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Saudi Arabia Information Technology Report Q2 2005

Including 4 year industry forecasts

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Including 4-year industry forecasts by BMI

Part of BMI's Industry Report & Forecasts Series

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Executive Summary

Overview

The Saudi IT market is likely to continue to be a leader in the regional IT products and services market over the forecast period, benefiting from the impact of the 2004 oil boom, better than expected performance by the non-oil private sector, and government initiatives such as the 'Home Computing Programme.' The total size of the IT market is expected by BMI to increase from US$3.2bn in 2005 to around US$4.2bn in 2008, with software and services displaying the fastest growth over the forecast period. Fastest growing verticals are likely to include communications, where the mobile telecoms market has opened up to competition this year, and media/broadcasting, as well as real estate, where spending on IT products and services is estimated at around US$38mn this year.

Computer Sales

Computer sales were estimated at US$1.2bn for 2005, up from US$1.1bn in 2004. Overall, hardware accounts for around 52% of IT spending, but this share is expected to fall slightly over the forecast period due to a demand for more sophisticated services and solutions that meet the needs of whole organisations. However, hardware spending will be sustained by fast growth in demand for mobile computers and higher-end desktops.

Internet

The number of Saudi internet users is expected to increase over the forecast period from 3.1mn in 2004 to 7mn in 2008. Internet penetration rate will more than double from 9.6% in 2004 to 24.8% in 2008. With Batelco now committed to modernising its infrastructure, the number of broadband subscribers should increase from 70,000 to 1.7mn over the same forecast period.

Government Initiatives

In a major move to spread computer literacy, the Saudi Arabian Telecoms and IT Commission (SAT&IT) has concluded a deal to import one million computers for distribution among the population.

Meanwhile, in a new departure for the domestic IT sector, Saudi Arabia is to establish the first of a series of high-tech industrial zones in the Eastern Province.

Company News

Toshiba Computer Systems announced at Gitex Saudi in April (see Industry Developments) that it had formed a partnership with one of Saudi's top retail organisations, **Abdul Latif Jameel Electronics Company** (ALJ Electronics), to establish a creative new route to market. The move by Toshiba capitalises on the Saudi company's well known USI (United Installment Scheme) finance option.

Meanwhile, **McAfee**, the leading pure play IT security company, has launched **Foundstone Enterprise** in Saudi Arabia. The launch coincides with the formation of a dedicated team to address the Saudi market.

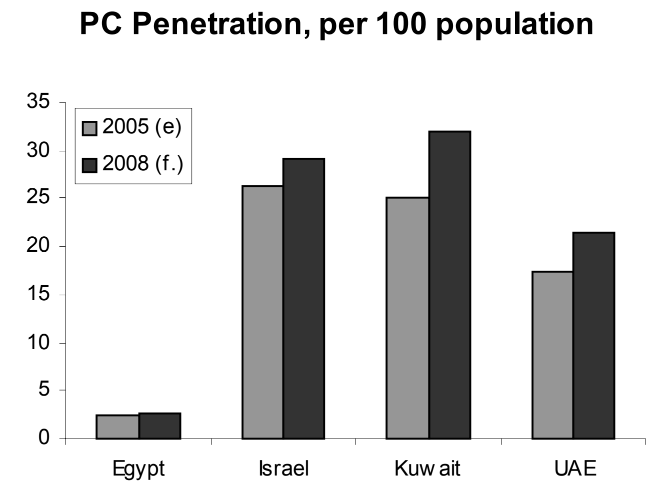
Saudi Arabia IT Sector SWOT	
Strengths	▪ Largest regional IT market, with projected spending of US$3.2bn in 2005 ▪ Maturing market, with growing demand of more sophisticated IT Services including outsourcing.
Weaknesses	▪ Absence of competition in fixed line telecommunications is a constraint on the business environment, especially because it retards the growth of the internet. ▪ Political inertia an inhibitor of economic liberalisation and reform that would unleash IT spending.
Opportunities	▪ Strong economic growth and the high price of oil is fuelling spending in the non-oil private sector economy, as well as public sector organisations and enterprises ▪ The CITC 'Home Computing Initiative' will make it easier for up to one million Saudi families to own a PC ▪ Increasing focus on software spending. According to a recent survey of 160 companies, over 75% of manufacturing, services and trading companies in Saudi Arabia are considering new deployments or upgrades of ERP solutions.
Threats	▪ Vested interests will continue to block economic reforms and initiatives in key areas. ▪ Current high oil prices will further delay drive to develop non-oil private economy.

Saudi Arabia Business Environment SWOT	
Strengths	▪ Geographically, the Kingdom is well placed for firms looking to establish a base in the region. ▪ According to the international anti-money laundering body Financial Action Task Force (FATF), the Kingdom has made some recent progress in introducing measures aimed at combating the financing of extremist groups.
Weaknesses	▪ The education system is not attuned to the needs of the private sector, with only limited technical training. ▪ Privatisation has been slow and, given the government's aim of increasing employment, ongoing political obstacles are likely.
Opportunities	▪ The government is investing in training as part of its efforts to 'Saudise' the workforce (i.e., to increase the proportion of nationals in the workforce relative to foreigners). ▪ The government's membership of the Gulf Co-operation Council (GCC) means it benefits from duty-free access to markets in Bahrain, Oman, Kuwait, Qatar and the UAE.
Threats	▪ The Saudisation process has been slow. Many Saudis perceive a stigma attached to semi-skilled jobs and tend to have higher wage expectations than expatriates. ▪ Perceptions of high political risk have added to the costs of insurance and of private security guards.

Middle East Regional IT Markets Overview

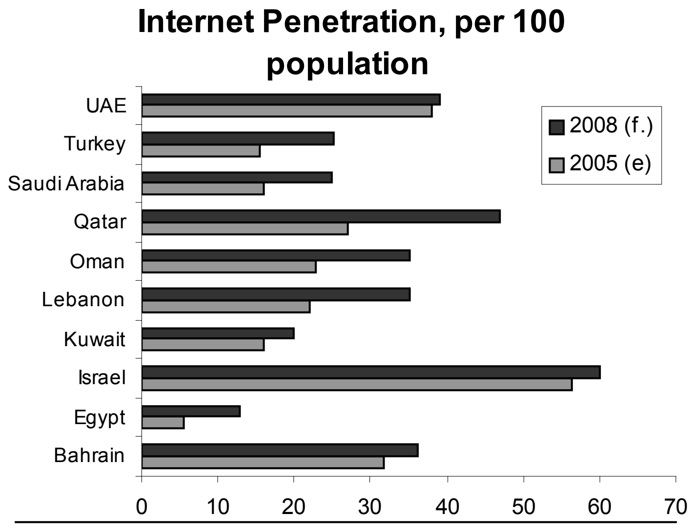
IT Penetration

Across the Middle East region, while lack of "e-preparedness" is also a market restraint, we anticipate a growing emphasis on computer education, and programmes aimed at making computers more affordable, and increasing the competitiveness of SMBs.



Source: BMI research

Our data illustrates a wide range of levels of PC penetration, from 2.4% in Egypt to 26.4% in Israel. At the same time, forecasts though 2008 reflect the unsaturated nature of all these markets, and corresponding vendor opportunities. Much will depend on government initiatives, such as the Egyptian 'PC for Every Home" or the Saudi 'Home Computing Initiative,' as well as programs aimed at bringing public services online.



Source: BMI research

A similar range is found with Internet penetration, where Egypt is once again lowest with 5.4% and Israel highest with 56.4%, while even in major regional markets such as Saudi Arabia, Turkey and Kuwait, penetration is barely 16%. Internet penetration in the UAE was estimated at around 37% in 2004, far above the MENA average, reflecting the Emirates' status as one of the most advanced IT countries in the region.

Even in the region's wealthier countries, there is therefore more of a digital divide than found in the US and other developed countries. For example, in Israel only 3% of the bottom income group have home internet access.

Aside from Egypt, fastest growth of internet subscribers in relative terms is expected in Qatar, driven in part by the 2006 Asian Games. Dial-up technology is still the dominant internet access format; however, the number of broadband subscribers will continue to gain ground steadily.

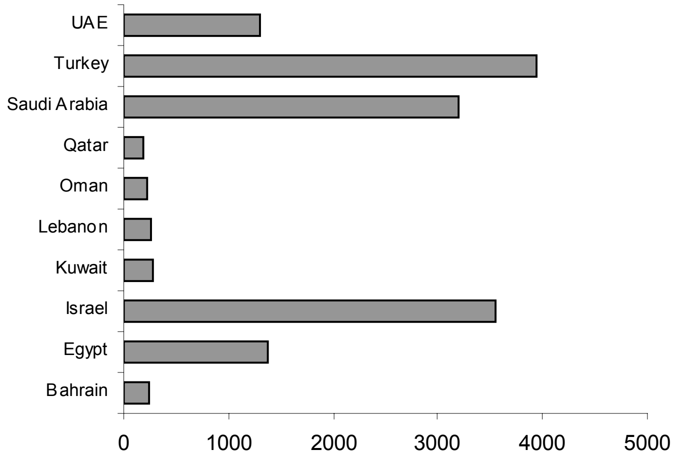
Market Growth and Drivers

The largest IT market in the region is Turkey's, estimated at US$3.9bn, followed by Israel (US$3.5bn) and Saudi Arabia (US$3.2bn).

However, Israel's IT market is largest as a proportion of national GDP (2.9%). This places it well ahead of Turkey (1.2%) which is actually on a par with Egypt (1.2%) and behind such countries as Saudi Arabia (1.6%) and Bahrain (2%).

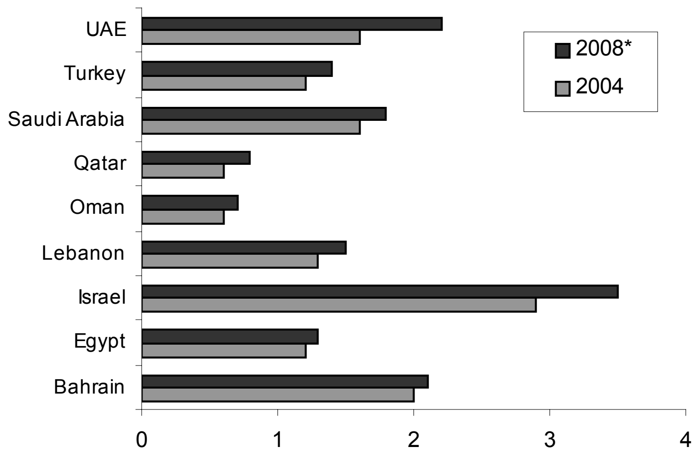
In the Arabian Gulf, strong economic growth and the high price of oil should fuel spending by both public sector organisations and enterprises to bring their IT levels up to international standards. The proposed elimination of customs duties within the GCC should also help stimulate the market, as will growth in the non-oil private sector, and liberalisation in certain sectors such as telecoms.

2005 IT Market Sizes,US$ mn (est.)



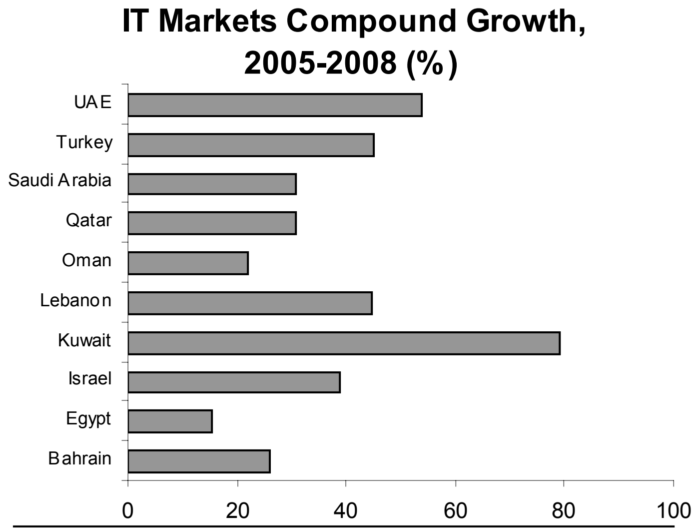
Source: BMI research

IT Market Sizes as % of National GDPs



*Source: BMI research * (2006, Qatar, Turkey; 2007, Israel, Lebanon)*

The Egyptian IT market should sustain moderately fast growth over the forecast period, benefiting from improved economic conditions, and a generally supportive government's programmes to encourage the IT sector. Similarly, the Israeli IT market should benefit from an improved economic and security situation.



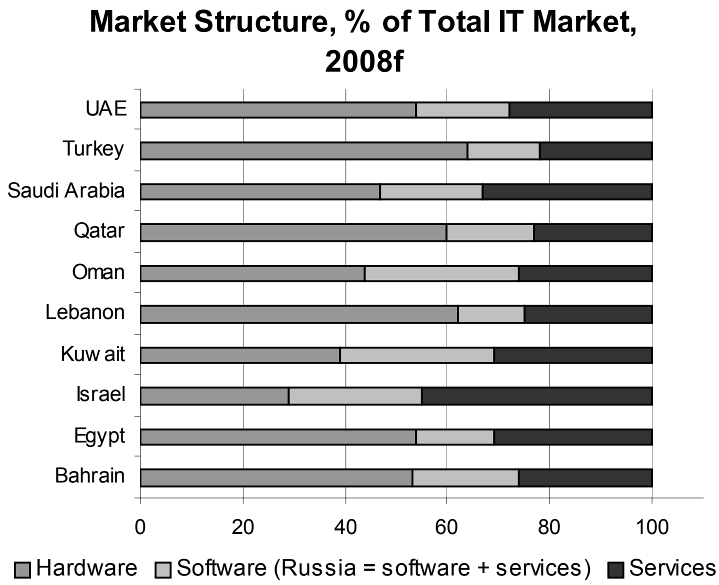
Source: BMI research

However, the fastest growing IT markets over the forecast period are set to be Lebanon (44.6%), emerging as a regional services hub, and Turkey (45.2%). In the case of Turkey, spending will be boosted by the prospect of future EU membership, as Turkish businesses and state institutions invest to compete. Turkey also benefits from an economy growing far stronger than Middle Eastern or Eurozone peers.

In each case, the prospects for more rapid IT market growth are directly correlated to the success of government initiatives. Across the region, generally positive growth scenarios could be threatened by a slowdown in the global or US economy, or renewed concerns about terrorism.

There is also concern about falling prices, partly as a result of the slowdown in IT spending in recent years, which enhanced customer market power and added pressure on pricing and margins. Lack of access to finance has also proved to be a stumbling block.

Sectors and Verticals



Hardware still dominates the regional IT spend, accounting for between 40% and 60% of the total for all markets, save Israel (30%). While there is a trend in the more mature markets towards greater demand for applications and services, the hardware share will largely be sustained by initiatives like the afore-mentioned Egyptian and Saudi schemes to drive PC penetration.

Desktops represent over 90% of most markets still and, despite growing enthusiasm for notebooks, are likely to remain dominant.

Spending on software as a share of total IT spend is as low as 13% in Egypt and Turkey, and below 20% in a majority of markets. The highest percentages are found in Israel, Oman, and Kuwait. One explanation for low spending is the presence of software piracy, with across the region, up to 80% of software counterfeit. Another important factor is of course low income, and the high costs of operating systems such as Windows has led some players to champion the cause of Linux.

However, we are detecting an increasing focus on software spending. According to a recent survey of 160 companies, over 75% of manufacturing, services and trading companies in Saudi Arabia are considering new deployments or upgrades of ERP solutions. During the next five years, high growth categories are set to include storage and security products, as well as customer relationship management (CRM) and enterprise resource planning (ERP).

Spending on software is shifting towards the SMB segment. BMI predicts plenty of room for growth in the forecast period as numerous untapped sub-sectors still exist. With deregulation in certain sectors expected, demand for more complex software should increase in an environment of greater competition.

BMI predicts that IT services will be the fastest-growing segment of the region's IT industry, as vendors shift their focus away from simply shifting boxes. Some IT services markets, such as UAE, are showing clear signs of maturity, reflected in increasing adoption of advanced IT services such as outsourcing and managed hosting. In other countries, such as Egypt, fast growing IT sectors are starting to create demand for larger projects. Support and maintenance typically account for around 35% of IT services spend. Other groups growing particularly fast include outsourcing and training services.

While the private sector accounts for the majority of domestic IT spending, the share of government spend is likely to remain above 40% in nearly all countries due to continuing e-government initiatives. Banks and telecoms operators are increasing their IT purchasing and this may well increase as a result of government programs to boost competitiveness in these sectors. Investment should also be strong in the oil, gas and telecoms verticals, and one should also mention the booming Gulf real estate sector.

Overall, there is shift in market focus from larger enterprises towards the SMBs which constitute the mainstay of most regional economies. With regard to consumer IT spending, there is the potential for this to go higher, but much depends on support from governments.

Market Overview

Government Authority

Government Authority	**Ministry of Communications and Information Technology**
Minister	Muhammad Jameel bin Ahmed Mulla
Government Authority	**Communications and Information Technology Commission**
Governor	Dr. Muhammed Al-Suwealm

The Ministry of Communications and Information Technology was established in 2003, replacing the former Ministry of Post, Telegraph and Telephones, in a move designed to bring responsibility for modern communications technologies under one roof.

Similarly, the Communications and Information Technology Commission (CITC) replaced what was formerly the Saudi Communications Commission. The Commission's "mission" is to ensure the provision of high quality Universal Telecoms and IT services at affordable prices. At a practical level, this means the preparation of all statutes required to achieve the objectives stipulated in the Telecommunicatons Act and the Ordinance of the Communications and IT Commission.

History and Market Structure

Saudi Arabia is a leader in the regional IT market, with projected spending of US$3.2bn in 2005, according to BMI estimates. This represents growth of about 10%. The relative maturity of the market is shown by a sizable and growing IT Services segment, estimated at around US$977mn for 2005. There is a trend towards broader IT solutions that meet the needs of the whole organisation. According to a recent survey of 160 companies, over 75% of manufacturing, services and trading companies in Saudi Arabia are considering new deployments or upgrades of ERP solutions.

The IT industry in Saudi Arabia is largely concentrated in three major areas of the country - Riyadh, Jeddah and Dammam. Riyadh by is by far the largest and most important IT incubator in the country, and most of the government agencies that sponsor R&D are located there

The National IT Plan (NITP) project, was launched by a decree of the Crown Prince in late 2001, steered by a committee under the Ministry of Interior. The plan outlined initiatives to establish an IT industry that could evolve into the second or third largest contributor to the Kingdom's economy. One core objective is the establishment of a home-grown software development industry.

Although a relatively un-liberalised communications environment has acted as a constraint on the market, Saudi Arabia is currently undergoing a transformation of its existing telecommunications sector starting with a US$4.2bn contract to modernise the infrastructure in 1994. Moves are afoot in 2005 to introduce more competition in both fixed line and mobile (see Industry Developments.)

In recent years and with the increase of global trade in Saudi Arabia, many vendors have called for better enforcement of these IPR laws with relation to software. Early efforts were mainly concerned with the audio and video materials. Unfortunately, a high piracy rate persists, with estimates placing it around 75%.

Hardware

Computer sales were estimated at US$1.2bn for 2005, up from US$1.1bn in 2004. The computer market has grown 15% since 2002, according to BMI figures, boosted by the growth rate in notebook shipments, and several large projects, particularly in the government administration sector. Server sales are estimated at US$384mn in 2005. Overall, hardware accounts for around 52% of IT spending, but this share is expected to fall slightly over the forecast period, due to a demand for more sophisticated services and solutions that meet the needs of whole organisations. However, hardware spending will be sustained by fast growth in demand for mobile computers and higher-end desktops. Laptop sales are increasing several times faster than computers overall, accounting for around 37% of sales in 2004. Strong economic growth and the high price of oil is fuelling spending by both public sector organisations and enterprises to bring their IT levels up to international standards. The proposed elimination of customs duties within the GCC should also help stimulate the market, as will growth in the non-oil private sector, and liberalisation in certain key sectors such as telecoms. Finally, CITC plans to import one million computes for distribution among Saudis on an easy-installment payments plan (see Industry Developments).

Software

The domestic software market is expected to grow significantly, driven by an increased focus by Saudi enterprises on more sophisticated solutions that still offer value for money. BMI predicts a value of US$608mn in 2005, up from US$522mn in 2004. Enterprise applications should account for around US$170mn, with **SAP** having a solid presence in the Kingdom and deriving substantial revenues from license and maintenance revenues. According to a recent survey of 160 companies, over 75% of manufacturing, services and trading companies in Saudi Arabia are considering new deployments or upgrades of ERP solutions. Overall, with the evolution of the Saudi IT market, a stronger focus on software spending is now being seen, with higher than expected oil revenues fuelling spending on new systems. Oil and gas was the largest vertical purchasing in 2004, followed by telecoms. Saudi domestic software companies are more advanced than their hardware equivalent, supplying a variety of Arabic language products to the local market.

Services

The Saudi IT Services market is estimated at reaching US$992mn in 2005, up from US$870mn in 2004. Support and maintenance accounted for around US$308mn of the 2004 figure. To meet the new demand for broader solutions packages, IT services providers have been consolidating operations through mergers or by expanding service portfolios. The use of sub-contracting has also increased, including support. **HP, Deloitte** and SAP all have a direct presence in the Kingdom, while **IBM, Oracle** and **Accenture** operate through regional offices and partners. In addition there are many large local integrators including **Saudi**

Business Machines, Ebttikar, Jeraisy Computer and Communication Services, Arabic Computer System, Al-Alamiya, Abdulla Fouad, and **Al Khaleej**.

End-User Analysis

Oil and gas will remain the largest spending vertical in 2005, boosted by higher than expected oil prices. However, oil revenues are also fuelling growth in the non-oil private sector economy. Liberalisation is occurring in selected sectors, particularly telecoms, where the mobile telecoms market is opening up to competition this year. Yet there is still no competition in the fixed-line market. In the absence of competition, the relative weakness of the fixed-line network is a constraint on the business environment, especially because it retards the growth of the internet, which could potentially create new business opportunities. The CITC 'Home Computing Initiative' will boost the household sector, while here as elsewhere, SMBs are becoming a major focus of vendor attention. Security products are a particular growth area, with McAfee recently opening a local office (see Competitive Landscape).

Industry Developments

In a major move to spread computer literacy, the Saudi Arabian Telecoms and IT Commission (SAT&IT) has concluded a deal to import one million computer sets for distribution among Saudis on an easy installment payment scheme. The initiative was announced recently by Dr. Muhammed Al- Suwaiyel, Governor of the Saudi Arabian Communications & IT Commission (CITC), addressing a group of businessmen at the Chamber of Commerce and Industry in Dammam. Those wishing to purchase a computer through the scheme will be able to spread the cost through monthly installments of SAR100 for a period of up to four years. The commission plans to launch further initiatives to develop a regulatory environment conducive to the provision of high quality affordable universal communications and IT services.

It is hoped the Home Computing Initiative will make it easier for a million Saudi families to own a high quality PC, along with internet access and training. The initiative was also described by Al-Suwaiyel, CITC governor, as a model for partnership between public and private sectors. CITC signed MOUs in May with a number of companies participating in the scheme. They include **Microsoft Arabia** (OS & desktop applications) **Zai** of **Alfaisaliah Group** (PC manufacturer), Alkhaleej- New Horizon (training provider), AwwalNet and Mesma (ISPs). Earlier, MOUs were signed with **National Commercial Bank** and **Saudi Telecom**.

Al-Suwaiyel also said the Commission will license a third mobile phone operator in Saudi Arabia by the end of 2006. A second fixed-line operator will also be licensed to open competition in the sector, currently monopolised by STC. There will also, for the first time, be an opportunity for international bidders to bid for a fixed-line license. The move comes as part of the Commission's strategic plans to open the telecoms market, because of WTO requirements. The Commission has not yet announced any plan to grant a license for data transmission service before 2006.

In a separate development for the domestic IT sector, Saudi Arabia is to establish the first of a series of high-tech industrial zones in the Eastern Province. Officials said the 35m ft^2 zone would shortly invite foreign investors to participate in the zone on a build-operate-transfer basis. The set-up cost will be around US$70mn.

Finally, in April, Minister of Telecom and IT Mohammad Mulla opened Saudi Gitex 2005, the fourth convening of the international IT show in the kingdom. The minister said the show underlined the kingdom's high status in the telecoms and IT market

Industry Forecast Scenario

The Saudi IT market is likely to continue to be a leader in the regional IT products and services market over the forecast period, benefiting from the impact of the 2004 oil boom, better than expected performance by the non-oil private sector, and government initiatives such as the 'Home Computing Programme.'. The total size of the IT market is expected by BMI to increase from US$3.2bn in 2005 to around US$4.2bn in 2008, with software and services displaying the fastest growth over the forecast period. In 2005, after an estimated expansion of at least 5% in 2004, non-oil private sector growth should continue on an above-average trend, as 2004's oil receipts continue to feed through into other sectors and interest rates remain low. Since oil still accounts for more than a quarter of GDP, growth will then dip in 2006 as oil prices fall. However, we do not expect a contraction: fiscal policy is less pro-cyclical, and the non-oil sector stronger, than in the past. In 2005, the economy should expand by 2.7% year-on-year (y-o-y), as export revenues accrued in 2004 continue to feed into the non-oil sector. However, we expect growth to dip to 1.1% in 2006, rising somewhat to 2.2% in 2007. The share of hardware in total IT spend is forecast by BMI to fall slightly during the forecast period from 52% to 47%, with services accounting for about 31% of spending.

Growth in the non-oil economy has predictably fallen down the agenda, but would drive demand for IT products and services across a number of sectors. Moves to liberalise the insurance and telecoms sectors are promising, but the Kingdom will face competition from Gulf peers such as Bahrain, Oman and the UAE, all of which enjoy more developed services sectors. Large-scale portfolio investment flows into insurance and telecoms shares imply considerable investor optimism about the services sector. Still, FDI flows (which tend to be more stable than portfolio capital movements) remain vulnerable to security shocks, especially in light of the militant attacks on Western expatriate workers last year. In any event, government plans to establish a series of hi-tech industrial zones should be helpful. Fastest growing verticals are likely to include communications, where the mobile telecoms market is opening up to competition this year, and media/broadcasting, as well as real estate, where spending on IT products and services is estimated at around US$38mn. The telecoms market as a whole is growing at about 30% per year. Continuing expansion at this level will improve the business environment and therefore facilitate growth in other sectors. As elsewhere, SMBs are becoming a focus of vendor attention.

Household demand for IT products and services would also benefit from improved internet connectivity, which probably requires liberalisation of the fixed line market. However, the whole IT sector should receive a boost from the government's 'Home Computing Initiative,' designed to make it easier for one million Saudis to own a high quality PC, particularly if the programme does not depend on cheap low-quality generic imports. Overall, the hardware market is predicted to grow from US$1.5bn in 2004 to US$2bn in 2008, with computer sales rising from US$1.1bn to US$1.5bn over the same period. Software spending will rise from US$522mn to U$836mn, and services from US$870mn to US$1.4bn. The number of broadband subscribers is projected to increase from 70,000 to 1.7mn over the forecast period.

Table - Saudi Arabia IT Historical Data & Forecasts

	2002	2003	2004e	2005e	2006e	2007e	2008e
IT Market (US$mn)	2,530	2,670	2,900	3,200	4,000	3,837	4,182
IT Market as % nominal GDP	1.4	1.3	1.4	1.6	1.7	1.7	1.8
Hardware (US$mn)	1,316	1,388	1,508	1,600	2,000	1,803	1,966
Services (US$mn)	759	801	870	992	1,000	1,266	1,380
Support/Installation Services (US$mn)	266	280	305	347	350	443	483
Software (US$mn)	455	481	522	608	720	767	836
Enterprise Application Software (US$mn)	118	125	141	170	202	215	234
Computers (including notebooks and accessories) (US$mn)	1,000	1,055	1,146	1,216	1,520	1,371	1,494
Servers (US$mn)	316	333	362	384	480	433	472
Internet Users (000)	1,600	2,250	3,100	3,900	5,100	6,300	7,000
Internet users (per 100 pop)	7.3	7.0	9.6	16.0	20.3	23.8	24.8
No of Broadband Internet Subscribers ('000)	5	30	70	250	800	1,400	1,700

Sources: BMI, US Commercial Service, SAT&IT, ISI, ITU, IDC

Macroeconomic Forecast Scenario

BMI's oil desk has revised our OPEC basket price forecasts up to US$41/barrel (/b) in 2005, sliding to US$30/b in 2006 and 2007. This revision is essentially due to two factors; higher-than-expected prices in Q105 and the likelihood of stronger demand in the remainder of the forecast period. Potential risks to supply persist (mainly from political risk in key producer states such as Iraq, Nigeria, Venezuela and Russia as well as – to a lesser extent – Saudi Arabia), meaning there are ongoing upside risks to our oil price forecasts.

Our forecasts for Saudi Arabia's growth, exports, government revenue and reserves have been revised up as a result of our revised oil price scenario. Higher oil prices do not have a direct impact on real growth in the oil sector, as real growth statistics are based on increases in volume (so as not to be distorted by inflation), while nominal growth statistics take rising prices into account. However, higher oil prices do feed through into higher growth in the non-oil sector, through their impact on government spending and private consumption.

In Q105, real GDP grew by an estimated 3.5% year-on-year (y-o-y). This was supported by firmer-than-expected oil prices; the OPEC basket is estimated to have averaged US$44/b during that quarter. In the latter part of Q1, prices started to come down; a trend that we expect to continue later in the year. We project an average Q205 OPEC basket price of US$38/b. As prices slide to an expected annual average of US$41/b from the US$44/b seen in Q1, real growth is also likely to come down marginally from its Q1 level. **BMI** expects real GDP growth of 3.2% for 2005 as a whole.

The rate of growth will then fall further as oil prices continue to go down, however there will be some time lags. As such, although oil prices are projected to fall by over a quarter in 2006, we anticipate only a moderate slowdown in growth to 2.3%. This view illustrates the lag between lower oil revenues and the consequent slowdown in consumer spending, private investment and government expenditure.

By 2007, lower oil revenues will have dampened confidence, curbing consumption and investment, while also forcing the government to rein in expenditure. Assuming that the oil sector grows by 1.5% in real terms, while the non-oil sector sees low growth of 1.3%, total real GDP growth will be 1.4% in 2007. While certainly a comedown, this would not be as poor as in 2001-02, when real growth averaged 0.3% per year. This is because, in 2001 and 2002, the oil sector actually contracted. By contrast, while we expect 2005 oil production to be marginally lower than that seen in 2004, we expect oil output to grow by 1% in 2006 and 1.5% in 2007.

Yet upside risks persist. The first major risk comes from oil prices. If OPEC hikes its target band to around US$40/b, which remains a possibility, higher oil prices will pose a major upside risk to Saudi growth. The second comes from oil production. Our forecasts assume that Saudi oil output will average

9.5mn b/d in 2005, which constitutes a 5% decline on 2004 levels. However, output is likely to rise above this in Q2. As Saudi Arabia takes on the bulk of OPEC's May production increase, in order to cool prices down, it is expected to pump around 10mn b/d.

If this production increase were to be sustained through the rest of the year, our assumption of negative real growth in the oil sector would no longer hold, while oil revenues would also be higher than expected (unless the production increase were large enough to push average OPEC basket prices below the annual average of US$41/b which we have forecast, which seems highly unlikely on the basis of our world demand forecasts.) This would result in growth of at least 4.5%.

Non-Oil Challenges

Non-oil growth currently continues to benefit from the oil-induced boom in regional demand, but the key question is how it will hold up in the face of lower oil prices. The government has made efforts to promote investment with a series of new laws on corporate tax, mining and capital markets, among others. The decision to slash corporate tax from 45% to 20% will certainly be a draw, and should compensate for the increases in insurance and security costs over the past year. The government has also established an array of new agencies and regulatory authorities, intended to strengthen the institutional framework. We remain somewhat concerned that creating a plethora of new institutions may not be the best way to cut bureaucracy.

According to the Ministry of Finance, the non-oil industrial sector grew by 6.4% in real terms in 2004. Breaking this down by sectors, construction grew by 7.5%, utilities (electricity, gas and water) by 4.5%, transport and communications by 7.8%, and shops, restaurants and hotels by 4.9%. This impressive growth was largely spurred by the expanding oil sector, which experienced nominal growth of 28%. However, growth could well have been higher were it not for the wave of militant attacks in mid-2004. Although the government may be making progress in rooting out militant cells, the country will continue to face relatively high political and security risks over the forecast period, while we also expect lower oil prices to curb demand. Both trends pose downside risks to growth, while the government's efforts to attract investment – both through real changes in costs and rewards and through a well-funded communications strategy – represent a key upside risk.

Aware of the need to diversify away from oil, the government is keen to attract foreign direct investment in order to increase indigenous knowledge and skills. According to the head of the Saudi General Investment Authority (SAGIA), the government will focus its efforts on attracting investment to sectors that relate to energy (such as petrochemicals), transport and 'knowledge-based industries'. The latter category includes education and training as well as information and communication technologies (ICT):

the government hopes to attract high-profile international universities to set up branches or programmes in Saudi Arabia, in order to address the existing mismatch between education and job opportunities.

The decision to slash corporate tax by more than half will certainly appeal to investors. The government needed to increase the rewards available to businesses, as insurance costs have risen, while many (especially Western) firms have increased spending on private security firms, both a direct result of the upsurge in militant violence last year. Furthermore, intensifying competition from other markets in the Gulf represents a persistent upside risk to wages in Saudi Arabia: firms may have to increase salaries in order to attract and retain skilled senior workers who could be offered jobs in lower-risk neighbours such as Dubai.

The government has also re-organised some of its economic ministries and agencies in an attempt to streamline the notoriously fractured decision-making process. New institutions include a supreme tourism commission and a capital markets authority as well as regulators in the electricity, water, gas and telecoms sectors. The government has also set up SAGIA, designed to be a one-stop shop for new investors, which will be a useful guide for potential investors who might otherwise be deterred by the country's complex bureaucracy. All the same, investors who **BMI** has spoken to still feel that a local partner is invaluable, and complain of the persistent risk of bureaucratic bottlenecks due to a lack of delegation in government agencies.

Table - Saudi Macroeconomic Data & Forecasts

	2001	2002	2003	2004f	2005f	2006f	2007f	2008f
Real GDP growth (%) [1]	1.0	1.4	3.7	5.6	4.7	4.4	4.3	4.0
Consumer price inflation (% y-o-y, eop) [1]	3.6	0.8	1.5	4.5	3.5	2.5	2.5	2.5
Exports fob (US$bn) [2]	41.66	46.74	61.01	70.16	74.37	78.09	82.77	87.74
Imports cif (US$$bn) [2]	49.32	53.99	66.73	74.74	78.48	83.97	89.85	96.14
Trade balance (US$bn) [2]	-7.66	-7.25	-5.73	-4.58	-4.11	-5.88	-7.08	-8.40
Current account (% of GDP) [2,3]	-2.8	-2.7	-1.7	-1.9	-1.5	-1.9	-2.2	-2.4
External debt (% of GDP) [2,3]	40.7	46.4	50.2	46.4	44.1	42.8	43.0	43.5

f = BMI forecasts (bold). Sources: [1] GUS. [2] National Bank of Saudi. 3 BMI.

Competitive Landscape

Competitive Landscape

Toshiba Computer Systems announced at Gitex Saudi in April (see Industry Developments) that it had formed a partnership with one of Saudi Arabia's top retail organisations, Abdul Latif Jameel Electronics Company (ALJ Electronics), to establish a creative new route to market. The move by Toshiba capitalises on the Saudi company's well known USI (United Installment Scheme) finance option, which makes high quality notebooks available to small and medium businesses, education and healthcare institutions and individuals. ALJ Electronics already distributes Toshiba's range of home and consumer electronics products. The company has 21 retail showrooms spread across the Kingdom. This scale means that ALJ is able to offer comprehensive support for Toshiba products, covering major cities and smaller towns.

Toshiba has had spectacular y-o-y growth in the Kingdom, growing its business volume between 2003 and 2004 by 63%. Currently, like other vendors, Toshiba is increasing its focus on the SMB segment, which is becoming a powerful driver of the economy.

Meanwhile, **Oracle** Middle East and Africa has hosted its largest-ever regional reseller meeting. Regional Oracle partners discussed strategies to increase profitability in the next twelve months through strengthening their vertical sector focus, responding to emerging demand in the mid-market, and scaling up with new technologies such as radio frequency identification. Oracle's Middle East based consulting team can boast a long list of customers in Saudi Arabia, including **Al Bank, Riyadh Bank**, and **Saudi Petroleum Investment Corporation**. As Oracle does not have a direct presence in the Kingdom, it serves the market from regional offices with the co-operation of partners such as **Raya Saudi**. Human Resource management implementations have been particularly successful, with recent customers including **Saudi Lighting** and Al Faransi. Oracle is also active in the financial sector, with **Rajhi Banking and Investment Corporation**, one of Saudi Arabia's largest financial institutions, recently finalising the second phase of a major business Oracle CRM initiative. Oracle consultants are managing the deployment. Finally, Oracle generates much business from the automotive sector with clients including **Abdulatif Jamil** (Toyota), **Abdullah Hashem Company** (Honda) and **Arabian Automobiles** (Nissan).

In Q1 2005, **HP** took a 43.6% share of the Saudi desktop market, according to recent IDC figures (see Industry Profile). Recently, HP ran a series of events called the HP and Open Source Roadshow, which stopped in Riyadh on March 23 2005. The event was also supported by key HP partners, including **Intel, Novell**, Oracle, and **RedHat**.

HP has also been showcasing its partnership with SAP through participation in the recent 'Best of SAP World Tour' aimed at helping business with new insights, best practices and contacts. In December 2003, HP opened a SAP Competency Centre in Riyadh. One of only 16 HP Competency Centres worldwide, the centre offers HP SAP Training Programmes, an HP Solutions Centre, and an HP Solutions Lab. It showcases the latest HP 'bolt-on' technology innovations created by HP for specific industries, and the breadth of HP Services division offerings, from Business Critical solutions to Consulting and Integration.

McAfee, the leading pure play IT security company, has launched Foundstone Enterprise in Saudi Arabia. The launch coincides with the formation of a dedicated team to address the Saudi maket and the appointment of Kenan Abou Lteif as the newly appointed territory manager for the Kingdom. McAfee acquired Foundstone in 2004 for US$86mn in cash. **Foundstone** has a customer base of more than 400 large enterprise customers including **AT&T, NASA**, **US Army**, **Nokia**, **Microsoft**, **Wal-Mart** and many more business organisations. In the Middle East, Foundstone is already successfully operational in several large companies. With Saudi the largest IT security market in the Middle East, McAfee is embarking on a more aggressive growth strategy, reflected in the appointment of its dedicated Saudi team, which will oversee market expansion for the product portfolio. This reflects the beginning of a more aggressive growth strategy for the company in the Saudi market.

Finally, **Sun** has successfully deployed a far reaching hardware and software solution at a Jeddah call centre operated by service providers **Frontlinters**. The technology infrastructure – which includes the provision of 50 Run Ray thin clients initially, will enable staff at the 24-hour call centre to provide voice, email, fax and SMS outsourced solutions for different companies in the country. The call centre can handle more than 15,000 call a day.

The solution was deployed in co-operation with **3iSolutio**n, Sun's local Saudi systems integrator, and regional channel development provider **Tech Access**. The contact centre provider was able to evaluate a mock-up of the solution at Tech Access's million dollar i-Force test centre located at its Dubai Internet City offices. Tech access is the only Datacentre Channels Development Provider of Sun products in the GCC, Levant , Saudi, Pakistan and North Africa region.

Company Monitor

Selected Profiles

Arabic Computer Systems

Arabic Computer Systems (ACS) is Saudi Arabia's leading IT company. ACS offers a comprehensive range of solutions and services catering to the IT needs of enterprise customers. Founded in 1984 the company has 400 employees. It ranked as the 43rd biggest company in the Kingdom in 2004, with revenues exceeding US$150mn, and the 82nd largest Middle East company.

ACS is part of the National Technology Group (NTG) of Companies, a multinational technology group with a presence in the Middle East, India, Sri Lanka and the USA.

The company offers a range of cross-industry products, applications and services to meet the majority of IT Infrastructure needs of its customers. Clients are mainly in the oil, telecoms, banking, and government sectors, and include Saudi Aramco, Saudi Telecom, Saudi Arabian Monetary Agency, Saudi American Bank, National Commercial Bank, and the Ministry of the Interior.

Address

- Al-Balla Building
  Old Airport Road
  Riyadh
  Saudi ArabiaTel:
- + 966 1 476 3777
- +966 1 476 3196

Key Statistics (H1, 2004)

- Year established: 1984
- Staff number: 400
- Total revenues (2004): US$150mn +

Key Personnel

- Chairman and Managing Director: Mohammed Rasheed Al-Ballaa

HP Saudi

HP is the largest global IT company in Saudi, employing about 150 people in the Kingdom. Locally derived services revenues were estimated at around US$46mn for 2004, of which around US$34mn were accounted for by support services. HP Services Middle East sees the Saudi market as important, and provides strong support to local partners from HP consultants. In December 2003, HP opened a SAP Competency Centre. One of only 16 HP Competency Centres worldwide, the centre offers HP SAP Training Programmes, an HP Solutions Centre, and an HP Solutions Lab. It showcases the latest HP 'bolt-on' technology innovations created by HP for specific industries, and the breadth of HP Services division offerings, from Business Critical solutions to Consulting and Integration. Recently, HP has been showcasing its partnership with SAP through participation in the 'Best of SAP World Tour' aimed at helping business with new insights, best practices and contacts. In 2004, HP started a strategic co-operation with Kuwaiti headquartered **Al-Alamiah** in Saudi Arabia (and Kuwait,) with an early result being a project for the **Saudi National Guard**.

In Q1 2005, HP took a 43.6% share of the Saudi desktop market, according to recent IDC figures. In the Middle East as a whole, HP took a 14% desktop share, almost double the share of the runner up for the region, and demonstrating 25.8% y-o-y growth from Q1 2004.

HP Educational Services is active in the Kingdom, with a recent e-learning project for the Saudi Ministry of Education involving teaching teachers and students how to use major Microsoft applications, including Windows, Explorer and Office.

Address

- Al Fasaliah Tower
  5th Floor, po Box 67280
  Riyadh 11598
- +966 1 273 1200
- +966 1 273 1202

Key Statistics

- Staff Number: 150
- Local IT Services revenues: (2004, est.): US$46 mn

Al-Falak-Al Khaleej

Al Falak is a wholly owned Saudi Arabian IT firm and part of the Al-Falak Al-Khaleej group. Founded in 1981, the company has over 500 employees and annual revenues in excess of US$100mn. The Al Falak software division provides solutions for integrated availability, performance, storage, security, applications development and database management. It has five offices servicing the GCC countries with its head office in Al-Khobar. Other offices are in Jeddah, Kuwait, Riyadh, and Bahrain. The company is targeting a 20% revenue rise in 2005.

Khaleej Computers Corp is a Saudi owned based and managed IT services company, which is a sole certified local distributor of HP products among others. Khaleej offers pre-sale support and after-sale support, including a one-year warranty on all equipment and maintenance assurance at the end of the warranty.

Address

- Al-Falak, Al-Mousa Center, Olaya Main Road, Fourth Floor, Tower C, Suite 342, PO Box 16091, Riyadh 11464, Saudi Arabia.
- Tel: +966 1 463-1474
- Fax: +966 1 465-2094

Key Statistics (Al-Falak)

- Year established: 1981
- Staff numbers: 500 +
- Annual revenues (est.): US$100 mn+

Key Personnel

- President & CEO Al-Falak: Ahmed Ali Ashadawi

BMI Forecast Modelling

How we generate our industry forecasts

BMI's industry forecasts are generated using the best-practice techniques of time-series modeling. The precise form of time-series model we use varies from industry to industry, in each case being determined, as per standard practice, by the prevailing features of the industry data being examined. For example, data for some industries may be particularly prone to seasonality, meaning seasonal trends. In other industries, there may be pronounced non-linearity, whereby large recessions, for example, may occur more frequently than cyclical booms.

Our approach varies from industry to industry. However, common to our analysis of every industry is the use of vector autoregressions. Vector autogressions allow us to forecast a variable using more than the variable's own history as explanatory information. For example, when forecasting oil prices, we can include information about oil consumption, supply and capacity.

When forecasting for some of our industry sub-component variables, however, using a variable's own history is often the most desirable method of analysis. Such single-variable analysis is called univariate modeling. We use the most common and versatile form of univariate models: the autoregressive moving average model (ARMA).

In some cases, ARMA techniques are inappropriate because there is insufficient historic data or data quality is poor. In such cases, we use either traditional decomposition methods or smoothing methods as a basis for analysis and forecasting.

It must be remembered that human intervention plays a necessary and desirable part of all our industry forecasting techniques. Intimate knowledge of the data and industry ensures we spot structural breaks, anomalous data, turning points and seasonal features where a purely mechanical forecasting process would not.

IT Industry

Forecasts

There are a number of criteria which drive our forecasts for each IT variable.

IT forecasting is complicated due to the fragmented nature of the market, with little transparency of vendor data, and low apparent agreement between many sets of figures in terms of market definition, base, and methodology. In addition, forecasts are naturally affected by consideration of a variety of internal and external political and economic factors.

Within best-practice techniques of time-series modeling, BMI's quarterly updated forecasts are improved substantially by intimate knowledge of the prevailing features of each local market.

Individual variables taken into account in creating each forecast include:

- overall economic context, and GDP and demographic trends
- underlying 'information society' trends
- projected GDP share of industry
- maturity of market structure
- regulatory developments and government policies
- developments in key client sectors such as telecommunications, banking and e-government
- technological developments, and diffusion rates
- exogenous events

Estimates are calculated using BMI's own macroeconomic and demographic forecasts.

Sources

Additional sources used in IT reports include national ministries and ITC regulatory bodies, national industry associations, and international industry organisations such as the ITU, officially released company results and figures, and international and national industry news agencies.

Appendix A: Global Economic Assumptions

Introduction

In this section, BMI presents the global assumptions that underpin both our macroeconomic and industry forecasts. The text is divided into four key sections. The first three - the US, Eurozone, Japan - discuss developments in the main global economies, while the fourth - oil - explains our view of the oil market, a key driver of global inflation and risk to long term economic growth.

The United States

The US In 2005

The US economy grew by an impressive 4.4% in 2004, following expansion of 3.0% in 2003. Growth is however set to slow over our forecast period, to a still-solid 3.7% in 2005, and 3.3% in 2006. In addition, with the current account deficit set to widen, and the fiscal deficit also likely to remain high, the economy is looking increasingly unbalanced.

Inflation in the US has accelerated over the past 12 months, reaching 2.7% at the end of 2004, compared with 2.3% at the end of 2003. Four main factors point to inflation remaining a concern over the next year. These include: lower levels of slack in the economy as capacity utilisation levels rise; increasing labour costs and slower productivity growth; high oil prices; and a still-accommodative monetary policy. As a result, inflation is set to average 2.2% in 2005, and 1.8% in 2006, according to BMI forecasts.

One major concern is that the Federal Reserve's recent tightening of monetary policy is being offset by higher inflation, with the result that real interest rates still remain very low. For example, the recent acceleration in core inflation has offset fully 74% of the 175 basis point increase in nominal Federal Funds rate over the current nine month tightening campaign. With inflationary pressures still a concern for the Fed, nominal interest rates are set to average 3.2% in 2005, and 4.5% in 2006, according to BMI forecasts.

Table: Global Assumptions

	2000	2001	2002	2003	2004e	2005f	2006f	2007f
Real GDP growth (%)								
US	3.7	0.8	1.9	3	4.4	3.7	3.3	3.4
Eurozone	3.6	1.6	0.9	0.5	1.8	1.4	1.8	2.1
Japan*	2.4	0.2	-0.3	1.4	2.6	0.6	1.3	1.2
World	4	1.4	1.7	2.6	4.1	3.3	3.3	3.4
Consumer inflation (year-end)								
US	3.4	2.8	1.6	2.3	2.7	2.2	1.8	2
Eurozone	2.6	2	2.3	2	1.9	1.6	1.9	2.1
Japan*	-0.8	-1	-0.5	-0.3	-0.1	0.7	-0.7	0.1
Interest rates (average)								
Fed funds rate	6.24	3.89	1.67	1.13	1.35	3.2	4.49	4.44
ECB refinancing rate	4.39	4.27	3.32	2.34	2.11	2.11	2.74	4.5
Exchange rates (year-end)								
US$/EUR	0.94	0.89	1.05	1.26	1.36	1.35	1.34	1.29
EUR/US$	1.06	1.12	0.95	0.79	0.74	0.74	0.74	0.77
JPY/US$	114.9	131.8	119.9	108.8	112.05	106.94	106.77	108.1
Oil prices (average)								
Oil - Opec basket US$/b	27.6	23.12	24.36	28.09	36.2	41	30	30

**Calendar-year basis, year-end inflation is average of fourth quarter compared with average of same period a year earlier; Source: BMI.*

Another even bigger concern is the widening fiscal deficit. Despite being in a healthy surplus of 2.6% of GDP in 2000, America's fiscal position has deteriorating significantly over the last five years, with the deficit in 2004 reaching 3.4% of GDP. While the Bush administration has said it is committed to halving the deficit by 2009, these promises are starting to look increasingly empty. In fact the situation could become worse before it starts to get better. Federal revenues in the US currently stand at only 16% of GDP, their lowest rate in 50 years. Despite this the Bush administration appears not only committed to getting the temporary tax cuts from his first administration made permanent, but is looking to push through new tax cuts, including big increases in tax-sheltered savings accounts. Coming at a time when the baby-boom generation is just starting to retire, which in itself is expected to significantly add to health and welfare spending, the US's fiscal deficit may well continue to deteriorate.

Despite the current lax fiscal policy, there has yet to be a reaction in the bond market, with US long-term interest rates still surprisingly low. However, this is mostly because in an effort to prevent their exchange rates appreciating against the US dollar, Asian central banks - most notably Japan and China - have picked up their purchases of US Treasury bonds. How long this continues for is however open to question.

The biggest concern about the US economy is the size of the US current account deficit, which reached an unsustainable 5.6% of GDP in 2004, compared to 4.8% in 2003, and is forecast to reach 5.8% in 2005.

The natural solution to America's large external balance would be a fall in the exchange rate, which would lower demand for imports, while making exports cheaper. However, while the US dollar has depreciated by over 50% against the euro over the last two years, it has fallen by nowhere near as much against the Japanese yen, and nothing at all against the Chinese yuan, the Hong Kong dollar, and the Malaysian ringgit (which are all pegged to the dollar). The forecast is therefore for the dollar to continue its fall against the euro, averaging US$1.34/EUR in 2005, while also experiencing a modest depreciation against the Japanese yen, averaging US$/JPY104.8. This however is unlikely to be enough to reduce the current account deficit to a more sustainable level.

The US In 2006 and 2007

The US economy is expected to enjoy solid, if unspectacular growth over the forecast period, with the economy expected to expand by 3.3% in 2006 and 3.4% in 2007. There are however few signs that economic growth will become more balanced over the same period.

The fiscal deficit shows no sign of any significant improvement. Revenue as a share of GDP is set to continue to fall as the government looks to continue with its tax-cutting agenda. Meanwhile, spending will probably continue to rise as the retiring baby boomers place an even greater burden on health and pensions. As a result, the fiscal deficit is set to remain above 3% of GDP in 2006 and 2007.

In addition, little is being done to reduce the size of the current account deficit. The administration will continue to put pressure on the Chinese to revalue their currency (pressure Beijing is likely to ignore). However little else is being done to reduce the budget deficit or to encourage consumers to save more - both of which are needed if the deficit is to be brought to a more sustainable level. As a result, the current account is set to remain at around 5% over our forecast period.

Japan

Japan In 2005: Economic Downturn

Japan's long-awaited recovery has been postponed once again. After showing a significant upturn in 2004, with strong export growth and a healthy current account balance, the economy appears to have passed its peak. The weakening external sector is the main cause of the slowdown, as the global economy moderates. But with signs of a slight improvement in consumer confidence, amid better job prospects, the economy will not go into recession. However, the upturn in the domestic sector is marginal, and we therefore forecast a slowdown this year with growth of just 0.64%.

Quarterly figures show that the economy in fact begun to struggle during Q104, with an official recession during the second and third quarters. Despite this sustained contraction, of -0.8% y-o-y and -1.1% y-o-y respectively, the 0.5% upswing in the final quarter of 2004 suggests that the recession was only shallow. Indeed, officially the economy is having a 'paused recovery', and the government still forecasts growth of 2.1% for fiscal 2004. Although Japanese GDP statistics are very volatile and say little about the real state of growth, the economy is certainly experiencing a prolonged soft patch in the stop-and-start recovery process that began in 2002. It is therefore unlikely to reach the 2.1% growth in the first quarter of this year necessary to meet the official forecast.

The moderating pace of growth is largely the result of weakening external demand, with export growth expected to halve to around 10% this year, after previously powering the economy forward. The outlook for exports not only reflects a slowdown in the global economy, but also the state of bilateral relations. The recent deterioration in Sino-Japanese ties, stemming from the release of a Japanese textbook playing down imperialist atrocities, risks spilling over into the economic sphere. The two countries are linked economically by trade and investment, with Japan's high-tech manufacturing abilities and China's low-cost workforce a winning formula. Both sides want to see enhanced Asian influence in multilaterals such as the IMF, while also managing the long-term decline of the dollar and the yuan's eventual floatation, but the necessary co-operation is being disrupted. Japan in particular risks being affected, considering its increasing dependence on China, now its biggest trade partner, with JPY22.2trn of Sino-Japanese trade last year.

The rising Chinese demand for Japanese goods partly reflects imports of components which are then assembled by Japanese companies into products shipped to the US. Although the US is still the biggest buyer of Japanese exports, considering that Japan's growth is highly dependent on shipments, calls in China for a boycott of Japanese goods and business could take a toll on the economy. Although shipments of cars and digital home appliances to the US are rebounding somewhat, the expected fall in exports to China this year, the continued burden of high oil prices and the appreciating currency, have led to a forecast contraction in Japan's trade balance in 2005.

Imports meanwhile are surging, which could reflect an upturn in domestic demand. This would be a great boost to the economy, with personal spending accounting for more than half of Japan's GDP. The Cabinet Office does indeed believe that private consumption is 'showing signs of improvement', the first upgrade from 'flat' consumption since mid-2004. And with government data showing a steady rise in employee wages, leaving consumers with more disposable income, and improved optimism over job growth, there are certainly reasons for optimism. But, it is taking time for this improved market to feed into greater spending. A pronounced recovery in consumption, sufficient to compensate for the weakening external sector, is thus unlikely.

Business sentiment does not show such ambiguity. The most recent Tanken survey, the central bank's quarterly business-sentiment survey, showed a fall in the index from 22 to 14, reflecting a smaller net proportion of companies expecting conditions to improve. This cautious outlook is due to higher prices for oil, steel and raw materials.

However, increased commodity prices will still fail to have any inflationary impact, with deflation continuing to plague the economy this year, averaging an estimated -0.5%. This persistent downward pressure on prices is in fact another factor restraining both demand and investment, which is only increasing marginally. The Bank of Japan has already stated that it will only raise interest rates when y-o-y changes in the core CPI stabilise above zero, so a loose monetary policy will be retained over the year ahead. However, with the current policy of zero rates failing to boost net bank lending, and fiscal policy restrained given perilous state of government finances, the balance of risk to growth remains on the downside.

Japan In 2006 and 2007: Fighting For Survival

During 2006 and 2007, overall GDP growth is expected to remain above 1%, at 1.3% and 1.2% respectively. However, the narrowing current account and relatively static consumer price index suggests little improvement in the economy during our forecast period. Japan's fiscal deficit will ease slightly over the next few years, but while it remains over 7% of GDP, this will still be far from sufficient to allow the government to manage the debt burden. Debt is already the highest among industrial nations, at around 140% of its GDP, and if the government does not meet its promise of achieving a surplus in its primary balance, this could worsen. However, if the finance ministry were to follow through with its aggressive spending cuts and tax-raising measures, there is the risk of choking off domestic demand. The controversial post office privatisation plan, due to take place over 10 years from 2007, may boost government finances, but the prime minister's desire to reduce state involvement and allow the market to work more effectively, is highly unpopular, and the bill risks being delayed.

As the government reins in expenditure, consumer spending is unlikely to accelerate, with deflation persisting through 2005 and only a slight rise in 2006 prices. However, this will be insufficient to warrant an interest rate rise.

Official advisors have already urged the government to address some of the long-term obstacles to growth if it wants to avoid falling into long-term economic decay. The '21st century vision' committee has not only warned about the mountain of debt, but also the risks of a lack of skilled labour and protectionist barriers. Indeed, if reforms to reverse the declining birth rate, loosen immigration policies and bolster the education system are not enacted, Japan could fall into decline. If the government were to implement the necessary changes, Japan should manage to preserve growth at around 1%. But further integration with the region, through various free trade and economic partnership agreements, will also be required to ensure Japan remains competitive and to ward off the pessimistic forecasts.

Eurozone

The Eurozone In 2005

Recent coverage of macroeconomic developments in the eurozone has been dominated by efforts to reform the region's strict fiscal rules. The credibility of the EU's Stability and Growth Pact, which limits the general government account imbalance of member states to 3% of GDP, had been fading fast as a consequence of persistent violations and the European Commission's failure to punish prominent fiscal miscreants. A renegotiated pact, which allows national governments to exclude certain expenditure items from official spending measures, has now emerged. However, while the precise impact on eurozone fiscal credibility will only become clearer over time, spending projections for 2005 suggest that public finances are unlikely to strengthen significantly over the course of this year.

With ongoing structural reforms constraining the contribution of government consumption to GDP across the eurozone, and euro appreciation holding back net export performance, hopes for more pronounced economic expansion depend on private consumption and investment. Eurozone consumer spending grew by 1.1% last year, and we are currently expecting an increase of 1.4% in 2005, which would represent the fifth consecutive year that real private consumption growth has remained below 2%. Disaggregating our eurozone forecast assumptions, anaemic growth in consumer expenditure of 0.6% in Germany and a below-trend 1.2% in Italy, will be contrasted by an anticipated 1.9% firming of French consumption.

Low expectations for consumer demand in Germany are borne out by the latest publicly released indicators of business confidence. The country's benchmark IFO index fell for the third successive month in April, as pessimism continued to attend the short-term outlook for both wholesale and retail trading. Indicators of business and consumer confidence reinforced this trend, with the March Purchasing Managers' Index revealing fears of a further weakening of economic growth in the months ahead.

Moreover, despite the relative resilience of private sector spending in France, the country's leading consumer confidence indicator reached a 15-month low in March. Given the atmosphere of gloom that currently pervades eurozone markets, consumption activity is unlikely to support a significant recovery in production during 2005.

Our expectation of a lack of growth stimulus from government policy, external demand or local consumer spending leaves investment as the only uncertain component of eurozone output. Despite strong savings rates in France and Italy, and, to a lesser extent, Germany, capital investment in the eurozone is set to grow only incrementally. Gross fixed capital formation is seen rising at just 0.4% in Italy this year, with the eurozone impact cushioned by a 2.25% rise in French fixed investment. Accordingly, the overall outlook for investment is fairly poor. This is reflected by measures of credit demand, which, despite low borrowing costs, reveal a widespread reluctance to increase debt financing. Against this backdrop, the eurozone is likely to continue to export its excess savings abroad, with the US Treasury market a favoured destination. Our view of the trajectory of the key components of GDP in the eurozone's three largest economies supports our expectation of 0.9% growth in GDP in both Germany and Italy this year, and an above-trend 1.8% in France. The national output of all 12 eurozone members is forecast to grow at a moderate 1.4%.

The Eurozone In 2006 & 2007

The medium-term outlook for the EU is clouded by the uncertainty which has accompanied the ratification of the proposed European constitution. The run-up to a public referendum on the issue in France has evolved into a broader, politically sensitive debate over the relative merits of the country's system of social democracy. In this tense climate, the 'no' vote has been able to mobilise strong support in France and eurosceptic political forces in other member states, including the UK, sense an opportunity to derail the process of European unification. Should the constitutional treaty fail to be approved by all 25 current member nations (and the signs are increasingly ominous that it will), leading politicians have warned of a crisis in terms of the mandate of the EU's governing institutions to legislate further acts of integration. Under this scenario, the consequences for the 12 countries which have adopted the single European currency are far from transparent. However, it seems reasonable to expect that political weakness at the heart of the EU would manifest itself in higher risks to economic stability across the eurozone. Nevertheless, we believe sufficient momentum exists behind the idea of European integration to deny the possibility of major macroeconomic instability and any associated unwinding of common political and economic structures, were the ratification process to fail.

Meanwhile, the EU continues to press ahead with its plan for creating a unified internal market for financial services. The harmonisation of financial regimes is consistent with the EU's goal of deepening its capital market to bridge the gap between Europe and the US. The plans also complement parallel ambitions to support higher medium-term growth across the region. Greater cross-border flexibility of finance may help to counteract weak appetite for credit across the eurozone. However, the legislative arrangements necessary to remove the barriers to internal finance have been subject to frequent delays in the past. Furthermore, with the EU's proposals likely to include sanctions for existing anti-competitive practices in member states, political factors are certain to weigh on the process.

The eurozone's largest three economies are unlikely to make greater progress in relation to domestic structural reform. Although Germany has managed to implement key aspects of the official Hartz IV programme with surprisingly little political opposition, unemployment will remain high over the forecast period, implying that persistently below-trend economic output will limit jobs growth. Our latest projections see unemployment remaining above 11% until late-2006. In France, public apprehension over labour market and social spending reform, which has infiltrated the debate over the European constitution, is likely to remain, and slow economic growth will keep unemployment above 10% until the last quarter of this year. After seven years of falling unemployment, Italy's weak economic activity outlook will keep the rate of joblessness close to 8% in the coming years. In sum, with aggregate eurozone growth forecast to remain within a below-potential range of 1.8-2.1% over 2006-2007, the ongoing reform of the national labour market is not expected to yield significant medium-term results.

Oil Price Assumptions

Supply, Demand, Inventories & Prices

A clear trend over the past three months has been the upwards revision of 2005 oil demand estimates by major organisations including the International Energy Agency (IEA), OPEC and the US Energy Information Administration (EIA). Earlier demand downgrades were clearly premature and, while some concerns exist over Chinese consumption trends, the consensus is now one of strong (2%-plus) demand growth this year. A combination of these developments, plus a return of speculative interest in the oil markets, outweighed the negative impact of sharply rising crude inventories which are well above year-earlier levels.

In the March 2005 monthly Oil Market Report from the Paris-based IEA, Q1 demand was estimated at 84.7mn barrels per day (b/d), up from 84.5mn b/d in the closing quarter of last year. The late arrival of cold weather in North America and Europe contributed to the healthy 2.8% year-on-year (y-o-y) rise in quarterly consumption. Thanks to OPEC's renewed quota discipline, production during January and February averaged a lower 83.84mn b/d but, with higher March volumes, supply for the quarter is set to have reached an average 84.1mn b/d. The implied average stock draw is therefore just 0.6mn b/d.

Prices were unexpectedly firm during the quarter, with net long open positions in the futures market closing in on last year's spring high. Brent, West Texas Intermediate (WTI) and OPEC basket prices reached new records immediately after the March OPEC meeting agreed a 0.5mn b/d hike in production quotas. A strengthening of the US dollar, combined with efforts by Saudi Arabia to talk down the market via hints of still greater supply, eventually pushed prices back down towards the US$52-53/b level for US and Brent blends.

Demand in Q205 is likely to approach 83mn b/d. The last IEA estimate is for 82.79mn b/d, up 2% y-o-y. Unless there is a return of unseasonally low temperatures in April, the IEA estimate looks realistic. OPEC supply, which had fallen to an estimated average 29.07mn b/d in Q1, is likely to break back above 29.5mn b/d for Q2. Non-OPEC production estimated at 50.68mn b/d, plus OPEC natural gas liquids (NGLs) of 4.7mn b/d, implies maximum potential supply of 84.9mn b/d - at least 2mn b/d above estimated demand. This would mean an inventory gain of twice the Q204 level and well above that seen in Q203.

As a result of this risk, OPEC has chosen not to raise further its production ceiling. Without demand surprising on the upside or supply falling short of expectations, there is scope for an ongoing price correction during Q2 - albeit from a much higher base than originally expected. The OPEC basket oil price, which is believed to have been around US$44/b during Q1, looks set to average nearer US$38/b in Q2.

Cracks In OPEC Unity?

There is no longer clear agreement within OPEC regarding production strategy. Saudi Arabia appears to be acknowledging the pressure from consuming nations and pushing hard for higher output, while smaller members with little surplus capacity feel enough is being done already. At the March 16 meeting, ministers agreed to raise the production ceiling by 0.5mn b/d from April 1, basically legitimising surplus supply. However, there was some resistance to the proposal from those concerned about rising crude stocks and a lack of spare capacity. At the meeting, the ministers flagged the possibility of a second 0.5mn b/d ceiling hike from May 1, although, with oil prices easing, the organisation admitted that the second ceiling increment would not be needed in late-March.

Having suspended the target price band at an earlier meeting, OPEC appears to be in no hurry to replace it. Worryingly for the consuming world, it has suggested that a price of around US$50/b is acceptable over the medium term. This view may have been coloured by the extreme weakness of the dollar, which has hurt OPEC revenues, but it is a big step from the previous average target price of around US$25/b. It seems likely that a significant and sustained move below US$50/b might lead to reduced OPEC supply when the ministers next meet.

Revised Forecasts

In Q104, the OPEC basket price appears to have averaged around US$44.0/b, up from US$41.5/b in Q404. The decline in prices seen during the latter part of Q1 is expected to continue into the second quarter of 2005, reflecting largely the rise in crude inventories. We are predicting an average Q205 OPEC basket price of US$38.0/b.

For 2005, March IEA forecasts suggest world oil demand of 84.3mn b/d, representing a 2.2% increase over 2004. This may be a cautious projection, given the robust level of economic activity in the major consuming regions, with China remaining a wild card that could as equally surprise on the upside as on the downside. The BMI model, based on individual forecasts for 60 countries and using our GDP growth assumptions, points to possible 2005 oil demand growth of approximately 2.3%. Supply is the key. Continued OPEC production at the forecast Q205 level means 2005 global output could average 85.3mn b/d, or a 1mn b/d surplus that would expand inventories. However, by Q4, consumption is set to exceed 86mn b/d. The call on OPEC crude would therefore reach 30mn b/d. This would stretch capacity and raise market tension. Even minor supply disruptions could precipitate a disproportionate price rise, while there remains scope for demand to exceed expectations. It hardly seems likely that the theoretical 2005 over-supply will result in prices appreciably below year-earlier levels. In fact, we are raising our estimate for the average 2005 OPEC basket oil price to US$41.0/b. The assumptions for other main crude types are now: US$43.3/b for Brent; US$45.9/b for WTI; US$38.4/b for Arab Light and US$39.2/b for Urals.

For the period 2006-2008, we have raised our OPEC basket price assumption from US$28/b to US$30/b. This will typically deliver a WTI price of US$35/b. Should OPEC introduce and implem nt a new price target that aims to secure an average US$40.0/b, there remains some medium- to long-term upside risk to our forecasts.

