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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- As US crude stockpiles rose to 388.1 million barrels in early November, WTI fell to the lowest level in five months, and the spread between Brent and WTI of crude oils topped USD14 a barrel recently, a level not seen since April
- The Fed decided to continue with its asset purchases pending more evident data on the recovery. Meanwhile, the ECB decided to cut its refinance rate down to 0.25% early November, which exerted downward pressure on the EUR, leaving it on the defensive
- The US debt ceiling brinkmanship early October revealed the loss of gold's status as a "safe haven" where despite the possibility of a US default, gold prices continued to decline
- The advancements in online banking and an increasing use of credit cards through points of sale units indicate that currency outside banks will remain relatively on a controlled upward trajectory
- The strong rise this month is likely to moderate as investors seek to skim capital gains for profit. Nonetheless, the upward trajectory is led by fundamentally strong stocks which will encourage a strong foothold for the index
- Banks are likely to maintain their current level of credit expansions given the opportunities arising from an expanding economy
- The lower decrease of imports value relative to weight might be indicative of global inflationary pressures

View of the Month

As per the EU's regulatory framework, the ECB is tasked with administering the monetary policy of the 17-country union, over 6,000 banks with varying sovereign affiliations. A task revealed to be much more complex as the components arising from monetary policy and common banking regulations are difficult to resolve as the ECB has no financial sufficient controls over European banks.

Said A. Al Shaikh
Group Chief Economist | **s.alshaikh@alahli.com**
Tamer El-Zayat
Senior Economist | *Editor* | **t.zayat@alahli.com**
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**
Majed A. Al-Ghalib
Senior Economist | **m.alghalib@alahli.com**

Macroeconomic Indicators

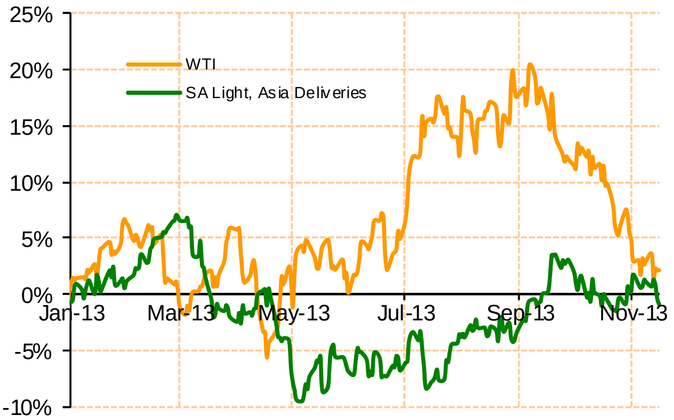
	2008	2009	2010	2011	2012F	2013F	2014F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	94.9	59.2	77.6	108.1	110.2	105.0	100.0
Average Daily Crude Oil Production, MMBD	9.2	8.2	8.2	9.3	9.8	9.6	9.8
GDP at Current Market Prices, SAR billion	1,949.2	1,609.1	1,975.5	2,510.7	2,666.4	2,703.4	2,786.5
GDP at Current Market Prices, USD billion	520.5	429.7	526.8	670.4	712.0	721.9	744.1
Real GDP Growth Rate	8.4%	1.8%	7.4%	8.6%	5.1%	4.1%	4.6%
Oil Sector GDP Growth Rate	4.3%	-8.0%	0.3%	11.0%	5.5%	-0.9%	2.2%
Non-oil Sector GDP Growth Rate	9.8%	5.3%	9.6%	8.0%	5.0%	5.6%	5.3%
Population, million	25.8	26.7	27.6	28.4	29.2	30.1	31.0
Population Growth Rate	3.4%	3.4%	3.4%	2.9%	2.9%	3.0%	3.0%
GDP /Capita, USD	20,184.2	16,116.2	19,112.7	23,625.3	24,387.0	24,005.1	24,021.9
CPI Inflation, Y/Y % Change, Average	6.1%	4.1%	3.8%	3.7%	2.9%	3.8%	3.3%
External Sector							
Merchandise Trade Balance, USD billion	212.0	105.2	153.7	244.7	246.6	215.1	204.2
Oil Exports, USD billion	281.0	163.1	215.2	317.6	357.1	312.1	297.5
Non-oil Exports, USD billion	32.5	29.3	35.9	47.1	51.0	55.1	60.9
Merchandise Imports, USD billion	-100.6	-86.4	-96.7	-119.0	-140.7	-152.0	-154.2
Net Unilateral Transfers, USD billion	-23.0	-27.7	-27.9	-29.4	-30.4	-33.2	-36.2
Current Account Balance, USD billion	132.3	21.0	66.8	158.5	164.8	137.4	125.7
Current Account Balance/GDP	25.4%	4.9%	12.7%	23.6%	23.1%	19.0%	16.9%
Net Foreign Assets with SAMA, USD billion	438.5	405.9	441.0	535.9	648.5	710.9	740.6
Fiscal Sector (Central Government)							
Budgeted Expenditure, SAR billion	410	475	540	580	690	820	877.4
Actual Revenues, SAR billion	1,101.0	509.8	741.6	1,117.8	1,247.4	1,045.8	1,012.2
Actual Expenditure, SAR billion	520.1	596.4	653.9	826.7	873.3	882.0	935.0
Expenditure Overrun, %	26.8%	25.6%	21.1%	42.5%	26.6%	7.6%	6.6%
Total Revenues/GDP	56.5%	31.7%	37.5%	44.5%	46.8%	38.7%	36.3%
Total Expenditure/GDP	26.7%	37.1%	33.1%	32.9%	32.8%	32.6%	33.6%
Overall Budget Balance, SAR billion	580.9	-86.6	87.7	291.1	374.1	163.7	77.2
Budget Balance/GDP	29.8%	-5.4%	4.4%	11.6%	14.0%	6.1%	2.8%
Break-Even Oil Price	40.2	60.8	64.1	75.3	73.9	77.0	80.8
Financial Sector							
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	4.75
Growth in Broad Money (M3)	17.6%	10.7%	5.0%	13.3%	13.9%	17.2%	11.7%
Growth in Credit to the Private Sector	27.9%	-0.6%	4.8%	11.0%	16.4%	18.8%	18.8%
Average 3M SAR Deposit Rate	3.3%	0.9%	0.7%	0.7%	0.9%	1.0%	1.1%
Average 3M USD Deposit Rate	3.0%	0.7%	0.4%	0.3%	0.4%	0.3%	0.5%
Spread, in Basis Points, SAIBOR-LIBOR	37.4	26.4	39.8	40.9	55.2	70.0	60.0

Oil Market

Prices Moderating

Brent crude futures have averaged USD109 a barrel so this year amid supply disruptions in Libya, Syria, and the US and European Union sanction on purchases of Iranian crude. Benchmark oil futures have rallied on speculation that Middle East unrest may disrupt shipments from the region, yet further increases in Brent crude price are seen limited as expansion of US shale oil frees up more barrels overseas. In addition, with OECD oil inventory at a healthy level, amounting to 59 days' demand, it has kept a lid on further gains. In the US, crude stockpiles rose to 388.1 million barrels in early November, as output surged to the highest rate since January 1989. Accordingly, WTI fell to the lowest level in five months, and the spread between Brent and WTI of crude oils topped USD14 a barrel recently, a level not seen since April. However, a weaker dollar had provided a boost for both types of the dollar-denominated crudes in October.

Chart 1: Oil Price Developments, YTD

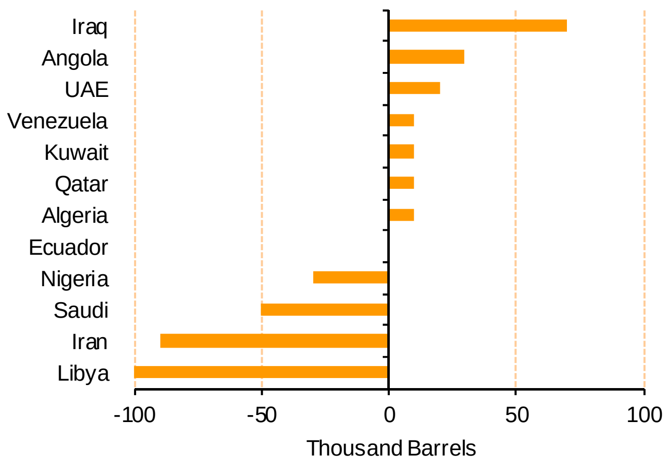


Source: Thompson Reuters

On the supply side, OPEC increased production to 30.6mmbd, as Iraqi output rebounded with the completion of maintenance work. Iraqi production increased by 0.28mmbd to 3.08mmbd, behind Saudi Arabia as the second largest producer in OPEC. Saudi output rose to 10mmbd in October, coinciding with a sharp drop in Supply from Libya. Moreover, the Kingdom will maintain its production capacity at 12.5mmbd, as additional capacities from offshore Manifa, Shaybah, and Khurais will replace the oil that is no longer produced from aging fields. In Libya, strikes led by local politicians who seek autonomy from the fragile central government have halted production from the east of Libya for nearly three months. Although Libyan output increased by 0.15mmbd to reach 0.45mmbd in October, down from 0.70mmbd in September, it is still a long way from its 1.6mmbd production level prior to the conflict in 2011.

In addition, the US crude oil production increased to 7.9mmbd in October, the highest since March 1989. The exploitation of shale basins using hudraulic fracturing and horizontal drilling techniques has helped the US to meet 87% of its energy needs in the first six months of 2013. However, the EIA acknowledges that the tight oil development is still at an early stage, and the outlook is still uncertain. In order for the production of tight oil to continue at increasing rates, the industry must overcome besides environmental challenges other economic challenges, which include diminishing rates of return, high depletion rates and the need for higher oil prices to justify investing in new shale wells.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, IEA trimmed its forecast for incremental global demand for 2014 to 1.1mmbd, with daily consumption projected at 92.1mmbd. The Asian region accounted for about 11% of global oil consumption in 2013, compared with 21% for the US. European demand is in structural decline though region's oil intake no longer rolling as firmer economy creates momentum. In the longer term, it is estimated that world oil demand will increase by an average of 0.9mmbd to reach 94.4mmbd in 2018, driven by growth in emerging economies. However, attributed to surging production from shale formations in the US and Canada, which is seen climbing to 4.9mmbd in 2018, the need for crude from OPEC, currently produces 40% of the world's oil, will fall by 1.1mmbd to 29.2mmbd between 2013 and 2018, according to OPEC annual world oil outlook.

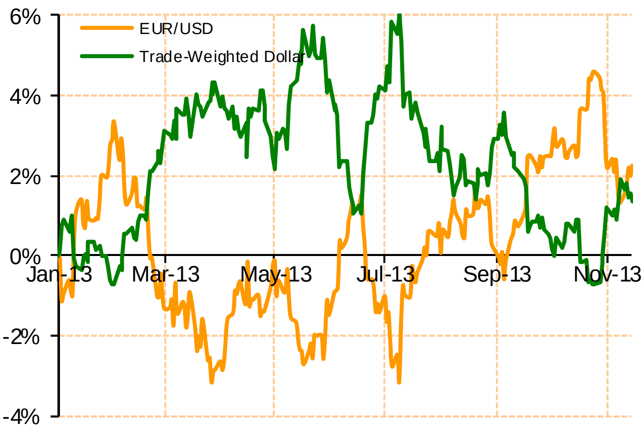
Said A. Al Shaikh
Group Chief Economist | **s.alshaikh@alahli.com**

Foreign Exchange

USD Battered Over Uncertainty, EUR Gains

In the month of October, heightened US-centered political uncertainties, and monetary policy divergence amongst core central banks have shaped the behavior of the USD's 5.3 trillion/day Forex market. The 16-day bipartisan impasse have dealt blows to the greenback throughout most of the month, driving the average-weighted USD below the 80 level. It rebounded towards the end of the month, recording a net loss of 3% M/M, closing at 80.2. The Fed decided to continue with its asset purchases pending more evident data on the recovery. Jobs creation of only 148,000 in September alarmed the Fed of the recovery's fragility, and despite the surprisingly high 204,000 jobs in October, the Fed is erring on the side of caution. In contrast, the upbeat US ISM report for October increased investors' risk appetite after it showed a 0.2% improvement over last month's 56.2% to 56.4%. Although there are faint speculations that the Fed's tapering might come as soon as December or January, consensus among economists indicates the likelihood of no earlier than March 2014. As a result, 10 year note yields eased from the two year highs seen in August down to 2.5%, losing 7 basis points from the beginning of October. The equity bubble continued to inflate to fresh highs benefitting from the fiscal moratorium and the Fed's dovish stance. The Dow surged by 2.8% throughout the month to close at 15,545.75, and continued upward trajectory onto November. On the other hand, the S&P500 broke the 1,700 level, overshooting last month's average by 4.5%, and closing at 1,756.5.

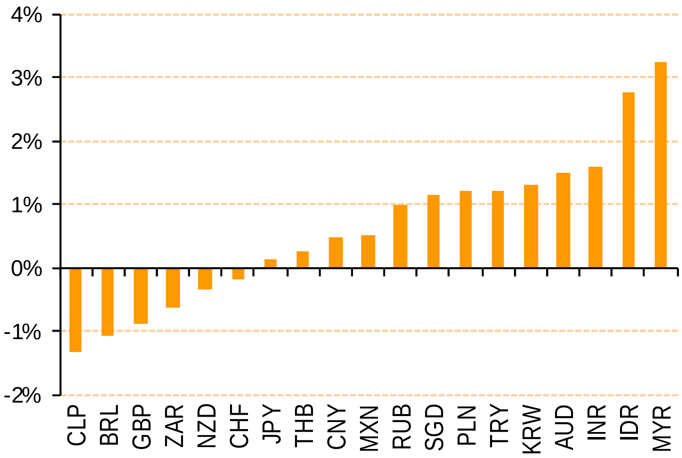
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thompson Reuters

Investor-sensitive policy developments in the US pressured the EUR/USD pair to close at a two-year high of 1.38. However, the announcement of Janet Yellen as Federal Reserve Chair softened the tone on the tapering rhetoric and renewed appetite for riskier assets. Global market participants are becoming more optimistic about a positive structural shift in Europe shown by a steady improvement in systemic risk indicators. Spanish equity securities rallied in all sectors since late June which reflects an improvement in the outlook of the country. Due to progress in fiscal reforms and deficit cuts, Fitch revised Spain's credit rating upwards to "stable" from a negative BBB. Spanish benchmark yields eased from the record high of 7.6 in Summer 2012 to below 4% in October for the first time in 3 years. However, the disinflationary impact of a stronger euro, combined with the uptick in the stubbornly high 12.2% unemployment rate is prompting the ECB to turn more dovish. According to the European Commission, inflation in the Eurozone has fallen down to 0.7% in October from 1.1% in September, drifting further away from the 2% inflation target. Therefore, the ECB decided to cut its refinance rate down to 0.25% early November, which exerted downward pressure on the EUR, leaving it on the defensive. By the end of October, the EUR/USD pair moderated down to 1.35, strengthening by 0.44% M/M.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thompson Reuters

China's manufacturing sector improved at the fastest rate in October since March. The HSBC PMI posted a 50.9 from 50.2 in September. The report also indicates that the improvement stems from an acceleration in exports as well as internal demand – in line with the upbeat global data. The appreciatory fixing trend in the CNY remains as the Renminbi saw new record highs against the USD in October. However, the ongoing risks of further CNY reforms, including a band-widening before the end of the year provides resistance for further strengthening. Consequently, the USD/CNY pair fell by 0.46% to 6.09.

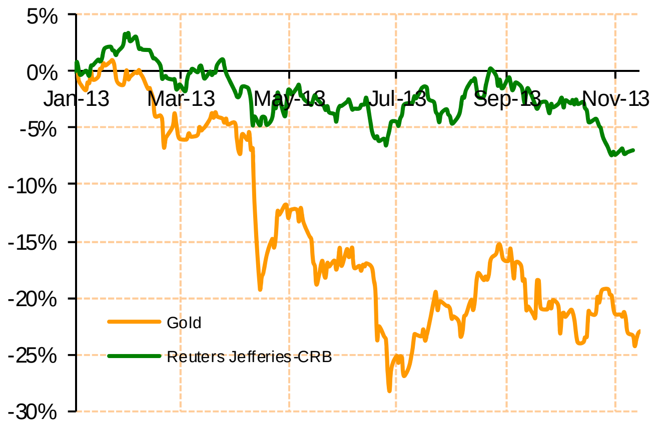
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

Commodities

Sticky Low Prices

Commodity prices continued to slip during October, furthering September's negative outlook. Despite the pick-up in the pace of manufacturing activity in China and Europe, the Thomson-Reuters/Jeffries CRB index slid by 2.7% from last month, down to 277.86. Declines in agricultural prices amid improving supply prospects, combined with a shying demand for precious metals in emerging markets were the main culprits. A weak seasonal demand in Europe, alongside a looming export ban on industrial metals in Indonesia played a role in disrupting copper and aluminum markets. Copper ended the month dropping by 0.7% to USD7,249/ton, while aluminum edged up by 0.8%, standing at USD1,859/ton as inventory backlogs eased up. London Metal Exchange (LME) inventory stock for copper fell to 502 thousand tons from 574 thousand tons in September, while aluminum stock shrank to 5.37 megatons from 5.85 megatons a month earlier. As China – the world's largest commodity buyer – gains stronger footing in manufacturing and export activity, we expect to see copper rebounding. Moreover, the direction of some firms to use copper as collateral for short-term loans should stoke increasing demand for the metal, providing an upward pressure on prices. The depreciation of the dollar softened the drop of the USD denominated commodities although we have been witnessing a broad-based decline during 3Q2013.

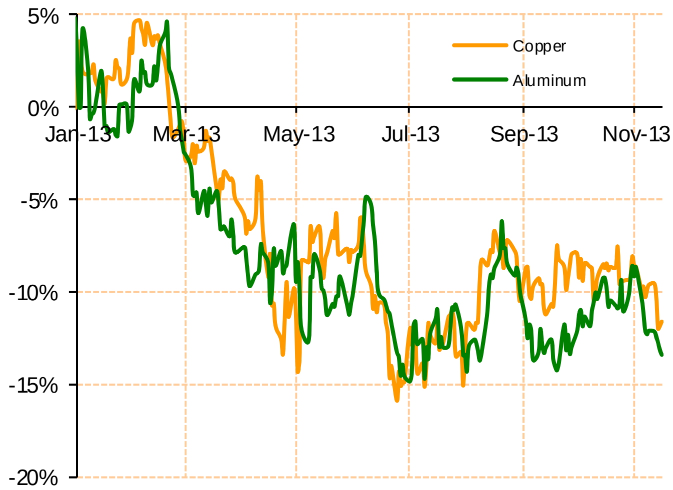
Chart 5: Reuters Jefferies vs. Gold



Source: Thompson Reuters

Precious metals showed higher volatility relative to their industrial counterparts. Spot gold continued its downward trend, sliding 0.3% by the end of the month, ending the last session at USD1,324.4/oz. The US debt ceiling brinkmanship early October revealed the loss of gold's status as a "safe haven" where despite the possibility of a US default, gold prices continued to decline. Downside risks persist due to the US monetary policy being geared towards tapering, in addition to India – the world's largest consumer of physical gold – restricting gold imports in order to curb its current account deficit. Silver rallied 0.97% at USD21.95/oz as demand picked up after the Fed decided on prolonging its QE3 program.

Chart 6: Base Metals



Source: Thompson Reuters

Most agricultural commodity prices have slipped towards the end of October as S&P GSCI agriculture index inched down by 2.5% to 363.7. According to the CME, wheat futures for December delivery closed at USD 6.69/bushel, losing 2.2% since September. Concerns about a cold and wet weather led wheat stocks below expectations, in addition to an increasing use of wheat for livestock feed compared to corn and soy. Corn futures declined by 3% to USD4.29/bushel continuing its slide post Summer 2012 supply shock. Ample supply of corn are capping prices. The National Agricultural Statistics Service (NASS) revised its forecasts for US average corn yield upwards at 160.4 bushels/acre from 155.3 bushels/acre, pointing to a new record crop of 13.989 billion bushels. However, with weather conditions being the most determining factor, we expect worsening conditions to aid in curbing further price declines for corn. As for Soy, prices also downturned by 0.3% to USD12.8/bushel. China – the world's top soybean buyer – estimates October's delivery at 4.27 megatons, down from 4.7 megatons in September on a tight market. Imports fell on lower supply which is due to surge in November as mills and crushers seek to replenish their stock, benefitting from cheaper beans.

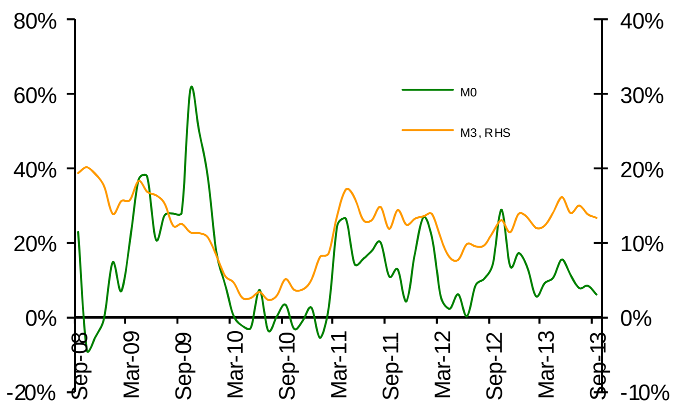
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

Money & Inflation

A Controlled Liquid Market

Elevated oil prices and higher production levels boded well for the Saudi economy as it benefited from large oil revenues over the past few years. The expansionary fiscal policy was easily financed through huge budget surpluses. Higher revenues resulted in an increasing monetary base (M0) which reached SAR305.3 billion by the end of September, an annual increase of 6.1%. The pace of annual growth has been decelerating due to base effects. Currency outside banks increased 6.9% Y/Y during September. The advancements in online banking and an increasing use of credit cards through points of sale units indicate that currency outside banks will remain relatively on a controlled upward trajectory. In addition, the latest government crackdown on illegal workers will spike up cash handling between consumers in the short term as illegals are unable to open bank accounts. Meanwhile, bank reserves gained 5.4% annually as cash in vault increased by 26.7% Y/Y while deposits with SAMA decelerated to 2.4% on an annual basis. We expect the first annual decline in M0 since January 2011 in the last three months of this year.

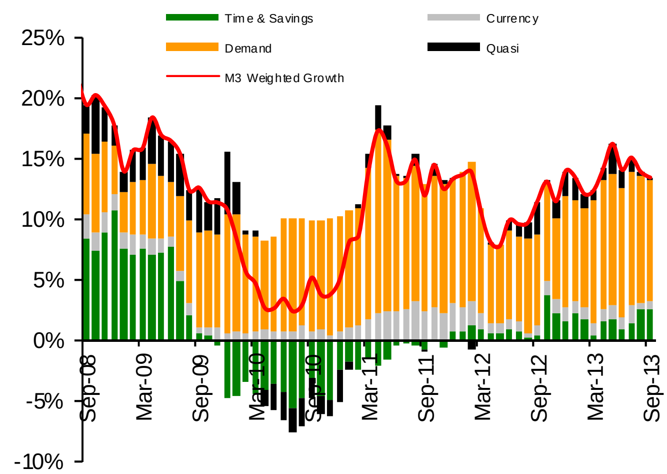
Chart 7: Growth in Monetary Aggregates



Source: SAMA, NCB Estimates

The broadest measure of money supply (M3) grew by 13.4% annually during September, the third consecutive deceleration. The robust expansion in the local credit market heavily contributed to M3's growth. However, local credit seems to have moderated which should slow the pace of M3's acceleration over the coming months. Growth is driven by its largest component, demand deposits, which added SAR132.8 billion over the past twelve months, a rise of 19.2% Y/Y. Meanwhile, time and savings deposits are still lacking behind with an annual gain of 10.8% to reach SAR325.6 billion, the highest level since November 2009. Additionally, other quasi-monetary deposits, which includes residents' foreign currency deposits, outstanding remittances, and other deposits, increased by 0.9% Y/Y by the end of September.

Chart 8: Money Supply, Contribution



Source: SAMA, NCB Estimates

Following the holy month of Ramadan, prices continue to ease as the benchmark inflation rate dropped to 3.2% during September. Within the largest and most influential categories, furnishings and household equipment coupled with transport recorded price hikes by 6.7% and 0.9%, respectively, on an annual basis. The two categories make up almost 20% of the 2007 rebased basket of goods. Meanwhile, food and beverage prices decelerated albeit remaining elevated at 5.8% Y/Y. The Reuters/Jefferies CRB index, a global commodities gauge, dropped 1.9% during September. The deceleration in local prices was undermined by a weakening USD as the trade weighted dollar decreased 2.3% in September. Imported inflation will continue to burden consumers as the dollar faces difficulties against other currencies (see Foreign Exchange Section). Rental price hikes peaked in July at 5.0% due to the academic holiday and Ramadan season. During September, rental prices increased at 4% as government execution plans to address the housing situation have been lacking. In our opinion, the high liquidity level backed by the robust state of the economy will likely contribute to relatively high consumer prices over the medium term. Imported inflation will also be decisive in assessing the direction of local prices, current USD trends are not in favor of Saudi consumers.

Majed A. Al-Ghalib
Senior Economist | **m.alghalib@alahli.com**

Capital Markets

Strong Corporate Profitability Drive Prices

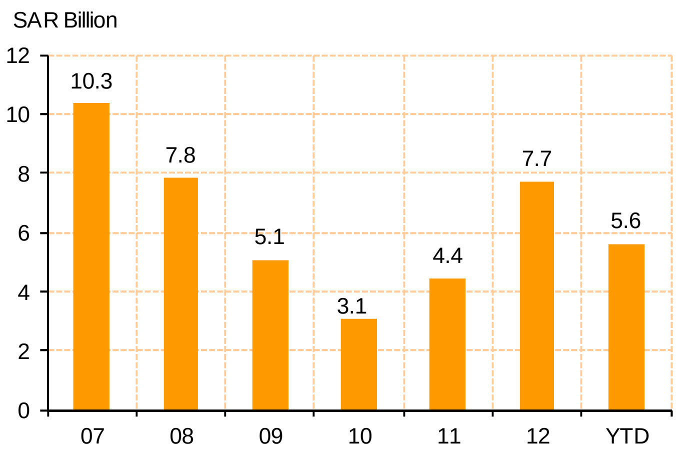
Geopolitical tensions, US congressional gridlock, and anticipation of corporate earnings held investors captive in uncertainty earlier last month. The Saudi stock market, Tadawul, recorded a marginal gain of 1.0% during the month of October. As the US government came back into full operation, investors were at ease and the flow of corporate announcements meant that portfolios are to be reshuffled again. In general, the market outperformed expectations and recorded strong earnings which drove prices higher. The leading petrochemical stock, SABIC, announced a SAR6.5 billion profit during 3Q, a 2.5% gain over the same quarter last year. Similarly, other "blue chip" stocks have also recorded strong profits last quarter such as Saudi Telecom and Riyad bank posting a gain of 73.3% and 18.8% Y/Y, respectively. The market created a good momentum going into November and reached above the 8'300 level, the highest level since 2008. By the end of last month, the best performing sectors this year are hotels followed by retail and real estate posting 102.9%, 48.5%, and 47.2%, respectively. The agriculture sector gained 32.4% as business activity picked up over the past few months, determined by their increased funding (see Loans Market).

Chart 9: Tadawul All-Share Index

Source: Tadawul

As previously mentioned, the anticipation of quarterly announcements to revamp portfolios triggered a drop in activity levels. During October, daily trading volumes averaged at SAR4.6 billion in comparison to SAR5.7 billion during September, a plunge of 19% M/M. The market is still predominantly driven by Saudi individual investors which results in a fluctuating market. However, Saudi institutions increased their exposure to riskier stocks as their trading share increased to 10.5% last month, up from 8.7% during September. By nationality, Saudi trading represented 94.1% of the total market, reflecting the limited ability of foreigners to trade in Tadawul, currently only available as SWAPs through local brokers. The strong rise this month is likely to moderate as investors seek to skim capital gains for profit. Nonetheless, the upward trajectory is led by fundamentally strong stocks which will encourage a strong foothold for the index.

Chart 10: Average Daily Traded Value



Source: Tadawul

The primary market concluded the month of October with no activity. However, Tadawul has announced two initial public offerings (IPO) for November and December. Bawan will be issuing 15 million shares, representing 30% of the company's capital, to the public. The second announced IPO is for the agricultural company Astra Food which will offer 11 million shares. Both companies have not disclosed their prices for the shares offered. As for the Sukuk market, Riyad bank concluded the issuance of SAR4 billion floating rate corporate Sukuk. The profit rate will be set at 3M SAIBOR plus 68bps over a tenor of seven years. Sukuk issuances have been a rising alternative in attracting funds, we expect the market to embrace this type of financing further next year. Additionally, the Shoura Council strongly advised Tadawul to turn public and limit IPO investor guarantors from trading within the first three months to limit speculative trading for individuals and create stability for entry stocks. The Capital Market Authority vowed for higher transparency and efficiency to ensure the progressive development of the local market.

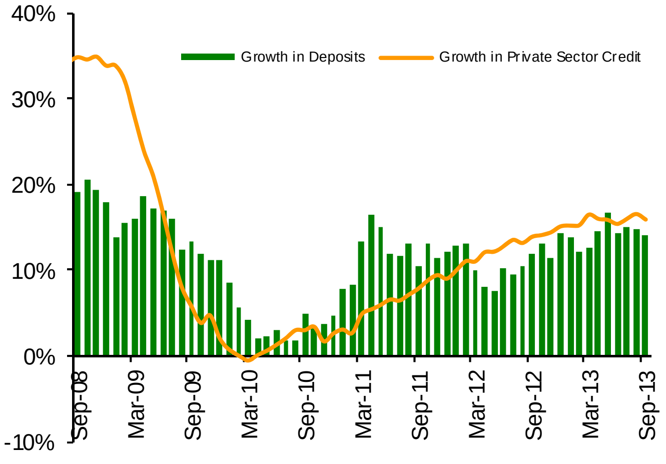
Majed A. Al-Ghalib
Senior Economist | **m.alghalib@alahli.com**

Loans Market

Moderating Credit Market

Saudi Arabia's banks recorded a profitable first nine months of 2013 and continue to reflect a strong financial system whereas many economies are still suffering from the global financial crisis. One of the essential components of facilitating such performances was the high level of liquidity in the domestic market. In assessing total deposits in Saudi banks, it has more than doubled in comparison to pre-crisis levels. By the end of September, total deposits reached SAR1'346.2 billion, an annual gain of 14.1%. Non-bearing interest deposits are still favored by businesses and individuals as their share of demand deposits stood at 91.3% in 3Q2013 while government entities represented the remaining 8.7%. However, government demand deposits have been rising rapidly, recording a staggering 86.8% Y/Y during September. As for time and savings deposits, growth was solely driven by government entities which increased their deposits to SAR149.6 billion, a 26.7% annual jump. Meanwhile, businesses and individuals were somewhat unchanged at SAR176.0 billion. In addition, foreign currency deposits decreased on an annual basis by 3.5% albeit recording a strong M/M rebound by 8.9%. Interestingly, outstanding remittances have averaged SAR14.7 billion during 9M2013 in comparison to SAR10.9 billion for the first three quarters of 2012 due to the Ministry of Labor's strict saudisation quest.

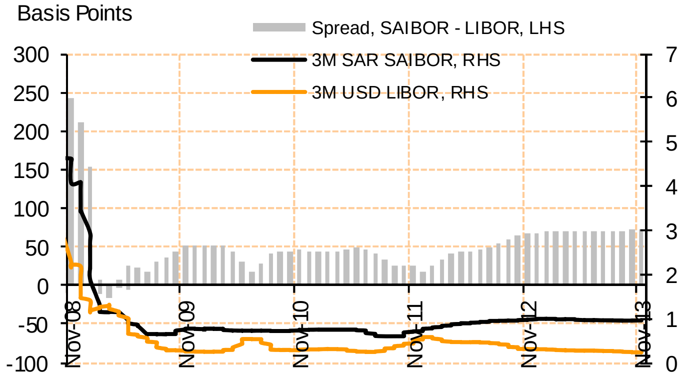
Chart 11: Private Sector Financing



Source: SAMA, NCB Estimates

On the financing front, total claims of the banking system, excluding T-bills and government bonds, posted an annual increase of 13.8% during September, the fifth consecutive deceleration. Saudi banks experienced a sturdy comeback for the credit market following 2009 and the momentum is evidently easing at sustainable levels. As total deposits outpaced the loans portfolio, the efficiency gauge represented by the loans-to-deposits ratio dropped slightly to 82.3 during September. Financing efforts continue to seek longer maturities as long-term credit posted another substantial gain at 30.5% Y/Y. Meanwhile, medium-term credit recorded a gain of 16.9% annually and short-term credit posted a growth of 5.5% annually by the end of September. Additionally, total credit to the public sector spiked by 23.5% as the government have been using Treasury bills to control liquidity levels. The government has issued an additional SAR54.0 billion worth of T-bills over the past twelve months, indicating the proactive measures taken by SAMA to control any risks to the local market.

Chart 12: Liquidity and Risk Detector



Source: Thompson Reuters

In assessing credit to different economic activities, the commerce sector is the largest recipient of funds in the local market. Since the beginning of the year, banks have granted SAR24.7 billion worth of credit lines to commerce related business activities by the end of September, bringing the stock credit level to SAR230.7 billion. The least active sector was utilities (electricity, water, gas, and health services) which only recorded a marginal gain of 0.2% on an annual basis. On the other hand, credit to the mining and quarrying sector increased by 39.7% Y/Y. furthermore, banks expanded their exposure to agriculture and fishing businesses as credit to the sector grew by 34.5% annually during September. NCB's Saudi Business Optimism Index rebounded to 54 from 49 on the back of stronger outlook on volumes, new orders, and profitability. Banks are likely to maintain their current level of credit expansions given the opportunities arising from an expanding economy.

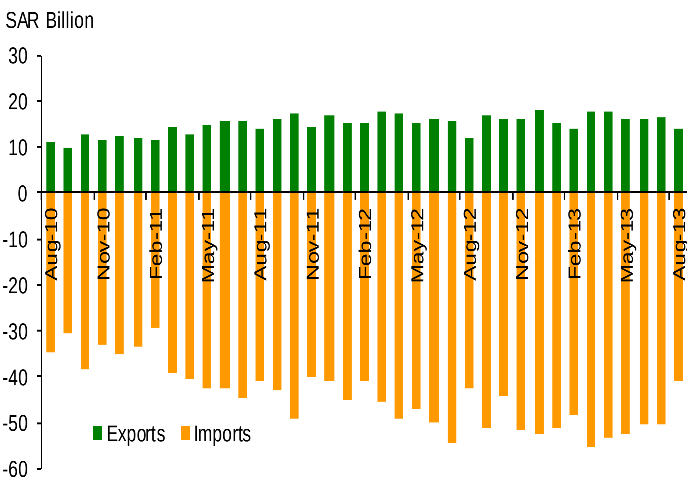
Majed A. Al-Ghalib
Senior Economist | **m.alghalib@alahli.com**

External Trade

Global Exuberance Supports Trade

In the month of August, Saudi Arabian non-oil trade witnessed a seasonal decline in both exports and imports. Albeit moderating from last year's dip by 16.7%, non-oil exports slid by 15.2% from July, amounting to SAR14.046 billion. The weight of exports have increased by 11.6% compared to last year to 3.5 megatons. Considering there are no major shifts in exports composition, the larger increase in exports revenue relative to weight indicates competitive prices. On the imports side, total value of non-oil goods inched downwards by 4.3% Y/Y, translating to SAR40.804 billion. Weight-wise, imports slumped by 11.6% Y/Y down to 4.7 megatons. The lower decrease of imports value relative to weight might be indicative of global inflationary pressures.

Chart 13: Saudi Non-Oil Trade Balance



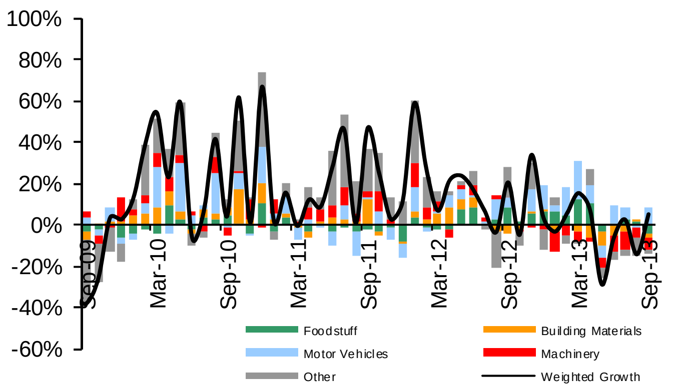
Source: CDSI, NCB Estimates

By composition, the largest non-oil exports remain plastics and chemical products, with the former registering SAR5.7 billion, roughly 40.4% of exports composition. Revenue from plastics climbed by 28% compared to August 2012, measuring a continued improvement in global demand. Similarly, chemical products which make up 36% of non-oil exports experienced a sizeable upturn of 54.6%, registering SAR5.1 billion. Base metals which are the third largest export category (7.2% of non-oil exports) up surged by a tremendous 79.2%. This large spike is mostly attributed to the upbeat factory data in the kingdom's trade partners, charging up demand for input materials.

Sorted by destination, 15.7% of Saudi exports in August headed to China in which demand soared by 132.9% Y/Y, the fastest pace in two years. Heightened manufacturing activity in China yielded SAR2.2 billion of export revenue. Exports to Singapore realized SAR1.1 billion of revenue, a 24.5% surge over last year. Exports to the UAE marked a downturn of 52.2% annually as they recorded a return of just under SAR1 billion.

On the other hand, over a quarter of the kingdom's imports (26.5%) consisted mainly of machinery and electrical equipment. In comparison to last year, Saudi imports of this category declined by 2.9% Y/Y, totaling SAR10.8 billion. Imported transport equipment, which make up 17.9% of imports, edged up by 0.9% Y/Y during August, amounting to SAR7.3 billion. Base metals, which constitute 13% of imports, dwindled by 19.6%, standing at SAR5.3 billion.

Chart 14: Attribution Analysis of Letters of Credit Opened



Source: SAMA, NCB Estimates

Analysis of imports reveal that 32% of imports inflow in August originated from China. Valued at SAR6 billion, Chinese imports increased 7.1% over the 12-month period. Imports from the US, which make up 28.5%, backpedalled by 3% as imports to the kingdom fell down to SAR5.4 billion. Imports of German origin which constitute as much as 13.6% of imports composition, also declined to SAR 2.6 billion, losing 6.9% Y/Y.

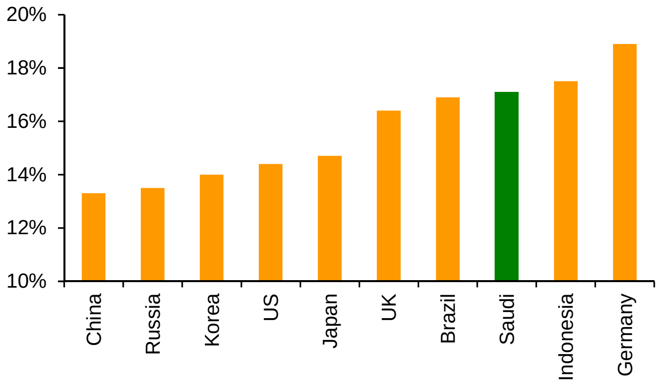
Settled Letters of Credit for September have plummeted on an annual basis across the board. Major categories such as machinery and building materials declined by 37.1% and 22.5% respectively. The decline seen in these vital categories is in line with the expected short-term stagnation of construction and contracting activities due to the rigorous Saudi labor reforms. Motor vehicles, however, continued to reflect a strong consumer appetite for durables, which grew by 4.3% Y/Y.

Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

Special Focus:
Will the Banking Union Put a Leash on the Debt Crisis?

While the growth of the manufacturing sector can be gauged by indicators such as steel shipments, autos driven off the assembly line or computer chips processed, indicators in the financial sector backing such activities is much more intricate, fragile, and often misleading. The flow of hot money towards the emerging economies inflated the market and prompted the expansion of their absorptive capacity, leading to double digit growth levels. In contrast, the impact of market globalization rendered the developed economies in need for structural reforms. The use of economic stabilization policy is critical to dampen the negative social and political ramifications. Therefore, it's imperative that central banks utilize monetary policy to ensure price stability, and supervise commercial banks to prevent bank runs. As per the EU's regulatory framework, the ECB is tasked with administering the monetary policy of the 17-country union, over 6,000 banks with varying sovereign affiliations. A task revealed to be much more complex as the components arising from monetary policy and common banking regulations are difficult to resolve as the ECB has no financial sufficient controls over European banks. This led to the fragmentation of the Euro area's financial market. In times of crisis, banks that were "European" have become national, and relied on their national governments for support. Capital flow which is supposed to move freely across the bloc stopped moving into the peripheries due to higher credit risk and fear of insolvency. In order to strengthen and foster the economic union in the Eurozone, a banking union which oversees resolution, recapitalization and deposit insurance is proposed by the European Council on May 2012.

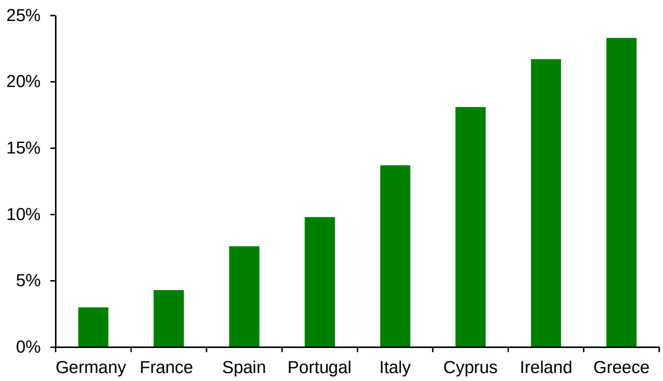
Table 15: Selected Capital Adequacy Ratios, 1Q 2013



Source: International Monetary Fund

Cementing financial integration in the union is crucial for its survival. The European Banking Union is expected to harmonize successive banking directions across the region. It would also allow capital requirements to be equalized. UniCredit, Italy's biggest bank by assets estimates as much as EUR7 billion to be repatriated from its German subsidiary HVB as a result. Accounting for the money multiplier effect, this would mean an addition of EUR40 billion into the Italian economy. Under Basel III accord, which is due to be enforced early next year, a tier 1 ratio of 9% would count as fully capitalized. This – in turn – would necessitate tapping into capital markets, government funds, and emergency funds from Europe's ESM and EFSF. However, to evaluate the Eurozone as a single market would entail an equal distribution of risk. Therefore, Germany's position has been uneasy towards levying the burden of failing banks on German taxpayers. Socializing government debt by introducing the Eurobonds is still held unfavorably by Germany, and socializing banking debt via the banking union is often viewed as unjust, and could result in credit misallocation. Unless a careful framework is implemented, below market borrowing costs, and free insurance in the forms of credit default swaps in the peripheries could cause a shift of capital from the core, undermining the union.

Table 16: Non-Performing Loans Ratio, 2012



Source: International Monetary Fund

On the other hand, Saudi Arabia, due to the more conventional nature of its policies, was able to meet some of Basel III requirements since December 2012, and is expected to fully comply by 2019. This reflects the Saudi Arabian Monetary Agency (SAMA)'s ability to supervise banks and maintain sound balance sheets. Currently, doubtful loans make up less than 1.5% of total loans and are 150% covered. This allows Saudi banks to stand in the safe zone in terms of volume and coverage of doubtful loans. SAMA's future provision strategy will be linked to the profitability of banks; as profitability grows, banks will be required to allocate larger amounts of provisions.

Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

NCB الأهلي

Economics Department

The Economics Department Research Team

Head of Research

Said A. Al Shaikh, Ph.D
Group Chief Economist
s.alshaikh@alahli.com

Macroeconomic Analysis

Tamer El Zayat, Ph.D
Senior Economist/Editor
t.zayat@alahli.com

Majed A. Al-Ghalib
Senior Economist
m.alghalib@alahli.com

Yasser Al-Dawood
Economist
y.aldawood@alahli.com

Sector Analysis/Saudi Arabia

Albara'a Alwazir
Senior Economist
a.alwazir@alahli.com

Mai Al-Swayan
Economist
m.alswayan@alahli.com

Shahrazad A. Faisal
Economist
s.faisal@alahli.com

Management Information System

Sharihan Al-Manzalawi
Financial Planning & Performance
s.almanzalawi@alahli.com

To be added to the NCB Economics Department Distribution List:

Please contact: Mr. Noel Rotap
Tel.: +966-2-646-3232
Fax: +966-2-644-9783
Email: n.rotap@alahli.com