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IMF Executive Board Concludes 2008 Article IV Consultation with Saudi Arabia

On July 21, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Saudi Arabia.[1]

Background

Saudi Arabia's macroeconomic performance in 2007 was strong. Real GDP grew by 3.5 percent, sustained by strong and broad based private non-oil sector growth (6 percent), especially in construction, retail trade, transportation and communication services. Inflation accelerated during 2007 and reached a historical high of 10.5 percent year-on-year in April 2008 driven by domestic demand pressures (especially rents) and higher import prices (mostly food). Higher oil prices contributed to a large current account surplus of US$96 billion (25 percent of GDP) despite a surge in imports. The surplus was used to build up the net foreign assets (NFA) of the central bank US$301 billion (19 months of imports).

The fiscal surplus declined to 12.3 percent of GDP due to higher-than budgeted spending and to a temporary decline in the proportion of oil receipts transferred from the state oil company (Saudi Aramco) to the budget owing to higher investment spending. Spending was driven mainly by capital expenditures and a higher wage bill.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Monetary policy was accommodative, given the peg to the U.S. dollar, and despite efforts to sterilize the build up in NFA. Broad money grew by 20 percent in 2007, similar to 2006, but private sector credit growth more than doubled to 21.4 percent. The central bank sought to contain the expansion in monetary aggregates by raising reserve requirements in late 2007 and early 2008. Speculation for a revaluation of the riyal emerged in 2007 and was reflected in forward premia in offshore futures markets.

The stock market rebounded in 2007 with an increase in the main stock exchange index (TASI) by 44 percent during 2007, following a major correction in 2006. However the TASI followed global markets downwards in early 2008. Anecdotal evidence suggests that real estate prices increased by double digits in 2007.

Structural reforms contributed to an improvement in investor confidence, record foreign direct investment (FDI) inflows, and strong non-oil private sector growth. A major reform and investment program has been launched to address weaknesses in education, health, utilities, and the judiciary.

The outlook for 2008 remains favorable. Real GDP growth is projected to reach 5 percent with a rebound in oil output to 9.2 million barrels/day and a further acceleration in non-oil growth. Reflecting higher oil prices, a record current account surplus of US$191 billion (35 percent of GDP) is projected despite continued strong import growth. The overall fiscal surplus is expected to more than double to 30.4 percent of GDP, and public debt is envisaged to shrink further to 11 percent of GDP. Inflation is projected to peak around 10.6 percent in 2008, exacerbated by rising imported commodities and domestic supply constraints, but to ease in subsequent years.

Executive Board Assessment

Executive Directors 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 progress made in compiling Saudi Arabia's International Investment Position data 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 Heavily Indebted Poor Countries (HIPC) Initiative. They encouraged the authorities to restructure claims on Iraq in line with recent Paris Club reschedulings.

Saudi Arabia: Selected Economic Indicators, 2004–08

	2004	2005	2006	Prel. 2007	Proj. 2008
			(Percentage change)		
Production and prices					
Real GDP	5.3	5.6	3.0	3.5	5.0
Real oil GDP	6.7	6.2	-0.8	0.5	4.3
Real non-oil GDP	4.6	5.2	5.1	4.8	5.3
Nominal GDP (in billions of U.S. dollars)	251	316	357	382	540
Consumer price index	0.4	0.6	2.3	4.1	10.6
			(In percent of GDP)		
Fiscal and Financial variables					
Central Government revenue	42.2	48.0	50.8	44.9	56.5
Of which: oil revenue	35.2	42.7	45.3	39.3	50.7
Central Government expenditure	32.1	29.6	29.8	32.6	26.0
Fiscal balance (deficit -)	10.0	18.4	21.0	12.3	30.4
Change in broad money (in percent)	18.8	11.6	19.3	19.6	24.6
Interest rates (in percent) 1/	1.7	3.8	5.0	4.8	2.2
			(In billions of U.S. dollars)		
External sector					
Exports	126.2	180.8	211.3	234.3	377.7
Of which: Oil and refined products	110.9	161.8	188.5	206.4	344.2
Imports	-41.1	-54.6	-63.9	-82.7	-107.8
Current account	52.1	90.6	99.6	95.8	191.7
Currrent account (in percent of GDP)	20.8	28.7	27.9	25.1	35.5
SAMA’s net foreign assets	86.5	150.5	221.4	301.3	437.5
SAMA's net foreign assets (in months of imports of goods and services)	11.8	15.8	18.2	19.0	23.1
Real effective exchange rate (percent change)	-6.7	-2.7	-1.6	-2.8	...

Sources: Data provided by the authorities; and IMF staff estimates.
1/ Three-month Saudi Arabian riyal deposits. Period average.