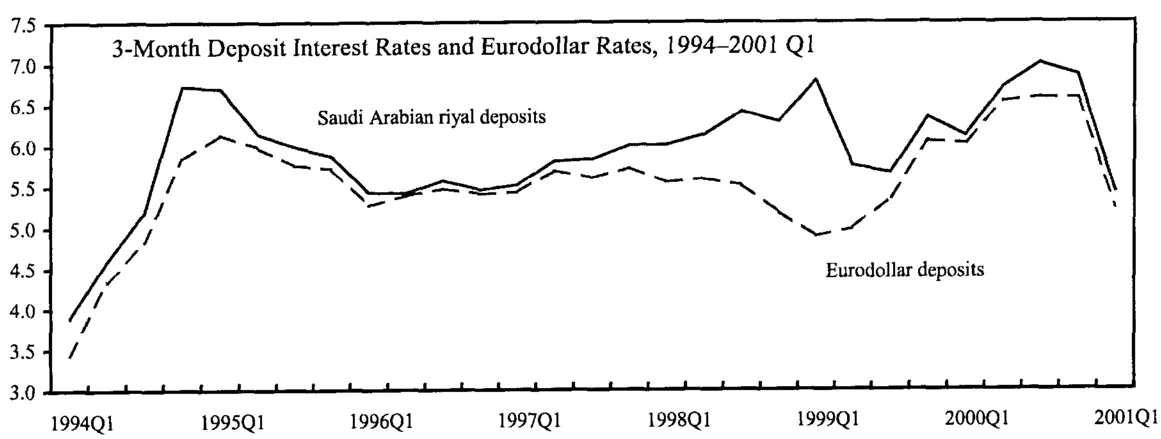


Sources: Data provided by the Saudi Arabian authorities; and Fund staff estimates and projections.

Figure 4. Saudi Arabia: Monetary and Financial Developments, 1994–2001

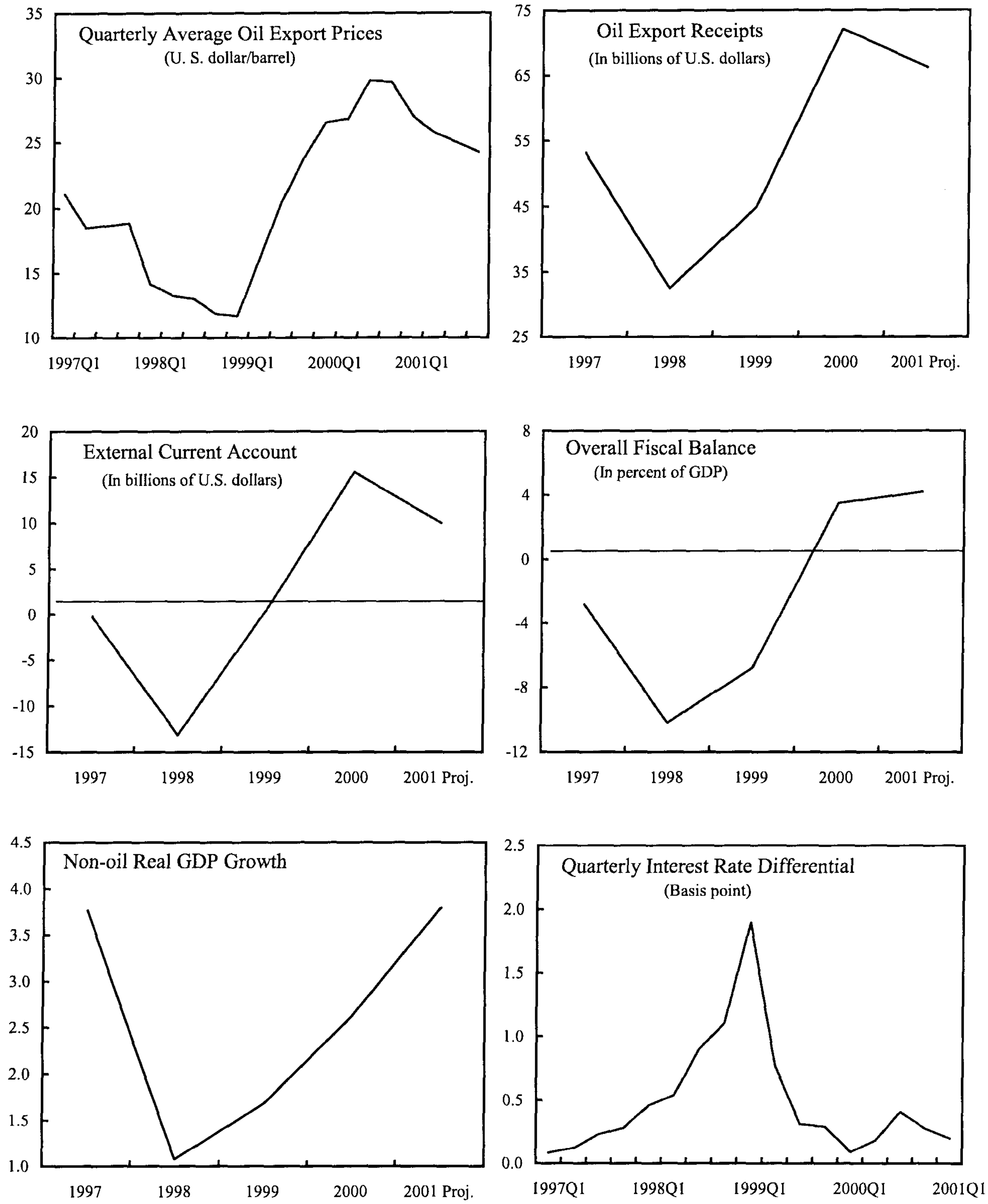






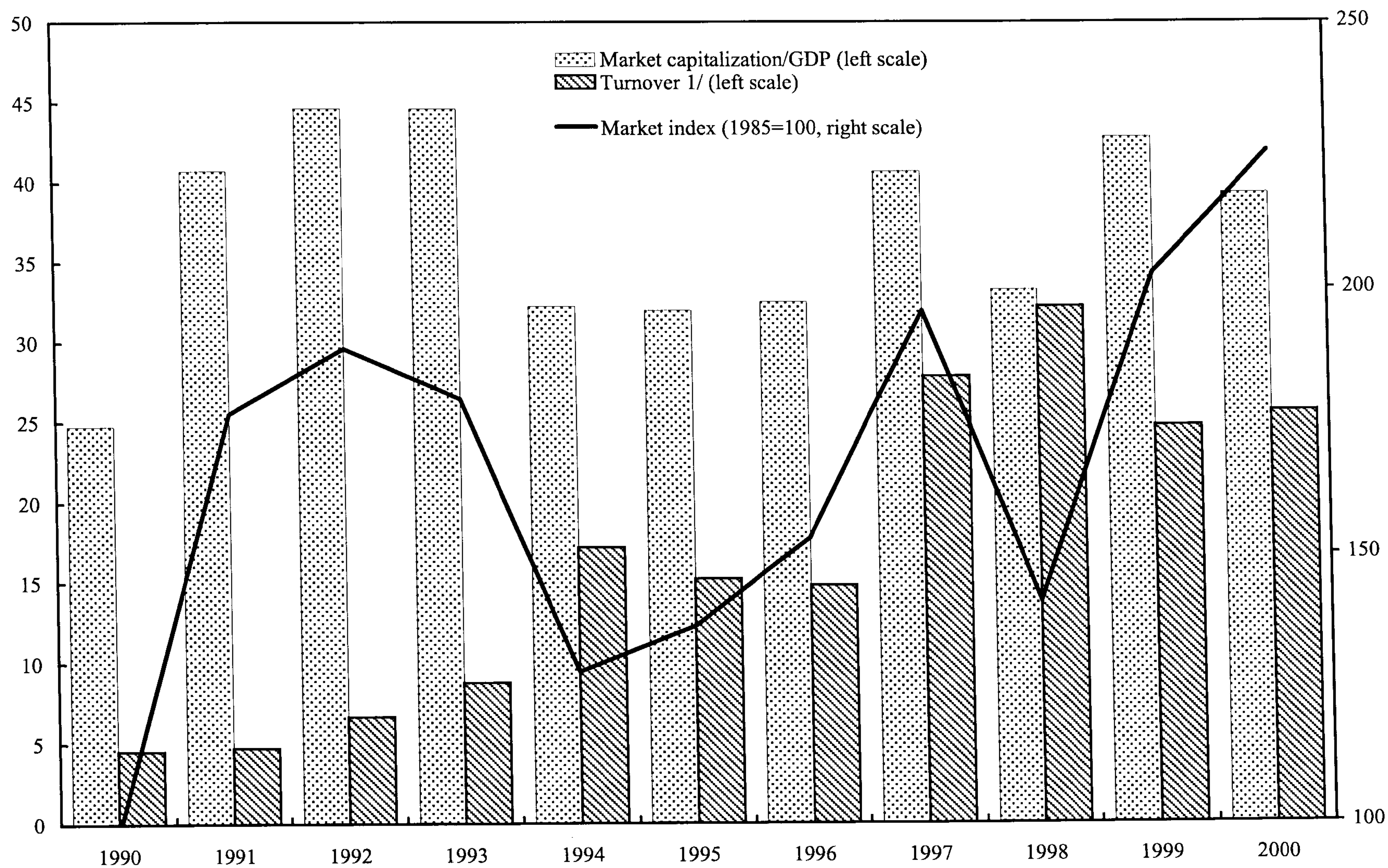
Sources: Data provided by the Saudi Arabian authorities; and Fund staff estimates and projections.

Figure 5. Saudi Arabia: Recovery from the 1998 Exogenous Shocks, 1997–2001



Sources: Data provided by the Saudi Arabian authorities; and Fund staff estimates and projections.

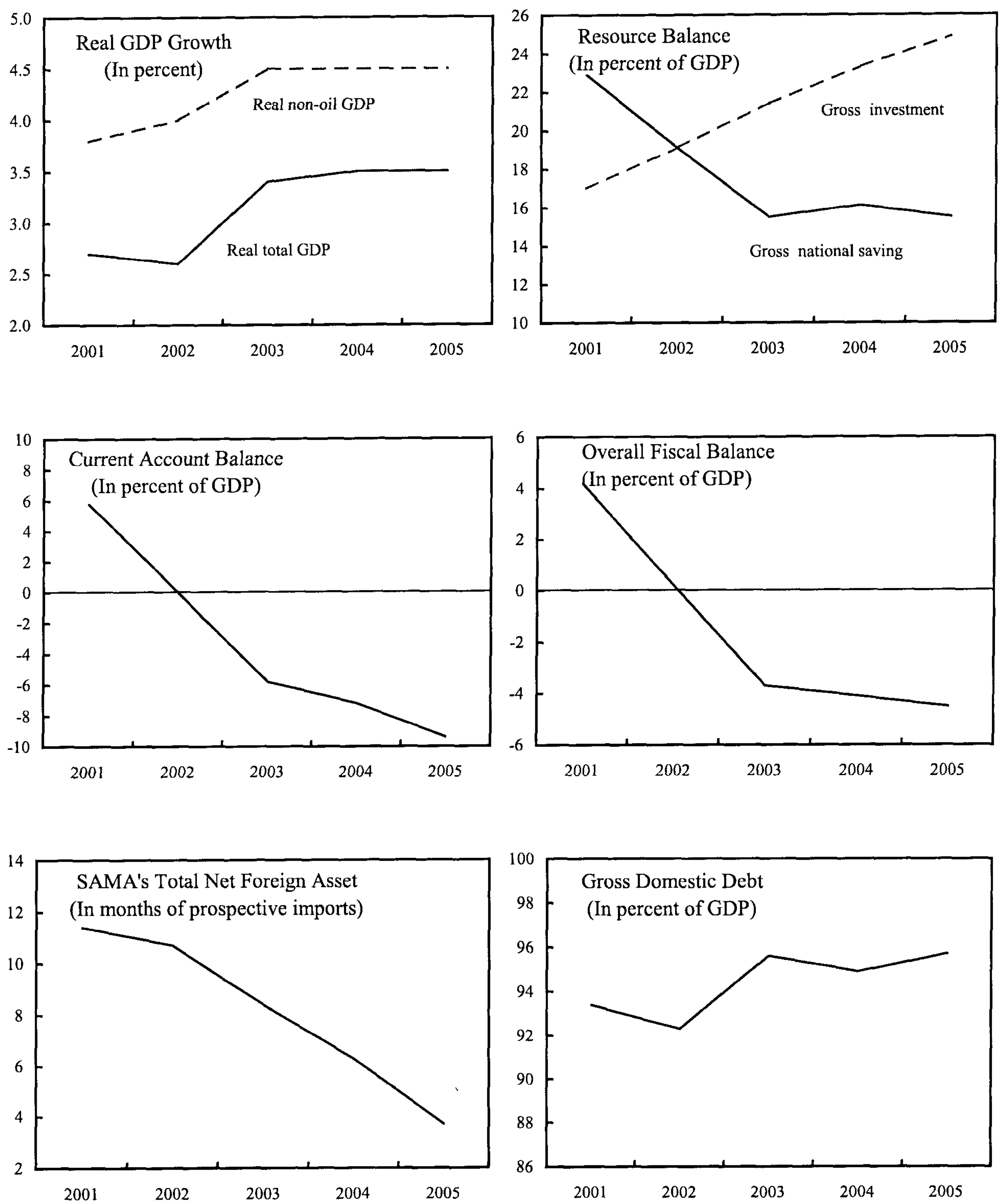
Figure 6. Saudi Arabia: Stock Market Indicators, 1990–2000



Source: Data provided by the Saudi Arabian authorities.

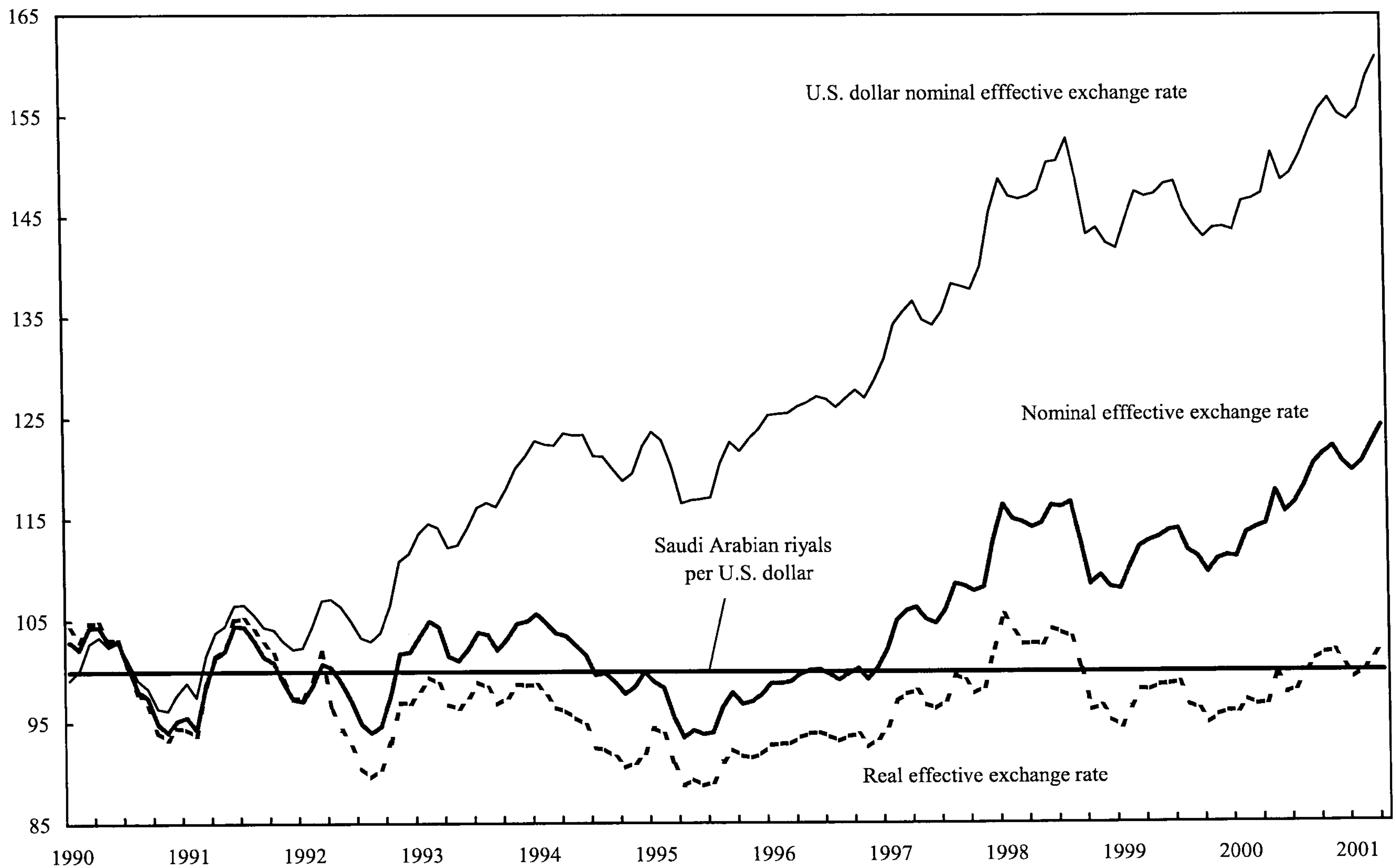
1/ Value of shares traded divided by market capitalization.

Figure 7. Saudi Arabia: Illustrative Medium-Term Scenario, 2001–05



Sources: Fund staff estimates and projections.

Figure 8. Saudi Arabia: Exchange Rate Indices, January 1990–April 2001
(1990 = 100)



Sources: IMF, Information Notice System; and *International Financial Statistics.*

Table 1. Saudi Arabia: Selected Economic Indicators, 1998–2005

	1998	1999	Prel. 2000	Proj. 2001	Baseline Scenario 2002	2003	2004	2005
	(Percent change, unless otherwise indicated)							
National income and prices								
Crude oil production (in millions of barrels per day) 1/	8.3	7.6	8.1	8.0	7.9	7.9	7.9	7.9
Average oil export price (in U.S. dollars per barrel) 2/	11.8	17.2	26.8	24.2	21.3	18.9	18.7	18.5
Nominal GDP at market prices (in billions of Saudi riyals)	481.2	535.0	649.0	644.0	640.6	647.4	675.8	706.0
Real GDP	1.7	-0.8	4.5	2.7	2.6	3.4	3.5	3.5
Oil	2.9	-5.6	8.5	0.3	-0.2	1.1	1.1	1.1
Non-oil	1.1	1.7	2.6	3.8	4.0	4.5	4.5	4.5
Real gross domestic income	-14.6	13.8	28.4	-1.9	-2.9	-1.1	3.1	3.1
Implicit GDP deflator 3/	-13.7	12.0	16.1	-3.3	-3.1	-2.3	0.9	0.9
Consumer price index (all cities index) 3/	-0.2	-1.3	-0.6	0.0	0.8	0.9	0.8	0.8
External sector								
Exports (f.o.b.)	-36.1	30.7	55.6	-6.7	-11.4	-9.3	0.0	0.5
Oil	-38.9	38.0	61.0	-8.2	-13.7	-11.7	-1.8	-1.9
Non-oil	-15.4	-7.0	13.9	10.0	9.0	7.5	10.6	12.9
Imports (f.o.b.)	4.4	-6.6	8.1	6.1	6.9	8.7	9.6	9.0
Current account balance (in billions of U.S. dollars)	-13.1	0.4	15.6	10.0	0.0	-10.1	-13.0	-17.7
(In percent of GDP)	-10.2	0.3	9.0	5.8	0.0	-5.8	-7.2	-9.4
Capital account balance (in billions of U.S. dollars)	1.6	-7.9	-5.8	-1.1	0.1	1.5	3.0	3.5
Of which: Foreign direct investment	0.0	0.0	1.0	1.0	1.8	2.8	3.8	4.5
Export volume	1.9	-9.2	7.9	0.2	-1.0	0.3	0.7	1.2
Import volume	5.9	-5.4	13.2	6.5	5.7	7.3	8.3	7.7
Terms of trade	-34.8	39.8	56.6	-8.6	-11.6	-10.9	-2.0	-1.9
	(Changes as a percent of beginning money stock)							
Money and credit								
Net foreign assets	-19.8	-10.9	10.9	9.4	...	...	...	...
Net domestic credit	13.1	8.1	-0.8	2.5	...	...	...	...
Credit to government	2.2	10.9	-3.5	-3.9	...	...	...	...
Credit to private sector	9.9	0.5	3.3	5.7	...	...	...	...
Credit to public enterprises	1.0	-3.3	-0.6	0.6	...	...	...	...
Money and quasi-money (M3)	3.7	6.8	4.5	7.5	...	...	...	...
Deposit interest rate (in percent) 3/ 4/	6.2	6.1	6.7	...	...	...	...	...
	(In percent of GDP)							
Central government finances								
Revenue	29.3	27.6	39.8	37.5	34.7	32.2	31.3	30.3
Of which: Oil	16.6	19.5	33.0	30.3	26.7	23.6	22.2	20.9
Expenditure	39.5	34.4	36.3	33.3	34.5	35.9	35.4	34.9
Current	35.6	31.3	32.1	29.7	30.8	32.0	31.4	30.9
Of which								
Wage bill	20.7	19.3	17.7	16.8	17.3	18.3	17.9	17.6
Interest payments	5.3	5.0	4.9	4.8	5.2	5.3	5.3	5.3

Table 1. Saudi Arabia: Selected Economic Indicators, 1998–2005

	1998	1999	Prel. 2000	Proj. 2001	Baseline Scenario 2002	2003	2004	2005
			(In percent of GDP)					
Capital expenditure	3.9	3.1	4.2	3.6	3.8	3.9	3.9	4.0
Overall fiscal balance	-10.2	-6.8	3.5	4.2	0.2	-3.7	-4.1	-4.5
Excluding oil revenue	-26.8	-26.3	-29.6	-26.1	-26.5	-27.3	-26.3	-25.4
Central government's gross domestic debt	116.1	116.8	95.0	93.4	92.3	95.6	94.9	95.7
Resource balance								
Gross investment	19.5	17.9	16.5	17.0	19.1	21.4	23.3	24.9
Public	3.9	3.1	4.2	3.6	3.8	3.9	3.9	4.0
Private	15.5	14.8	12.3	13.5	15.3	17.4	19.4	20.9
National saving	9.8	18.2	25.4	22.9	19.1	15.5	16.1	15.5
Public	-6.2	-3.7	7.7	7.8	4.0	0.3	-0.2	-0.6
Private	16.0	21.9	17.8	15.1	15.1	15.2	16.3	16.1
	(In billions of U.S. dollars, unless otherwise indicated)							
Memorandum items								
SAMA's total net foreign assets	45.4	37.9	47.5	56.5	...	...	...	...
In months of total imports of goods and services 5/	11.5	8.2	10.0	11.4	...	...	...	...
Of which: Gross official reserves 6/	14.4	17.2	16.6	...	...	...	...	...
Total external debt 7/	28.9	30.2	30.0	...	...	...	...	...
Of which : Short-term debt on a remaining maturity basis	10.4	13.0	12.2	...	...	...	...	...
Real effective exchange rate (depreciation -) 3/	3.6	-4.4	2.1	...	...	...	...	...
Average exchange rate Saudi Arabian riyal/U.S. dollar	3.745	3.745	3.745	...	...	...	...	...

Sources: Saudi Arabian authorities; and Fund staff projections.

1/ Includes production from the Neutral Zone.
2/ Includes refined products.
3/ Period average.
4/ Three-month Saudi Arabian riyal deposits; annual average.
5/ Next 12 months.
6/ As reported to the *International Financial Statistics.*
7/ Joint BIS-IMF-OECD-World Bank external debt database.

Table 2. Saudi Arabia: Budgetary Developments and Projections, 1998–2005

(In billions of Saudi Arabian riyals)

	1998	1999	Prel. 2000	Budg. 2001	Proj. 2001	Baseline Scenario 2002	2003	2004	2005
Total revenue	141.2	147.5	258.1	215.0	241.3	222.5	208.6	211.4	214.2
Oil	80.0	104.5	214.4	169.0	195.0	171.0	152.9	150.2	147.4
Non-oil	61.2	43.0	43.7	46.0	46.3	51.4	55.7	61.2	66.9
Investment income	12.4	6.7	5.5	6.2	6.2	6.3	6.5	6.7	6.7
Income taxes	2.2	2.2	2.2	1.6	1.6	1.7	2.0	2.3	2.6
Fees and charges 1/	21.2	18.7	20.8	24.2	24.2	26.6	29.3	32.2	35.4
Customs	10.0	9.6	9.7	9.6	10.0	11.8	12.8	14.1	15.3
Other 2/	15.4	5.9	5.5	4.4	4.4	5.0	5.1	5.9	6.9
Total expenditure	190.1	183.8	235.5	215.0	214.2	221.3	232.3	239.1	246.3
Current expenditure	171.2	167.2	208.3	192.0	191.2	197.1	206.9	212.5	218.4
Wage bill 3/	99.8	103.1	114.9	108.4	108.4	111.1	118.5	121.0	124.1
Supplies and services 4/	19.4	13.6	24.4	20.0	20.0	20.4	21.0	21.5	22.0
Subsidies and transfers	5.4	5.9	9.4	6.2	6.2	6.2	6.2	6.2	6.2
Foreign aid	0.2	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Interest payments	25.4	26.9	32.0	32.0	31.2	33.2	34.3	36.0	37.5
Of which: Domestic	25.4	26.9	32.0	32.0	31.2	33.2	34.3	36.0	37.5
Operations and maintenance	20.9	17.4	27.1	25.0	25.0	25.8	26.5	27.3	28.1
Capital expenditure	18.9	16.6	27.2	23.0	23.0	24.2	25.4	26.6	28.0
Overall balance (excluding oil revenue)	-128.8	-140.8	-191.8	-169.0	-167.9	-169.8	-176.6	-177.9	-179.4
(In percent of GDP)	-26.8	-26.3	-29.6	-26.2	-26.1	-26.5	-27.3	-26.3	-25.4
Overall balance	-48.8	-36.3	22.6	0.0	27.1	1.2	-23.7	-27.7	-32.1
(In percent of GDP)	-10.2	-6.8	3.5	0.0	4.2	0.2	-3.7	-4.1	-4.5
Financing (net)	48.8	36.3	-22.6	0.0	-27.1	-1.2	23.7	27.7	32.1
Domestic (net)	48.6	54.1	-39.0	0.0	-27.1	-1.2	23.7	27.7	32.1
Net bank financing	5.9	30.6	-10.5	0.0	-12.1	8.8	-4.1	5.5	-2.3
Net nonbank financing	75.8	53.0	-18.5	0.0	-15.0	-10.0	27.8	22.3	34.4
Regularization of late payments	-33.2	-29.6	-10.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discrepancy 5/	0.3	-17.7	16.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items									
Central government's gross domestic debt	558.8	624.7	616.2	616.2	601.2	591.2	619.0	641.2	675.7
(In percent of GDP)	116.1	116.8	95.0	95.7	93.4	92.3	95.6	94.9	95.7
Non-oil revenue/non-oil GDP (in percent)	18.5	12.6	12.3	12.4	12.4	13.0	13.2	13.7	13.7

Sources: Ministry of Finance and National Economy; and Fund staff projections.

1/ Includes charges for communications, post office, water, air rights, and several fees (landing, telephone license, residence, and passport). The sharp decline in 1998–99 reflects the loss of telecommunication charges due to the corporatization of these services.

2/ Includes Zakat, government sales of property, fines, rental of government property, and others.

3/ In 2000 includes SRls 8 billion for the 13th month salary according to Hijri calendar; 2003–04 share equally the 13-month salary.

4/ Includes some expenditure on wages and salaries of temporary employees.

5/ Difference between the budget deficit and the various sources of budget financing, considering the net bank financing as reported by Saudi Arabian Monetary Agency.

Table 3. Saudi Arabia: Balance of Payments, 1998–2005

(In billions of U.S. dollars)

			Prel.	Proj.	Baseline Scenario			
	1998	1999	2000	2001	2002	2003	2004	2005
Merchandise trade (f.o.b.)	11.2	24.9	51.0	44.0	33.6	24.8	21.5	18.4
Exports	38.7	50.6	78.8	73.5	65.1	59.0	59.0	59.3
Oil exports 1/	32.5	44.8	72.1	66.2	57.2	50.5	49.6	48.6
Other exports 2/	6.3	5.8	6.6	7.3	7.9	8.5	9.4	10.7
Imports	-27.5	-25.7	-27.8	-29.5	-31.5	-34.2	-37.5	-40.9
Services and transfers	-24.3	-24.5	-35.4	-34.0	-33.6	-34.9	-34.4	-36.1
Receipts	10.6	11.3	8.4	9.6	11.0	11.0	12.7	12.4
Investment income	5.8	5.8	3.3	4.6	5.7	5.3	6.4	5.4
Other 3/	4.8	5.5	5.0	5.0	5.4	5.7	6.3	6.9
Payments	-34.9	-35.8	-43.7	-43.5	-44.6	-45.9	-47.1	-48.4
Freight and insurance	-2.5	-2.3	-2.5	-2.7	-2.8	-3.1	-3.4	-3.7
Other private services 4/	-9.2	-10.0	-11.4	-12.1	-12.5	-13.1	-13.6	-14.1
Other government services	-8.1	-9.4	-14.3	-13.0	-13.1	-13.2	-13.4	-13.5
Official transfers	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Private transfers	-15.0	-14.0	-15.4	-15.7	-16.0	-16.4	-16.7	-17.0
Current account balance	-13.1	0.4	15.6	10.0	0.0	-10.1	-13.0	-17.7
(In percent of GDP)	-10.2	0.3	9.0	5.8	0.0	-5.8	-7.2	-9.4
Capital account (net)	1.6	-7.9	-5.8	-1.1	0.1	1.5	3.0	3.5
Commercial banks	2.8	0.7	1.0	1.0	1.0	1.0	1.0	0.5
Other capital movements 5/	0.4	0.6	-3.8	-2.1	-1.0	0.5	2.0	3.0
Of which: FDI	0.0	0.0	1.0	1.0	1.8	2.8	3.8	4.5
Errors and omissions 6/	-1.6	-9.2	-3.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-11.5	-7.5	9.7	8.9	0.0	-8.7	-10.1	-14.3
Financing	11.5	7.5	-9.7	-8.9	0.0	8.7	10.1	14.3
Change in SAMA's total net foreign assets	11.5	7.5	-9.7	-8.9	0.0	8.7	10.1	14.3
Memorandum items								
SAMA's total net foreign assets (end-year)	45.4	37.9	47.5	56.5	56.5	47.8	37.7	23.4
(In months of prospective imports) 7/	11.5	8.2	10.0	11.4	10.7	8.4	6.3	3.7

Sources: Saudi Arabian Monetary Agency; and Fund staff projections.

1/ Excluding bunker oil; includes LPG exports from 1995.
2/ Including re-exports.
3/ Including bunker oil exports.
4/ Oil sector payments and payments for other private services.
5/ Includes Autonomous Government Institutions and oil sector net borrowing.
6/ Includes net private capital movements and valuation adjustments.
7/ Imports of goods and services.

Table 4. Saudi Arabia: Monetary Survey, 1996–2001

	1996	1997	1998	1999	Prel. 2000	Proj. 2001	March 2000	March 2001
	(In millions of Saudi Arabian riyals)							
Foreign assets (net)	256,445	266,653	212,875	182,167	215,021	244,536	185,871	226,951
SAMA	188,927	213,182	170,036	141,834	178,261	211,692	144,610	183,259
Commercial banks	67,518	53,471	42,839	40,333	36,760	32,843	41,261	43,692
Domestic credit (net)	159,996	189,239	224,882	247,808	245,477	253,349	227,726	248,279
Bank claims on government (net)	19,746	34,694	40,628	71,271	60,801	48,675	55,774	63,782
Claims on government (net)	65,266	83,209	89,366	102,266	112,273	112,273	100,446	112,401
Government deposits at SAMA 1/	-45,520	-48,515	-48,738	-30,995	-51,473	-63,598	-44,672	-48,619
Net claims on state enterprises	16,703	20,861	23,599	14,347	12,439	14,435	17,163	11,978
Net claims on private sector	123,547	133,684	160,655	162,190	172,238	190,238	154,789	172,519
Money and quasi-money (M3)	258,501	271,999	282,062	301,145	314,631	338,099	302,250	321,286
Money (M1)	132,928	141,184	140,272	156,665	165,500	179,193	159,918	172,568
Currency outside banks	43,038	45,823	45,019	55,060	51,019	54,654	47,690	50,096
Demand deposits	89,890	95,361	95,253	101,605	114,481	124,539	112,228	122,472
Quasi-money	125,572	130,815	141,789	144,480	149,131	158,907	142,332	148,718
Time and savings deposits	71,081	77,166	83,436	85,341	90,832	96,786	84,492	92,627
Other quasi-money deposits	54,492	53,649	58,353	59,139	58,299	62,120	57,840	56,091
Other items (net)	157,940	183,893	155,695	128,831	145,868	159,785	111,347	153,944
Memorandum items								
Net foreign assets of AGIs	97,342	104,154	118,894	113,788	122,794	...	...	123,585
	(In percent of beginning broad money stock)							
Foreign assets (net)	13.9	3.9	-19.8	-10.9	10.9	9.4	1.3	13.6
Domestic credit (net)	-1.4	11.3	13.1	8.1	-0.8	2.5	-8.0	6.8
Net claims on government	0.9	5.8	2.2	10.9	-3.5	-3.9	-6.7	2.6
Government deposits (- increase)	-4.5	-1.2	-0.1	6.3	-6.8	-3.9	-5.0	-1.3
Net claims on state enterprises	-3.2	1.6	1.0	-3.3	-0.6	0.6	-1.0	-1.7
Net claims on private sector	1.0	3.9	9.9	0.5	3.3	5.7	-0.3	5.9
Money and quasi-money	7.7	5.2	3.7	6.8	4.5	7.5	3.7	6.3
Other items (net)	4.8	10.0	-10.4	-9.5	5.7	4.4	-10.4	14.1
	(Annual percent change)							
Foreign assets (net)	14.9	4.0	-20.2	-14.4	18.0	13.7	2.1	22.1
Domestic credit (net)	-2.0	18.3	18.8	10.2	-0.9	3.2	-9.3	9.0
Net claims on government	11.8	75.7	17.1	75.4	-14.7	-19.9	-26.0	14.4
Net claims on state enterprises	-31.7	24.9	13.1	-39.2	-13.3	16.0	-14.2	-30.2
Net claims on private sector	2.0	8.2	20.2	1.0	6.2	10.5	-0.6	11.5
Money and quasi-money	7.7	5.2	3.7	6.8	4.5	7.5	3.7	6.3
Other items (net)	7.9	16.4	-15.3	-17.3	13.2	9.5	-21.4	38.3
	(Ratios in percent)							
Memorandum items								
Ratio of M3-to-GDP	48.8	49.6	58.6	56.3	48.5	52.5	...	...
Ratio of net domestic credit to GDP	30.2	34.5	46.7	46.3	37.8	39.3	...	...

Sources: Saudi Arabian Monetary Agency (SAMA); and Fund staff estimates.

1/ Includes deposits other than those of the central government.

Table 5. Saudi Arabia: Vulnerability Indicators, 1997–2000

(In percent, unless otherwise indicated)

	1997	1998	1999	Prel. 2000
External solvency indicators				
REER (CPI based - period average)	4.9	3.6	-4.4	2.4
External debt (in billions of U.S. dollars) 1/	21.3	28.9	30.2	30.0
Short-term debt (on a remaining maturity) 2/	8.6	10.4	13.0	12.2
External debt/GDP	14.6	22.5	21.2	17.3
External debt/total exports of goods and services	30.1	58.6	48.8	34.4
Short-term debt (remaining maturity basis)/total exports of goods and services	18.5	27.9	26.4	17.5
External debt service/total exports of goods and services	9.0	11.3	8.9	5.7
Public sector solvency indicators				
Central government's gross domestic debt/GDP	86.9	116.1	116.8	95.0
Total debt service/total revenue	29.7	61.8	48.2	31.2
Interest payments/total revenue	11.9	18.0	18.2	12.4
Distribution of the public domestic debt by holders				
Local commercial banks	17.4	16.0	16.4	18.2
Autonomous government institutions (AGIs)	78.6	79.4	77.2	76.9
Other	4.0	4.6	6.4	4.9
Oil revenue/total revenue	77.9	56.5	70.8	83.1
External liquidity indicators				
Total official net foreign assets (in billions of U.S. dollars)	84.7	77.2	68.3	80.4
SAMA	56.9	45.4	37.9	47.6
AGIs	27.8	31.7	30.4	32.8
SAMA's gross foreign assets (in billions of U.S. dollars)	58.5	46.9	39.4	49.0
In months of imports of goods and services 3/	14.9	11.9	8.5	10.3
Vis-à-vis short-term external debt (remaining maturity)	679.0	449.5	302.8	403.3
Vis-à-vis M0	478.0	390.1	267.7	359.8
Vis-à-vis M1	155.1	125.2	94.1	110.9
Total official net foreign assets/M3	116.7	102.4	84.9	95.7
Commercial banks net foreign assets (in billions of U.S. dollars)	14.3	11.4	10.8	9.8
Foreign assets	26.6	22.9	24.4	27.0
Foreign liabilities	12.3	11.5	13.7	17.2
Oil exports/total exports	87.8	83.9	88.5	91.6
Financial sector indicators				
Foreign currency deposits/total deposits	19.8	21.3	20.1	18.6
Risked adjusted capital/asset ratio	22.5	21.2	21.2	21.0
Nonperforming loans/total assets	9.3	8.4	11.4	10.4
Net domestic credit (percent change)	18.3	18.8	10.2	-0.9

Table 5. Saudi Arabia: Vulnerability Indicators, 1997–2000

(In percent, unless otherwise indicated)

	1997	1998	1999	Prel. 2000
Private sector credit (percent change)	8.2	20.2	1.0	6.2
Net domestic credit/GDP	34.5	46.7	46.3	37.8
Private sector credit/non-oil GDP	41.1	48.6	47.7	48.4
Private sector credit/total assets of banks	35.0	39.7	39.1	38.0
Market assessment/financial market indicators				
Stock market index (percent change; period average)	27.9	-27.8	43.6	11.3
Banking sector stock market index (period average)	41.0	-22.4	48.2	12.3
Interest rate spread (basis points, quarter IV average) 4/	28.2	111.0	29.2	28.0
Moody's investor services rating 5/	...	Baa3	Baa3	Baa3

Sources: Saudi Arabian authorities; and Fund staff estimates.

1/ BIS-IMF-OECD-World Bank database.
2/ Includes amortization of the medium and long term due in the period.
3/ Imports of goods and services projected for the next 12 months.
4/ Spread between three-month Saudi riyals and eurodollar deposits.
5/ Long-term bonds and notes.

Table 6. Saudi Arabia: Budgetary Developments, 1998–2005 (Alternative Scenario)

(In billions of Saudi Arabian riyals; unless otherwise indicated)

			Prel.	Proj.	Alternative Scenario			
	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	141.2	147.5	258.1	241.3	222.5	209.7	217.5	221.7
Oil	80.0	104.5	214.4	195.0	171.0	152.9	150.2	147.4
Non-oil	61.2	43.0	43.7	46.3	51.4	56.8	67.4	74.3
Investment income	12.4	6.7	5.5	6.2	6.3	7.6	9.5	10.6
Income taxes	2.2	2.2	2.2	1.6	1.7	2.0	2.3	2.6
Fees and charges 1/	21.2	18.7	20.8	24.2	26.6	29.3	32.2	35.4
Customs	10.0	9.6	9.7	10.0	11.8	12.8	14.1	15.3
Other 2/	15.4	5.9	5.5	4.4	5.0	5.1	9.3	10.4
Total expenditure	190.1	183.8	235.5	214.2	221.3	218.5	219.4	221.7
Current expenditure	171.2	167.2	208.3	191.2	197.1	191.5	190.1	190.4
Wage bill 3/	99.8	103.1	114.9	108.4	111.1	111.1	111.1	111.1
Supplies and services 4/	19.4	13.6	24.4	20.0	20.4	20.7	20.9	21.1
Subsidies and transfers	5.4	5.9	9.4	6.2	6.2	1.0	0.0	0.0
Foreign aid	0.2	0.3	0.5	0.5	0.5	0.5	0.5	0.5
Interest payments	25.4	26.9	32.0	31.2	33.2	32.5	31.9	31.2
Domestic	25.4	26.9	32.0	31.2	33.2	32.5	31.9	31.2
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operations and maintenance	20.9	17.4	27.1	25.0	25.8	25.8	25.8	26.5
Capital expenditure	18.9	16.6	27.2	23.0	24.2	27.0	29.3	31.4
Current balance 5/	-30.0	-19.7	49.8	50.1	25.4	18.2	27.5	31.3
(In percent of GDP)	-6.2	-3.7	7.7	7.8	4.0	2.8	4.1	4.4
Overall balance (excluding oil revenue)	-128.8	-140.8	-191.8	-167.9	-169.8	-161.7	-152.0	-147.4
(In percent of GDP)	-26.8	-26.3	-29.6	-26.1	-26.5	-25.0	-22.5	-20.9
Overall balance	-48.8	-36.3	22.6	27.1	1.2	-8.8	-1.8	0.0
(In percent of GDP)	-10.2	-6.8	3.5	4.2	0.2	-1.4	-0.3	0.0
Financing (net)	48.8	36.3	-22.6	-27.1	-1.2	8.8	1.8	0.0
Domestic	48.6	54.1	-39.0	-27.1	-1.2	8.8	1.8	0.0
Net bank financing	5.9	30.6	-10.5	-12.1	8.8	8.8	1.8	0.0
Net nonbank financing	75.8	53.0	-18.5	-15.0	-10.0	-5.0	-5.0	-5.0
Bond sales	...	...	55.5	55.5	55.5	73.6	74.6	75.6
Total amortization	...	...	-64.0	-70.5	-65.5	-78.6	-79.6	-80.6
Regularization of late payments	-33.2	-29.6	-10.0	0.0	0.0	0.0	0.0	0.0
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	5.0	5.0	5.0
External borrowing (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discrepancy 6/	0.3	-17.7	16.3	0.0	0.0	0.0	0.0	0.0
Memorandum items								
Central government's gross domestic debt	558.8	624.7	616.2	601.2	591.2	586.2	581.2	576.2
Central government's gross domestic debt/GDP (percent)	116.1	116.8	95.0	93.4	92.3	90.5	86.0	81.6
Non-interest current expenditure	145.7	140.3	176.3	160.0	163.9	159.0	158.2	159.1

Sources: Ministry of Finance and National Economy; and Fund staff projections.

1/ Includes charges for communications, post office, water, air rights, landing fees, telephone license fees, residence fees, and passport fees.

2/ Includes Zakat, government sales of property, fines, rental of government property, and others. Effective 2004, also includes revenue from the introduction of indirect tax.

3/ In 2000, includes SRls 8.0 billion for extra month salary according to Hijri calendar; 2003–04 share equally the 13-month salary.

4/ Includes some expenditure on remunerations and wages and salaries of temporary employees.

5/ Total revenue less current expenditure.

6/ Difference between the budget deficit and the various sources of budget financing, considering the net banking sector financing as reported by Saudi Arabian Monetary Agency (SAMA).

Saudi Arabia: Fund Relations
(As of June 30, 2001)

I. **Membership Status:** joined 8/26/57; Article VIII.

II.	**General Resources Account:**	**SDR Million**	**% Quota**
	Quota	6,985.50	100.0
	Fund holdings of currency	5,518.92	79.0
	Reserve position in Fund	1,466.58	21.0
	Financial transactions plan	370.00	N/A

III.	**SDR Department:**	**SDR Million**	**% Allocation**
	Net cumulative allocation	195.53	100.0
	Holdings	168.43	86.1

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VII.	**Lending to the Fund:**	**SDR Million**
	Lending in association with PRGF	49.5

Saudi Arabia has consented to the Fund's fourth amendment. It has an associated lending agreement for an amount up to SDR 1.5 billion with the General Arrangements to Borrow (GAB), which was renewed for another five-year period from December 26, 1998. It is also a participant in the New Arrangement to Borrow (NAB) for an amount up to SDR 1.78 billion. In March 2001, Saudi Arabia agreed to support the PRGF-HIPC Trust with deposits totaling SDR 94.4 million. As of end-June 2001, SDR 69.5 million was received as scheduled.

VIII. **Exchange Rate Arrangement:**

Saudi Arabia maintains an exchange rate system free of restrictions on the making of payments and transfers for current international transactions except for restrictions against Iraq and the former Federal Republic of Yugoslavia (Serbia and Montenegro) in accordance with Decision 144 (52/51). The Saudi Arabian riyal is formally pegged to the SDR at the rate of SRls 4.28255=SDR 1, with margins of 7.25 percent; however, since mid-1981, observance of margins has been suspended. In practice, the Saudi Arabian riyal has been pegged to the U.S. dollar since 1986; the middle rate of the riyal against the U.S. dollar is SRls 3.7450= US$1.

IX. **Article IV Consultation:**

(a) Saudi Arabia is on the standard 12-month consultation cycle. The last Article IV consultation was held during May 10–25, 2000.

(b) The staff report (SM/00/210) and the associated Recent Economic Developments (SM/00/215) were considered by the Executive Board on October 6, 2000 (SUR/00/94).

X. **Technical Assistance:**

INS: Regional seminar for GCC countries, November 1997.
Regional seminar for GCC countries, May 1998.
Regional seminar for GCC countries (Design of Fiscal Policies), May 1999.

STA: Balance of payments statistics, March–May 1997.
Government finance statistics, September 1997.
Money and banking (international reserves), May 1998.
National accounts statistics, August–September 1998.
Balance of payments statistics, January–February 2001.

FAD: Reform of customs administration, June and November 1997.
Strengthening of tax administration, February–March 1998.
Tax and customs administration seminar, March 1998.
Customs administration, September–November 1998.
Tax and customs administration, June 1998.
Customs administration information advisor, November 1998–November 1999.
Tax administration advisor, November 1998–November 1999.
Tax and customs administration, October–November 1998.
Study group to review domestic tax departments, December 1998.
Tax and customs administration, February–March 1999.
Tax reform implementation, June 24–July 13, 1999.
Evaluation of current approach to customs modernization, October 6–17, 1999.
Modernization of the Department of Zakat and Income Tax, May 22–June 1, 2000.

LEG: Reform of income tax system, March 1997.
Income tax, June 19–29, 1999.

XI. **Resident Representative:**

No resident representative is stationed in Saudi Arabia. However, there is currently a long-term FAD resident advisor on tax administration.

Saudi Arabia: Relations with the World Bank

1. The World Bank maintains a special relationship with Saudi Arabia by providing reimbursable services through the Technical Cooperation Program (TCP), the largest such program for the Bank. It also provides a limited amount of nonreimbursable services. The program, which was initiated in FY1975/76, peaked at 32 staff years in the mid-1980s, declined in the following years, but has been rising again to around 13 staff years in FY2000/01. The Bank's main counterpart is the Ministry of Finance and National Economy (MOFNE).

2. Historically, the bulk of the technical assistance has been for infrastructure and for information systems. In the 1990s, however, the emphasis shifted toward policy advice and implementation. Most recently, a Country Economic Memorandum (CEM) was completed. Private sector development (PSD), which was initially a component of the CEM, emerged as an area of considerable activity. In FY 2000, important initiatives were completed, among them: corporatization of Saudi Telecom Company (STC); strengthening of the nascent privatization ministerial committee and implementation agency (PIF); setting up of the Export Finance Program within the Saudi Fund for Development; design of the regulatory framework for the electricity sector; recruitment of advisory consortium for Saudi Arabian Airlines privatization; development of a mining strategy, including a workshop on Reform and Investment Promotion in the mining sector; water pricing reform through a tariff structure model and strategy for water sector; and initiation of the process for private sector participation in the Jeddah Industrial City Wastewater treatment facility through a 15-year BOT and in King Fahad Medical City through a lease.

3. Several joint ministry-bank workshops and symposia have been held, including on health care reform, water/wastewater sector reform, investment promotion, IPPS and small- and medium-enterprise reform, among others. Also, the Bank is collaborating with an Interministerial Committee on preparation of a symposium to be held October 20–24, 2001 to develop a comprehensive vision for the Saudi economy focusing on human development, diversification, public-private partnerships, and other areas of development.

4. Capacity building has emerged as a priority for government, and the Bank has been carrying out such work with the PIF regarding implementation of privatization transactions; the Export Promotion program within the Saudi fund for development; the Saudi Arabian General Investment Authority; and the Supreme Commission for tourism, among others.

5. Video conferences are organized frequently to deliver cost-effective, just-in-time policy advice, and promote knowledge sharing with the participation of high level officials including several deputy ministers.

6. Also, the World Bank Institute is actively involved in offering courses for and in cooperation with the Kingdom's Institute of Public Administration (IPA). Preparations for setting up a distance-learning center at IPA are advanced.

Saudi Arabia: Statistical Issues

National accounts and price indices

Data on GDP, value added per sector at current and constant prices, and GDP deflators are available on a yearly basis. In 1998–2000, the Central Department of Statistics (CDS) implemented several new surveys, which aimed at converting the national accounts from the 1968 System of National Accounts (SNA) to the 1993 SNA, and changing the base year from 1970 to 1999 for the constant price calculations. These surveys included: the annual economic surveys of establishments (1998 and 1999 completed, the 2000 survey in process); the manufacturing sector survey (1999 published); the transportation sector survey (1998); the 1999 household expenditure and income survey (to be finalized by end-2001); the household-based labor force survey (1999); the establishment-based wages and salaries survey (1999 completed, 2000 underway); the agricultural sector survey (1999 near completion); and the demographic survey (2000 underway). The results of the labor survey, which started in May 2000, are expected to be published soon. Other proposed economic surveys include the compilation of import and export price indices (annual, starting 2001), and the input and output of industrial production indices (five-yearly, starting 2001). The processed surveys for 1998–99 will allow the publication of the 1998–99 national accounts statistics in accordance with the 1968 and 1993 *SNA* presentation in the forthcoming CDS annual report. The completion of the 1999 household expenditure and income survey will allow the construction of a new basket for the CPI. The new CPI index will be extended to include the 13 regions of the country and will have a better coverage of the rural areas. It should be available starting in 2002.

To improve the compilation of the national accounts, the CDS has been working to shorten the long delays in the availability of data on the oil sector; to estimate government expenditures in constant prices and consumption of government fixed capital; to construct industrial production indices, to compile data on employment, unemployment, and earnings, and to break down the balance of payments services into factor and nonfactor services. The authorities intended to accompany these achievements with a revision policy to include the new results in the national accounts along the lines suggested by the 1998 STA mission.

The authorities have developed databases on labor markets available for use by the regional labor offices. These databases have regularly been updated. The preliminary results for 1998 employment by sector and in large establishments (with more than 20 employees) are also available.

Fiscal sector

During consultation missions, the authorities provide detailed information on the operations of the central government, including the stock of the gross domestic debt, the distribution of government debt by holders, amortization payments, and the breakdown of the fiscal financing between bank and nonbank sources. In addition, statistical information is provided on the Saudi Fund for Development, and some data on the General Organization for Social

Insurance and the PIF, as well as on four other lending institutions (Saudi Agricultural Bank, Saudi Credit Bank, Saudi Industrial Development Fund, and Real Estate Development Fund). However, there has been no progress in publishing detailed fiscal data and in presenting a consolidated situation of the public finances (central government, PIF, and autonomous government institutions).

Following recommendations by the September 1997 Fund technical assistance mission on fiscal accounts, the authorities are working to fully address remaining weaknesses in the fiscal data. As a first step, expenditure on wages and salaries has been reclassified to be fully captured in Chapter I of the Budget according to the UN System of National Accounts (SNA) methodology. Also, the Ministry of Finance and National Economy (MOFNE) has taken some steps in using Government Finance Statistics (GFS) definitions to put national data in a format consistent with the 1993 SNA.

Monetary data

Most monetary and financial data are readily available in SAMA's Monthly Statistical Bulletin, published with about one-month lag and available since March 2000 on the SAMA website. In particular, commercial bank data are adequate and are provided on a regular basis. Information on deposit interest rates is included (and published on a daily basis in the national press), but not interest rates on government securities. In addition, on its website SAMA provides stock market information that is updated every 10 minutes, while information on mutual fund transactions is also published daily in the local press. Monetary data for SAMA are provided to the Fund on a monthly basis. However, liabilities are provided in aggregates without detailed breakdown into components (e.g., no indication of foreign liabilities), which does not permit an accurate compilation for the monetary survey. More disaggregated data on SAMA's liabilities are only provided during consultation missions. As of June 30, 2001, the authorities provided the following monthly data for publication in International Finance Statistics (IFS): currency issued and currency in circulation, SAMA's accounts, deposit money banks' accounts, and interest rates on deposits and the domestic share prices index, all through May 2001; and quarterly consolidated accounts of other financial institutions through the fourth quarter 2000.[1] In the reporting on SAMA's accounts, there has been a dramatic improvement in the timeliness of reporting, beginning with the submission for April 2001. Prior to that time, there had been long lags in reporting SAMA's data, but after that time the lags were cut dramatically to one month. The authorities have revised the definition of official international reserves in light of the recommendations of a STA–MED mission (May 16–19, 1998).

Balance of payments

Progress has been made in several areas to improve the balance of payments statistics, although the data are not yet compiled or reported according to the Balance of Payments

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[1] The monthly reports also include weekly data on money supply M1, M2, and M3.

Manual, Fifth Edition (BPM5). Only the major items of the balance of payments are presently reported, and limited breakdown is provided. However, steps are underway to address the remaining issues, such as improvement in the compilation of data on services, income, and transfers, as well as on the financial and capital accounts, reconciliation between oil sector statistics published in SAMA's annual reports and those in the real sector, improvement on the classification of public sector imports and services. The 1997 STA mission on the balance of payments assisted the authorities in reclassifying the BOP data according to Fund methodology, and recommended new collection methods that would allow SAMA to convert the balance of payments to the new BPM5 presentation within a relatively short period. SAMA has made significant progress in implementing these recommendations, particularly in the design and dispatch of survey forms used for data collection, including from: the MOFNE and several other government agencies and ministries; a large number of private sector companies, including telecommunication and transportation companies; and financial institutions. To ensure continued progress in this regard, SAMA has established a committee of 11 officers (with weekly meetings) to review progress in the collection and usage of BOP data; some of the material is also being used for training to aim at improving data collection. Finally, to improve the compilation of balance of payments data in accordance with the BPM5, the authorities together with STA organized a seminar in January/February 2001.

Data publication

Publication is generally limited to officially finalized and approved data. Data on real sector, national accounts, financial sector, budgetary accounts, and balance of payments are published in official documents, such as the CDS and the SAMA annual reports (the 2000 annual report was published in September 2000 and contains data up to end-1999, and up to March 2000, whenever available). In addition, as mentioned above, main financial data are available in SAMA's Monthly Statistical Bulletin with about one-month lag and since March 2000 on the SAMA website. The budget document is not published but limited actual fiscal data are published in SAMA's annual report. Data provided to the consultation missions are available in the Fund documents and intended for internal circulation. In May 2001, the authorities made the decision to publish main economic and financial data.

Saudi Arabia: Core Statistical Indicators
As of July 11, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	May 2001	May 2001	May 2001	May 2001	May 2001	May 2001	May 2001	2000	2000	2000	2000	2000
Date Received	June 2001	June 2001	June 2001	June 2001	June 2001	June 2001	July 2001	May 2001	May 2001	May 2001	May 2001	May 2001
Frequency of Data	M	M	M	M	W	M	M	A/M	A	A	A	N/A
Frequency of Reporting	M	M	M	M	M	M	M	A/M	A	A	A	Q
Source of Update	A	A	A	A	A	A	A	A	A	A	A	O (Joint Database)
Mode of Reporting	M	M	M	M	M	M	M	M	M	C/V	C/V	O (Internet)
Confidentiality	C	C	C	C	C	C	C	C/B for Recent Data	C/B for Recent Data	C/B for Recent Data	C/B for Recent Data	C
Frequency of Publication	M	M	M	M	M	M	M	A	A	A	A	N/A

Saudi Arabia: Financial Sector Performance and Evolution[1]

The performance of the financial sector remained strong in 2000. The commercial banks were well capitalized, profitable, and well supervised. Their average risk-weighted capital-to-assets ratio remained high at about 21 percent in 2000, about the same as in 1999—and about 2½ times the minimum international standard under the Basel Core Principles. Bank profits rebounded strongly, increasing by nearly 40 percent in 2000 compared with 1999 levels. Banks' capital and reserves increased by approximately 3 percent in 2000, reaching US$12 billion, or about 17 percent of total deposits. Total provisions for loan losses as a percent of nonperforming loans increased to 93 percent in 2000, compared to 88 percent a year earlier. Nonperforming loans as a proportion of total loans improved, by declining to 10.4 percent in 2000, from 11.4 percent a year earlier. The overall stock market price index, unlike stock prices worldwide, increased 11 percent in 2000 from a year earlier.

Banking supervision

The Saudi banking system, which consists of 11 commercial banks, is closely supervised by SAMA (Box 1).[2] Banks are supervised through onsite inspections and continuous offsite monitoring and analysis. SAMA performs a full scope onsite inspection of each bank once every three years. A limited scope onsite inspection focusing on selected items is carried out twice each year. In addition there are special in-depth inspections that may include staff from an external audit firm. This is in addition to the provision in the Banking Control Law that requires banks to be audited by two independent auditors annually.

For offsite monitoring, SAMA collects data from banks in a unified manner for banking supervision and monetary policy using a sophisticated, highly current, electronic system of reporting and data management. Banks are required to conform to International Accounting Standards (IAS). Within the last year, SAMA strengthened the accounting framework for banks by requiring them to conform to IAS 34 and 39.[3]

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[1] Prepared by Mr. George Iden, MAE.

[2] Excluding branch of a foreign bank.

[3] The former (IAS 34) pertains to interim financial reporting, and basically specifies the financial reporting framework for financial reports that are required within the financial year. These reports must be consistent with the annual financial statements, although they can be more aggregated and summarized. They should also be based on the same accounting policies used to compile the annual financial statements, contain disclosure of any material changes in business activities during the period, and also show comparative financial position data for the previous year-end (balance sheet data), and comparable performance data (income statement) for the same period in the previous year. Implicit in this approach is that the reporting entity has adopted all relevant international accounting standards that are applicable to its activities.

With few exceptions, SAMA's prudential regulations for banks are in accordance with international good practice. Compliance of banks with prudential standards is high. As indicated above, Saudi banks in the aggregate have a risk-weighted capital-asset ratio of 21 percent—about two and a half times more capital than the minimum requirement under the Basel rules. All banks are in compliance with the minimum. However, there are no limits on banks' foreign exchange exposure, although SAMA closely monitors the banks' balance sheets and, in particular, credit concentration.[4] In addition, the limit on borrowing by a single customer (or a connected group of borrowers), as provided in the Banking Control Law, is 25 percent of a bank's capital and reserves, which is high by international standards. SAMA's Banking Department recommends that banks not exceed 15 percent in their lending to a single customer, although at any one time some banks may be exceeding the 15 percent. SAMA requires banks to report single loan exposures in excess of 10 percent of their capital and reserves. Lending to shareholders, officers, and other related parties is limited to 10 percent of capital, and must be fully collateralized and extended at commercial terms.

With regard to oversight of banks' loan classification and provisioning, SAMA's regulations require the bank's management to study and analyze outstanding loans at regular intervals in order to determine the borrowers' solvency. SAMA's requirements include the following:

- loan classification policies are to be approved by the Board, subject to the approval of SAMA, and agreed by the external auditors;
- banks are required to classify their credit portfolios, and these are reviewed by SAMA for reasonableness;
- loan classification systems are examined during the onsite examinations in each bank.[5]

While SAMA provides general guidance on loan classification and provisioning to the banks, it does not impose a standard system that ensures comparability among banks. The authorities felt that given there are only 11 banks to supervise, uniform system for loan

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IAS 39 pertains to the "recognition and measurement" of financial instruments. The provision specifies the standards for initial recognition and subsequent measurement of all financial instruments included on- and off-balance sheet assets and liabilities. Essentially all financial assets, other than those that will be held to maturity or loans originated by the organization, have to be valued at fair (i.e., market) value. Also, all financial assets must be subjected to at least annual review for impairment.

[4] The authorities note that there was no international standard for foreign exchange exposure and that most advanced countries had abandoned limits on foreign exchange exposure.

[5] Guidance on loan classification is offered by SAMA's internal Control Guidelines and Accounting and Disclosure Standards.

classification and provisioning was not essential. Nevertheless, in the absence of some uniformity, it may be difficult to compare nonperforming loan estimates among banks, or the aggregate of the banking sector over time.[6]

The data on nonperforming loans and provisions suggest that Saudi banks are in a comfortable position. The ratio of nonperforming loans to gross loans had fallen to 8.4 percent in 1998, and then increased to 11.4 percent in 1999, reflecting a generally weak economy following the fall in oil export receipts. However, in 2000, as oil prices increased and the economy strengthened, the ratio of nonperforming loans declined to 10.4 percent. Most of the nonperforming loans have been provisioned against, with provisions amounting to 93 percent of nonperforming loans in 2000—up substantially from 74 percent in 1996, and 83 percent in 1998.[7]

In 1998, SAMA conducted a self-assessment of the supervisory system and practices in Saudi Arabia against the Basel Core Principles (BCP). The survey indicated that the banking supervisory framework was compliant with almost all of the BCP (approximately 23 out of 25). Currently, SAMA is again assessing its banking supervision against BCP using the "Core Principles Methodology", developed in October 1999. This assessment, which calls for collaboration with outside examiners, is in process.[8] SAMA is leaning towards a review by a leading international accounting or consulting firm.

SAMA is taking an active role in dialoguing with banks on the proposed new Basel capital standard, which is expected to be implemented in 2005. Earlier this year, SAMA with participation of a Basel Committee official and attended by representatives from the commercial banks, organized a conference on the new capital standard. Banks are also participating in the Basel study of the impact of the new standards by responding to a survey. SAMA management noted that some banks believed that the length of time before its

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[6] The authorities stated that they saw some benefit from standard loan classification and provisioning, but noted that there were no international standards in this area. SAMA has a minimum set of standards of loan classification and provision of which banks are expected to meet. The Basel Committee is currently working on this issue and SAMA is waiting for an international consensus to develop on this subject.

[7] The ratio of nonperforming loans in gross loans varies considerably among banks. Some banks reported under 5 percent. The ratio of nonperforming loans for Saudi American Bank, the second largest bank by assets, was slightly above this level at 5.6 percent, but that was down sharply from 7.6 percent the year before, reflecting SAMA's merger and efforts to lower nonperforming loans. At the other extreme, one of the smaller banks reported about 27.5 percent nonperforming loans, although the ratio was less than half the level from four years earlier. Data on nonperforming loans in 1999 and 2000 are not publicly available for NCB, the largest bank.

[8] See "Core Principles Methodology," Basel Committee on Banking Supervision, October 1999.

introduction (2004) was too short,[9] that it was complex, and that it would require upgrading of technical skills. Comments on the New Capital Accord have already been posted on the BIS website since early June 2001.

Bank competition and structure

Saudi banks are large and well managed, and face a competitive environment. In particular, Saudi banks face strong cross-border competition. For example, some 65 percent of banks' assets in Bahrain are from Saudi Arabia. Similarly, Saudi banks are in competition for deposits and related services with banks from G-10 countries. SAMA encourages this kind of cross-border competition. Saudi banks already have involvement of international banks, including through joint ventures.

Until last year, no new banking licenses had been granted by SAMA since 1988. However, recently GCC banks have been given priority for entry into the local market. In the last year, SAMA received three applications for banking licenses. One was approved, for Gulf International Bank (GIB).[10]

In 1999, Saudi American Bank and United Saudi Bank merged, temporarily reducing the number of Saudi banks to 10. With the entry of GIB in 2000, the number of banks again increased to 11. As of early 2000, there were approximately 1200 bank branches operating in the Kingdom.

At present, the government holds a 40 percent stake in **National Commercial Bank (NCB)**, the largest bank in Saudi Arabia in terms of assets. The government acquired this share in 1999, through the General Organization for Social Insurance (GOSI) which acquired a 10 percent stake, and the Public Investment Fund (PIF) which acquired a 40 percent stake. NCB is going through reorganization. The authorities believe that it has reached the point where it is in a solid financial position and making suitable profits.

Banks' lending operations have evolved in the recent years. In particular, consumer finance has shown significant growth, stimulated by the spread of electronic banking that makes possible automatic deductions from wages to service consumer loans. Some of the banks are focusing on bank assurance services, which assist individuals in saving for major life events,

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[9] The Basel Committee later postponed the target date for implementation to 2005.

[10] According to the Bank Control Law, the applications are studied by SAMA, which submits its recommendation to the Minister of Finance and National Economy. In the case of a foreign bank, the grant of a license is subject to any conditions specified by the Council of Ministers. The license is issued by the Minister of Finance after the approval of the Council of Ministers.

such as education for the children and retirement.[11] Opportunities are being explored by banks for the further development of longer-term instruments, such as joint lending with the state-owned Saudi Industrial Development Fund.

In the period ahead, banks will become involved with new activities, and new instruments for lending will be developed. Banks will expand within the Kingdom, regionally, and globally, and further consolidation will be up to the banks. Banks see growth opportunities from developing the relatively untapped market for consumer loans, wealth management, and investment banking. Availability of skilled human resources is currently a constraint on expansion of the investment banking area.

Money and capital market development

Progress is being made on a number of fronts in the development of Saudi money and capital markets.

Stock market

The Saudi stock market is the largest in the Gulf region, and in the Arab world. The stock market index increased by 11 percent in 2000 compared with the year earlier, and the value of shares traded rose 15 percent over the same period. Market capitalization rose another 11 percent to SRls 254 billion in 2000, or approximately 39 percent of GDP. However, the stock market continues to lack depth and liquidity.

Trading in common stocks began in Saudi Arabia in 1935, but did not become organized until the mid-1980s. Important developments in the stock market include the introduction in 1990 of an electronic screen-based stock trading system, the Electronic Securities Information System (ESIS). A closed-end mutual fund was opened for foreigners in 1997, and open-ended mutual funds were later opened to foreigners (in 1999), subject to a "negative list" provision that prohibits foreign investment in insurance, telecommunications, wholesale trade, and retail distribution services. Foreign investment in individual issues through the stock exchange continues to be prohibited.

An earlier study concluded that weaknesses in the stock market stemmed more from the supply side than from the demand side.[12] On the supply side, several factors have tended to limit market depth and liquidity. First, the number of listing (70 companies) appears to be relatively low compared with the potential number, and the number of companies (over 7,000) operating in Saudi Arabia. In addition, a small number of companies account for a

[11] On the business front, "Guaranteed Company Obligations," which are a form of short-term commercial paper—have been introduced which are partially guaranteed (50 percent) by the bank.

[12] *Saudi Arabia—Recent Economic Developments and Selected Issues*, SM/98/152, June 22, 1998.

relatively large share of market capitalization. Also, a sizable block of shares (almost half) is held by owners who do not trade. Consequently, market turnover at approximately 26 percent in 2000 was relatively low.

On the demand side, ownership of common stock is relatively widespread in Saudi Arabia, with the number of shareholders as a proportion of the total adult population at about 35 percent—roughly the same as in the United States. However, institutional demand for capital assets is limited; in particular there are essentially no corporate retirement schemes, and companies listed on the market are not allowed to purchase their own shares. One reason for the limited offerings is that many companies in Saudi Arabia are family-owned businesses, and the current owners may be unwilling to provide information about or relinquish information and control of their businesses. Another factor relates to the stringency of listing requirements. Although these requirements were relaxed somewhat in 1999, they may still constitute a substantial barrier. In particular, the requirements for conversion of a company into a joint-stock company, eligible for listing on the stock market, include the following:

- achievement of relatively significant profitability and size in the year preceding the conversion request, such that the net assets of the company shall not be less than SRls 50 million;

- return on equity in any of the three years preceding the conversion shall not be less than 7 percent, and an economic feasibility study shall have confirmed that the anticipated return will not be less than 7 percent in any of the three years following the conversion; and

- at least five years shall have lapsed since the establishment of the company requesting conversion.

In addition, direct participation in the stock market is limited to banks, which use an electronic system (ESIS) that is order driven. There is no "stock exchange" per se. While banks can transact for their customers, they are not allowed to make a market and cannot hold shares in their own account.

Participation of foreign investors in the stock market is relatively restricted, and banks report that as yet there is little foreign interest in buying mutual funds. Under the new investment law, foreign investors can participate through ownership in mutual funds, except for the negative list of industries; however, they are not permitted to own individual stocks.

Further development of the Saudi stock market would be beneficial for several reasons. It would improve the liquidity for owners of businesses, and greater investment opportunities for savers. In addition, it would help in raising capital to further diversify the economy, and in particular, the stock market could provide support for the privatization program.

Many of the weaknesses of the current stock market are expected to be addressed by **the new draft capital markets law**, which is well advanced in the law-making process. Among other things, the draft law, which contains more than 60 articles, would provide for a new Securities and Exchange Commission as a regulatory body, and establish an independent and privately held stock exchange. In addition, a new more advanced trading platform is envisioned for implementation in conjunction with the new legal framework.

Bond market

While there is a sizeable primary market for government securities, there is very little trading of government securities in the secondary market and there is no corporate bond market, or market for commercial paper. In the money market, there is some activity in the interbank market, but very little movement in commercial paper and other short-term instruments.[13] There appears to be four main obstacles to developing a corporate bond market in Saudi Arabia.[14] First, there is competition from the state-owned specialized credit institutions which offer longer-term credit at subsidized rates. A second obstacle is cultural resistance to lending and interest charges. Third, the secondary market for government securities is not yet developed.[15] Fourth, the money market also needs to be developed as a prerequisite for the bond market—including the use of auctions in the issuance of government securities, an active interbank market, and a market for short-term commercial paper.

At present, government securities are issued by SAMA for the Ministry of Finance and National Economy with a set price, depending on maturity (usually about 30 to 50 basis points over comparable U.S. treasury securities). SAMA and the banks are considering a number of options to develop the secondary market for government securities, including possible establishment of a primary dealer system.

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[13] Development of a bond market is a potentially important component of the capital market. A bond market provides longer-term finance for investment projects, and liquidity for holders of these longer-term claims. In addition, many businesses, especially closely held businesses, may find bond financing relatively attractive because it does not dilute ownership and control, unlike equity financing. Development of the bond market also reduces the cost of long term borrowing—thus lowering the cost of servicing the public debt and the cost of funds for private investment. The usual sequence in developing a bond market is to first develop the primary market for government securities, including, as a centerpiece, a well functioning auction. A next step is to develop the secondary market for government securities which establishes a basis for a corporate bond market.

[14] See *Saudi Arabia—Recent Economic Developments and Selected Issues*, SM/98/152; June 22, 1998, page 54.

[15] It may be difficult to establish a secondary market for government securities since a substantial proportion of these securities is held by government agencies that generally are not interested in trading in the secondary market. Also, information about yields on government securities, both in the primary and the secondary market, is presently lacking.

Insurance

At present, the insurance industry is not regulated. SAMA authorities are encouraging banks to develop their insurance business in view of the potential synergies with banking. At present, there is only one licensed insurance company in Saudi Arabia, National Company for Cooperation Insurance (NCCI), which was licensed by the Council of Ministers. NCCI is a cooperative joint-stock company owned by the PIF (50 percent), the GOSI (25 percent), and the Pension Fund (25 percent). In addition, there are approximately 110 insurance companies that are operating without licenses and without supervision.

In order to facilitate growth of the insurance sector, a **new draft insurance law** is under preparation. The new law would establish a legislative framework for the development of a national insurance industry, with the banks being allowed to establish insurance subsidiaries. However, some of the regulatory issues, such as the division of responsibilities between SAMA and the Ministry of Commerce, have not yet been worked out.

Mortgage lending

There is essentially no mortgage lending in Saudi Arabia, especially for purchase of personal homes. The main barriers include the need for "perfection of security" and its "enforcement" within the current legal framework. At present, mortgage-type agreements would be difficult to enforce, especially on houses. A committee of bank representatives has been established to work on this area.

Box 1. Saudi Banking Supervision and Regulation

Saudi Arabia's 11 banks are closely supervised by SAMA, whose functions, authority, and enforcement provisions are spelled out in legislation, particularly the Charter of the Saudi Arabian Monetary Agency and the Banking Control Law. Banks are supervised through onsite inspections and offsite monitoring and analysis. Banks are inspected routinely, and in addition, selected banks are subject to special in-depth inspections, which may include an outside auditor. This is in addition to the provision of the Banking Control Law that requires banks to be audited by two auditors annually. SAMA has broad powers to take corrective actions including revoking licenses, appointing advisors to a bank, and other steps that may be required. Within the last year, SAMA strengthened the accounting framework for banks by requiring them to conform to IAS 34 and IAS 39, which pertain to interim financial reporting and recognition and measurement of financial instruments, respectively.

Saudi Arabia's supervisory framework includes policies and procedures on capital adequacy, liquidity, credit concentration, legal lending limits, connected lending, risk management procedures and audit requirements. SAMA has set the minimum capital adequacy regulation in line with the Basel Committee recommendations—capital of at least 8 percent of risk-weighted assets. All banks are in compliance with this minimum standard, and, on average, the banking system has a capital adequacy ratio of 21 percent in 2000. The ratio of deposits to capital and reserves is limited to 15. In addition, banks are required to maintain a liquid reserve in relation to their deposit liabilities.

With regard to risk diversification, lending to a single borrower (or connected group of borrowers) is limited to 25 percent of capital and reserves; however, SAMA requires banks to report exposures of 10 percent or larger, and discourages bank lending to a single borrower in excess of 15 percent. Bank lending does not seem overly concentrated in any one sector. The highest exposure of banks has been for commerce, which amounted to 22 percent of commercial credit outstanding at end-2000. Lending for building and construction appears moderate at approximately 11 percent of total credit.

Lending to shareholders, officers, and other related parties is limited to 10 percent of capital, and should be fully collateralized and extended on "arms-length" terms. Banks are required to obtain SAMA's approval before purchasing shares of any bank doing business in the Kingdom, and are prohibited from owning stock in any other joint-stock company in excess of 10 percent of paid up capital of that company. There are no regulations on banks' open foreign currency positions.

Data on nonperforming loans and provisions suggest that Saudi banks are in a comfortable position. The ratio of nonperforming loans to gross loans declined moderately from 11.4 percent in 1999 to 10.4 percent in 2000, reflecting higher oil prices and a stronger economy generally. Loan provisions as a proportion of nonperforming loans increased to 93 percent in 2000, up from 88 percent in 1999, and 74 percent in 1996.

Bank profitability is relatively high. Banks' profits increased 39 percent in 2000 compared with a year earlier, and the average pretax return on banks' assets increased from 1.5 percent in 1999 to 2.0 percent in 2000. Return on equity was also high. Net income after taxes increased from approximately 28 percent of equity in 1999 to 38 percent in 2000.

SAMA is currently undertaking a self-assessment of its supervisory system in relation to the Basel Core Principles, using the "Core Principles Methodology." In addition, SAMA has taken a leadership role in educating banks on the proposed new Basel capital standards, including a sponsorship of a conference on the subject in early 2001. Also, banks were encouraged to participate in the survey conducted by the Basel Committee on the potential effects of the proposed standards.