

SUR/08/75

July 23, 2008

**The Acting Chair's Summing Up
Saudi Arabia—2008 Article IV Consultation
Executive Board Meeting 08/67
July 21, 2008**

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the continued strong growth performance and highly positive external financial position, and concurred with the authorities' plans to expand oil production and refining capacity to support global oil market stability. They agreed that Saudi Arabia's medium-term economic prospects appear bright, with continued strong inflows and propitious conditions for the further development of the non-oil sector. At the same time, inflation, fuelled in large part by rising food import prices and infrastructure bottlenecks, has accelerated recently, and poses the main challenge for the authorities in the period ahead.

Directors emphasized that the macroeconomic policy mix should aim at sustaining job-creating growth while preserving domestic and external stability, with a critical focus on containing inflation. In view of the limitations imposed on interest rate policy by the currency peg, fiscal restraint will be critical. Directors observed that strengthening prudential measures to contain credit growth will also help to reduce demand pressures.

Directors recommended that public expenditure focus on investments in infrastructure, education and public services, with a view to diversifying the economy, encouraging job creation, and reducing dependence on oil income over the medium term. Introduction of a value-added tax would help diversify fiscal revenues away from oil and gas. While recognizing that many elements of this strategy are already in place, Directors urged the authorities to further tighten current spending, in particular for wages, and to target more narrowly large implicit water and energy subsidies. They also recommended anchoring one-year budgets in a rolling medium-term fiscal framework, and further improving the availability of fiscal data. Directors encouraged the authorities to develop a long-term strategy of accumulating foreign assets beyond stabilization purposes, so that the benefits of the current oil wealth can be shared with future generations.

Directors took note of the staff's finding that the Saudi riyal appears to be undervalued, given sizable terms of trade gains. At the same time, it was noted that the riyal is starting to appreciate in real effective terms due to higher inflation, and increased absorption through higher imports will reduce the current account surplus. Further expansion

of oil production will help global oil market stability, even if it will boost Saudi Arabia's external surpluses.

Directors observed that the peg of the riyal to the U.S. dollar has provided a credible anchor that has contributed to macroeconomic stability. Most Directors considered the benefits of maintaining the peg to outweigh the cost of higher short-term inflation, provided current inflationary pressures prove temporary. If, however, inflation should persist and the Gulf Cooperation Council monetary union be delayed, they recommended to consider also alternative exchange rate regimes. A number of Directors, however, were of the view that, given the limited role of monetary policy and the riyal's undervaluation, all policy options, including alternative exchange rate regimes, should remain under review. Directors urged the authorities to monitor inflation developments closely.

Directors noted that downside risks to the outlook include a sharp drop in oil prices and fresh external inflationary pressures that would arise from a further depreciation of the U.S. dollar or further increase in global commodity prices. Under such circumstances, Directors saw a greater role for monetary policy in stabilizing inflation.

Directors welcomed efforts to further liberalize the financial sector and strengthen its soundness. They looked forward to the adoption of a new mortgage law that would help clarify the legal framework for housing finance. They encouraged the authorities to continue fostering greater competition in the financial sector and developing the corporate market for Islamic bonds ("sukuk"). Directors commended the central bank for progress made in implementing Basel II.

Directors welcomed the authorities' recent subscription to the General Data Dissemination Standards. They encouraged the authorities to improve further the timeliness, availability, and comprehensiveness of key economic data, and to develop an action plan for subscription to the Special Data Dissemination Standards. They welcomed the authorities' intention to compile data on Saudi Arabia's International Investment Position for the public sector.

Directors commended the authorities for the substantial assistance Saudi Arabia has extended to developing countries, and its active support for the HIPC Initiative. They encouraged the authorities to restructure claims on Iraq in line with recent Paris Club reschedulings.

It is expected that the next Article IV consultation with Saudi Arabia will be held on the standard 12-month cycle.