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# Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

## Contents




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## Executive Summary


- Crude oil exports by Iraq have so far not been disrupted but the recent violence raises serious concern about whether the country can rebuild its oil infrastructure and meet global demand.

- As the Euro area is still in the danger zone for the 8th consecutive month, and with no macroeconomic improvement on sight, the ECB might still opt to launch a UK-style quantitative easing; buying government bonds on the condition of lending to SMEs.

- The slower pace of liquidity injection by the Fed in 2014 turned heads towards the equity market which continue to climb to fresh highs. Gold prices will remain supported, however, by some physical safe-haven demand from China seeking to benefit from relatively lower prices.

- This Summer season we expect a surge in rentals and utility prices as we near the holy month of Ramadan. Demand on rentals will heighten most in the holy cities of Makkah and Madinah, while the rising temperatures will provide a boost to utility bills

- The market edged higher last month driven by strong appetite from investors to yield from the positive momentum. During May, energy stocks gained 9.3% M/M followed by the real estate sector which posted a 5.5% monthly increase.

- Longer maturity tranche of bank credit is nearing 30% of total loans; a growing trend we have been observing since last year. The shift from short term loans to higher tenors is a strong indicator of investors' confidence in the stability of the Saudi market.

- The lower return from the UAE is most likely linked to a sluggish demand from China; as most of the Kingdom's exports to the UAE are re-exported to China.


### View of the Month

The prudency of local banks translated into higher asset quality and controlled level of risks. Banks successfully reduced their non-performing loans (NPL) to SAR15.6 million, a 21.7% annual decline. Accordingly, provisions continue to reflect a downward trend, reduced by 15.1% last year to SAR24.5 billion.

# Macroeconomic Indicators

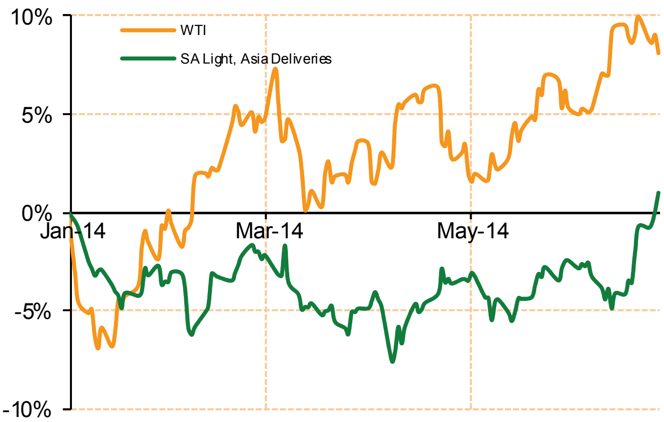
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013P | 2014F |
|---|---|---|---|---|---|---|---|
| **Real Sector** | | | | | | | |
| Average KSA Crude Spot Price, Arab Light, USD/BBL | 94.9 | 59.2 | 77.6 | 108.1 | 110.2 | 106.4 | 100.0 |
| Average Daily Crude Oil Production, MMBD | 9.2 | 8.2 | 8.2 | 9.3 | 9.8 | 9.6 | 9.4 |
| GDP at Current Market Prices, SAR billion | 1,949.2 | 1,609.1 | 1,975.5 | 2,510.7 | 2,752.3 | 2,794.8 | 2,835.0 |
| GDP at Current Market Prices, USD billion | 520.5 | 429.7 | 526.8 | 670.4 | 734.9 | 746.3 | 757.0 |
| Real GDP Growth Rate | 8.4% | 1.8% | 7.4% | 8.6% | 5.8% | 3.8% | 4.1% |
| Oil Sector GDP Growth Rate | 4.3% | -8.0% | 0.3% | 11.0% | 5.7% | -0.6% | -1.2% |
| Non-oil Sector GDP Growth Rate | 9.8% | 5.3% | 9.6% | 8.0% | 5.8% | 5.0% | 5.4% |
| 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 | 25,172.6 | 24,816.2 | 24,440.6 |
| CPI Inflation, Y/Y % Change, Average | 6.1% | 4.1% | 3.8% | 3.7% | 2.9% | 3.6% | 3.3% |
| **External Sector** | | | | | | | |
| Merchandise Trade Balance, USD billion | 212.0 | 105.2 | 153.7 | 244.7 | 246.6 | 214.2 | 185.5 |
| Oil Exports, USD billion | 281.0 | 163.1 | 215.2 | 317.6 | 357.1 | 315.3 | 283.0 |
| Non-oil Exports, USD billion | 32.5 | 29.3 | 35.9 | 47.1 | 51.0 | 52.2 | 58.0 |
| Merchandise Imports, USD billion | -100.6 | -86.4 | -96.7 | -119.0 | -140.7 | -153.3 | -155.5 |
| 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 | 130.0 | 105.2 |
| Current Account Balance/GDP | 25.4% | 4.9% | 12.7% | 23.6% | 22.4% | 17.4% | 13.9% |
| Net Foreign Assets with SAMA, USD billion | 438.5 | 405.9 | 441.0 | 535.9 | 648.5 | 713.3 | 749.0 |
| **Fiscal Sector (Central Government)** | | | | | | | |
| Budgeted Expenditure, SAR billion | 410 | 475 | 540 | 580 | 690 | 820 | 855.0 |
| Actual Revenues, SAR billion | 1,101.0 | 509.8 | 741.6 | 1,117.8 | 1,247.4 | 1,131.0 | 972.8 |
| Actual Expenditure, SAR billion | 520.1 | 596.4 | 653.9 | 826.7 | 873.3 | 925.0 | 952.8 |
| Expenditure Overrun, % | 26.8% | 25.6% | 21.1% | 42.5% | 26.6% | 12.8% | 11.4% |
| Total Revenues/GDP | 56.5% | 31.7% | 37.5% | 44.5% | 45.3% | 40.5% | 34.3% |
| Total Expenditure/GDP | 26.7% | 37.1% | 33.1% | 32.9% | 31.7% | 33.1% | 33.6% |
| Overall Budget Balance, SAR billion | 580.9 | -86.6 | 87.7 | 291.1 | 374.1 | 206.0 | 20.0 |
| Budget Balance/GDP | 29.8% | -5.4% | 4.4% | 11.6% | 13.6% | 7.4% | 0.7% |
| Break-Even Oil Price | 40.2 | 60.8 | 64.1 | 75.3 | 73.9 | 81.1 | 86.8 |
| **Financial Sector** | | | | | | | |
| USD/SAR Exchange Rate | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 |
| Growth in Broad Money (M3) | 17.6% | 10.7% | 5.0% | 13.3% | 13.9% | 10.9% | 10.0% |
| Growth in Credit to the Private Sector | 27.9% | -0.6% | 4.8% | 11.0% | 16.4% | 13.5% | 13.8% |
| Average 3M SAR Deposit Rate | 3.3% | 0.9% | 0.7% | 0.7% | 0.9% | 1.0% | 1.2% |
| Average 3M USD Deposit Rate | 3.0% | 0.7% | 0.4% | 0.3% | 0.4% | 0.4% | 0.7% |
| Spread, in Basis Points, SAIBOR-LIBOR | 37.4 | 26.4 | 39.8 | 40.9 | 55.2 | 60.0 | 50.0 |

# Oil Market

## Insurgencies Send Crude Through the Roof

Brent crude oil spot prices increased from a monthly average of USD108 a barrel in April to USD110 a barrel in May, recording the 11th consecutive month in which Brent average fell within a narrow range of USD107-112 a barrel. While the rapidly unfolding events in Iraq, following the launch of a military campaign by ISIS that subsequently claimed control of Mosul and several key cities in Northern and Central Iraq, have led Brent price to rise to USD115 a barrel over the past ten days, it does not look set to shed its risk premium as long as the fighting continues. Crude oil exports by Iraq have so far not been disrupted but the recent violence raises serious concern about whether the country can rebuild its oil infrastructure and meet global demand. The recent developments in Iraq coincided with further disruption of Libyan crude oil exports as rebels shut down a recently opened oil port after protesting the appointment of the country's new prime minister.

**Chart 1: Oil Price Developments, YTD**

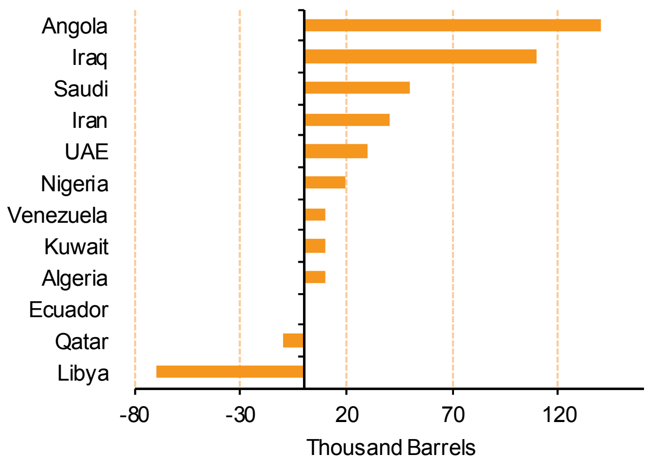



Source: Thomson Reuters

The ICE August Brent crude traded at USD114 a barrel, while WTI crude oil futures for August delivery traded at USD107 a barrel on the NYMEX. The premium of Brent crude over WTI, which averaged more than USD13.0 a barrel from November through January, dropped below USD4.0 a barrel in April, but rose to USD7.0 in June.

On the supply side, Iranian crude oil and condensate exports, based on customs and other publicly available data, have increased to an average of 1.33MB/D in the first four months of 2014 from 1.04MB/D on average in 2013. China, which remained the largest buyer of Iranian oil, has increased its imports to an average of 0.621MB/D of crude and condensates in the first four months of the year. In Libya, oil output amounted to 0.16MB/D in May, down by 90% from its pre-conflict level. In Iraq, production is expected to have eased to 3.4MB/D in May, as attacks on pipelines and oil-revenue dispute with Kurdish region continue to diminish the prospect of achieving its 2014's target of 4.0MBD.

**Chart 2: OPEC's Monthly Oil Production Changes**




Source: OPEC Survey

Saudi Arabia increased its production in May to 9.71MB/D, maintaining a seasonal rise in output as the summer peak domestic demand began. Accordingly, total OPEC production amounted to 29.9MB/D for May, just short of the 30MB/D target that has been in place since January 2012. Meanwhile, in its recent June's meeting, OPEC has left this target unchanged, indicating that the market is very well balanced and there is no shortage of oil at any place in the world.

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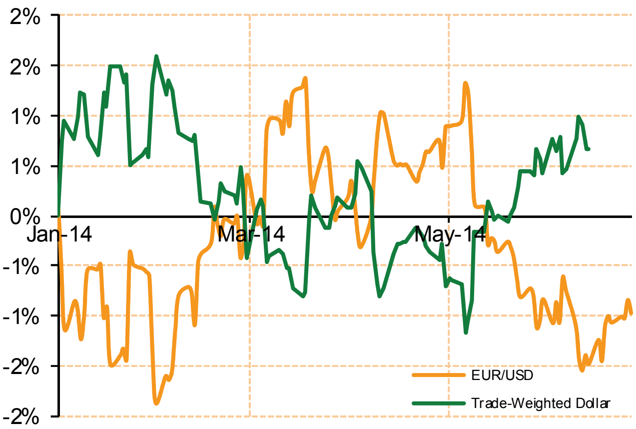
# Foreign Exchange
## All Eyes on the ECB

In May, the high leverage created in the forex market set the dollar as investors' mainstay. The multi-faceted support for the greenback was manifested in supportive capital flows, growth differentials, in addition to the ECB's divergence from the Fed, highlighted by the recent easing in monetary policy. As we dissect the EUR/USD pair we find that the EUR entered a negative territory versus the dollar. On a fundamental level, excluding the equity market boost seen in May which resulted from the rising easing expectations, the persistently high structural unemployment, currently at 11.7%, alongside lingering concerns from the Ukraine/Russia conflict put the single currency on a downtrend. In addition, the protracted period of disinflation which recorded a fresh cyclical low of 0.5% in May added pressure to the ECB and the single currency. In retrospect, the euro which by the end of the month touched a three and a half-year trough, closed at USD 1.36, losing 1.7% from April. The underlying fundamentals for price pressure also include a disappointing German PMI falling to a 7-month-low of 52.3 from 54.1 a month earlier, and the French manufacturing sector contracting to a 4 month low of 49.6 from 51.2 in April.

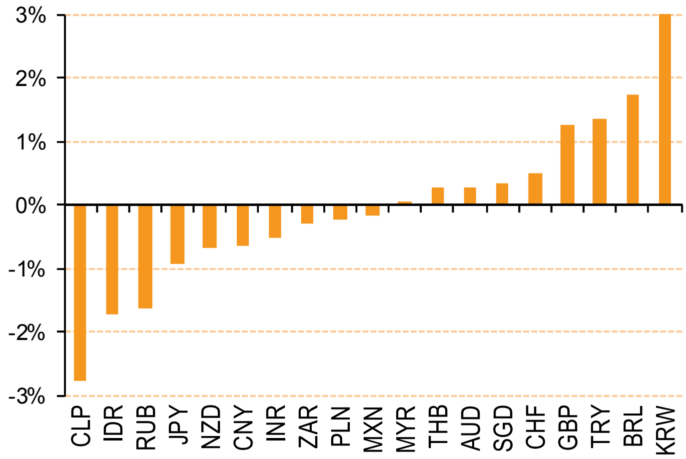
**Chart 3: Trade-Weighted Dollar and the Euro**




Source: Thomson Reuters

Moving onto June, a more bearish shift for the EUR is expected as the ECB eased monetary policy by lowering its key interest rates and announced measures to support lending to the real economy. The main refinancing operations rate was cut down to 0.15%, and a negative deposit interest rate of -0.1% was introduced on June 11th. In addition, the ECB suspended sterilization of liquidity injected under the Securities Market Program (SMP), coupled with a series of Targeted Long Term Refinancing Operations (TLTRO) which will be conducted with a 4-year maturity. This combination of measures, although seen by many market analysts as inadequate, is aimed towards incentivizing lending, the quagmire in the transmission mechanism. As the Euro area is still in the danger zone for the 8th consecutive month, and with no macroeconomic improvement on sight, the ECB might still opt to launch a UK-style quantitative easing; buying government bonds on the condition of lending to SMEs.

**Chart 4: Monthly Foreign Exchange Rate Changes**




Source: Thomson Reuters

The US dollar has regained traction and began appreciating on a trade-weighted basis, aligning with the US economic outlook relative to its global peers. The DXY index rose by 1.1% M/M in May to 80.36, and is poised to strengthen further after employment returned to pre-recession levels. Unemployment in May reached 6.3% and payroll employment recorded 217,000 jobs created, beating expectations. Furthermore, US factory orders rose by 0.7% to 1.5% in April, and despite the highly publicized recalls, auto sales surged by 11.4%, the strongest since February 2007. In early June, the recent rise in insurgent activity in Iraq, and potential for more monetary stimulus in Japan pushed the greenback even further higher against its peers. Soft data from the Eurozone took its toll on the bond market as easy policy expectations pressured the benchmark German 10 year bund yield down by 12 basis points during May. Spanish and Italian bond yields hit record low of 2.85% and 2.96%, respectively losing 17 and 10 basis points. Towards the end of May, 10 year US treasury yield dropped to its lowest levels in 10 months, falling by 19 basis points.

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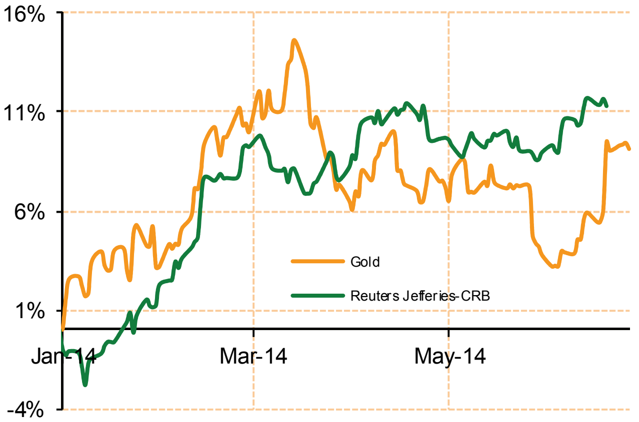
# Commodities

## Base Metals Soar While Commodities Tank

Commodity prices, save industrial metals, took a beating in May as strong US economic data and ECB rate cuts expectations diverted investors away from bullion and into the forex and bond market. Agricultural commodity prices were also downbeat after federal forecasters reiterated expectations for a record US crop and projected higher-than-expected global stockpiles. Therefore, the overall commodity index TRJCRB was down by 1.3% M/M in May after closing at 305.5. The net gainers in the commodity market were basic metals, primarily nickel, copper and aluminum. One of China's main ports, Qingdao halted shipments of aluminum and copper due to government probe into loan irregularities involving stocks in port warehouses. As copper and aluminum stockpiles are widely used as collateral for loans in China, some local trading companies are suspected of reusing warehouse receipts multiple times to secure financing from banks. In addition, the controversial 25% tax imposed on Indonesian exports which was passed back in January led to a copper and nickel deadlock. Newmount Mining Corp and McMoRan Inc., two major foreign miners in Indonesia, halted production after their stockpiling facilities reached capacity. Indonesia's curb on exports of metal ores is aimed towards encouraging local processing to spur industrial development, in addition to increasing the value of

**Chart 5: Reuters Jefferies vs. Gold**

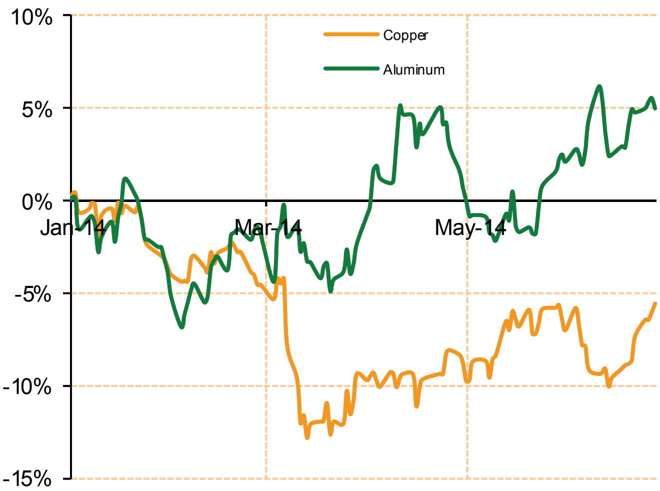



Source: Thomson Reuters

the country's raw material exports. As a result, London Metal Exchange (LME) copper upturned by 3.1% during May, closing at USD6,845/ton. LME aluminum, which has been less impacted by volatility in the commodity cycle, inched up by 2.1% M/M, standing at USD1,838/ton. The LME warehouse stock movement indicates an reduction in inventory buildup by 26% compared to April, closing at 170.8 thousand tons. Aluminum stock, on the other hand, inched lower by 2.9% M/M. The prices of nickel soared by 5% to levels not seen since 2012, closing at USD19,250/ton in May. Of course, this did not create an immediate supply shock due to the abundance of industrial metals in China and other major importer under contractual agreements; however, beyond this year, we expect to see more pronounced price pressures as the tax levy is transferred onto consumers. Foreign mining companies will install processing facilities in Indonesia and expand their operations within the country borders as a means to mitigate losses. In the meantime, we should also see base metals outperforming across the board due to a stronger dollar.

Improving fundamentals in the US economy put bullion on a bearish trend, reducing its investment-hedge appeal throughout most of May. Spot gold headed for a second monthly drop in three months, slipping by 3.2% to USD1,251.4 per troy ounce; whereas silver slid for the third consecutive month, erasing 2.2% of its gains and closing at USD18.8/Oz. While gold climbed as high as USD1,385 mid-March, institutional investors took profits in April as the Fed continues to normalize its monetary policy. The slower pace of liquidity injection by the Fed in 2014 turned heads towards the equity market which continue to climb to fresh highs. Gold prices will remain supported, however, by some physical safe-haven demand from China seeking to benefit from relatively lower prices. Gold prices are expected to remain range-bound between USD1,300/Oz and USD1,375/Oz, making weekly gains which are driven by short covering rather than investment demand.

**Chart 6: Base Metals**




Source: Thomson Reuters

Soft commodities tumbled as investors bet on favorable weather to deliver ample supply this Summer. The S&P/Goldman Sachs Agricultural Commodity index (SPGSAG) recorded an 8.1% downturn on a monthly basis, marking the biggest loss this year. Prices of wheat futures for contracts ending in July incurred a 13% loss, standing at USD6.29/bushel. The US Department of Agriculture indicates that larger-than-expected ending stocks are the culprit, and with Egypt, the world's largest wheat importer opting for the cheaper Black Sea yield, price supporting factors are no longer enough to warrant current levels. Corn futures plummeted by 10.2% in May to USD4.66/bushel, while Soybeans inched down by 1.4% to USD14.93/bushel.

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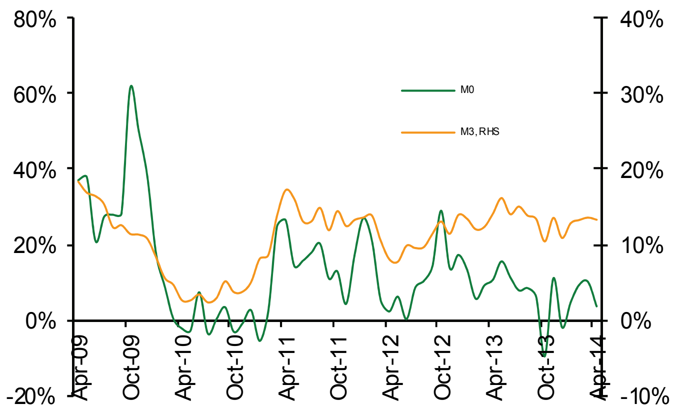
# Money & Inflation

## Comfortable Inflation Levels

Liquidity in the Saudi economy remains high as a result from previous years' historical oil revenues. Elevated oil prices in the years following the financial crisis endowed the Saudi economy with massive capital buffers with which it could deflect external economic shocks. Despite the high monetary base last year, M0 still shows a 3.6% annual growth in April, reaching SAR335.1 billion. A 10% rise in currency outside banks to SAR 149 billion is the main contributor to the growth in the monetary base as deposits with SAMA declined by 2.9% to SAR162.2 billion. Demand deposits which represent over half the money supply in the Saudi economy grew by around 14.2% in April to SAR937.9 billion, leading narrow money (M1) to increase by 13.6% to SAR1.1 trillion. Despite the very low interest income received from savings accounts (between 0 and 1.5%), we have been noticing a gradual shift towards time and savings accounts in commercial banks, and a moderation in demand deposits since October 2012. This came contemporizing with the plateauing government mega-projects whereby lesser need for funds on standby encouraged this allocation for government deposits. Although lower than last year's growth rates, broad money (M3) still managed a double-digit surge of 13.3% Y/Y to a total of SAR1.6 trillion. More so, the shift in the depositary base signals a moderation in credit for private and public sectors (see Loans Market section). SAMA's net foreign assets surged by 9% compared to the same period last year,

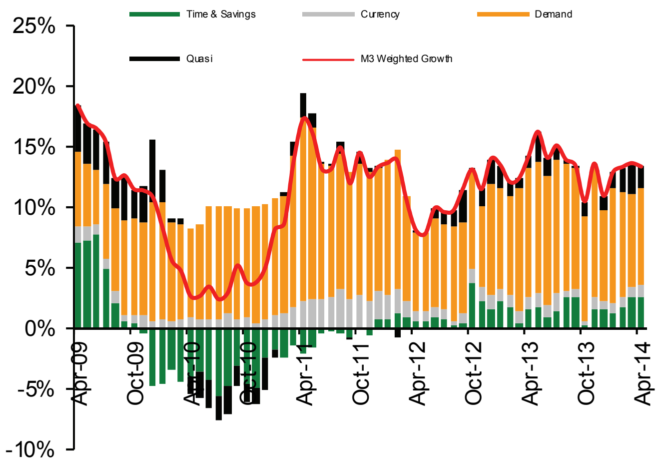
**Chart 7: Growth in Monetary Aggregates**




Source: SAMA, NCB Estimates

reaching SAR2.7 trillion.
The Cost of Living index has been steadily subsiding since it ended last year at around 3%. In the month of May, the annualized inflation rate was already down to 2.7%. This level of inflation is within the comfort zone indicating healthy growth and employment levels in the economy. In addition, given the country's import-

**Chart 8: Money Supply, Contribution**




Source: SAMA, NCB Estimates

dependence for essential goods, the general index also indicated a low imported inflation. Foodstuff, which represents over 21.7% of the average market basket of goods and services in the kingdom grew by 3.4% Y/Y; the lowest on record since the financial crisis. The price levels in housing and utilities remain the highest pacing among weight-bearing categories, advancing by an annualized rate of 4.4% in April. Housing and utilities account for 20.5% of the 2007-based benchmark index, giving it a large influence on overall price pressures in the Kingdom. This Summer season we expect a surge in rentals and utility prices as we near the holy month of Ramadan. Demand on rentals will heighten most in the holy cities of Makkah and Madinah, while the rising temperatures will provide a boost to utility bills.

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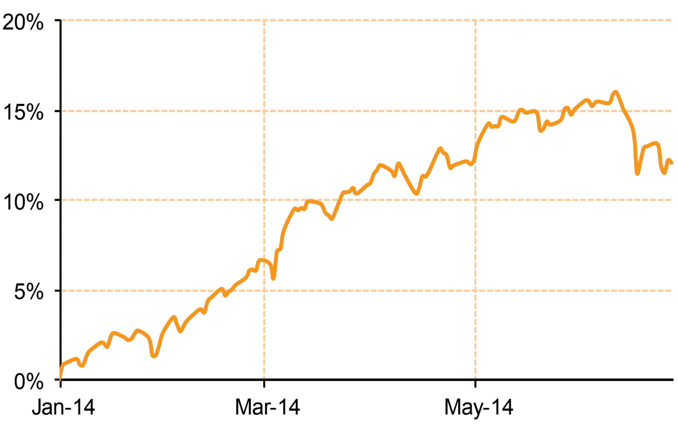
# Capital Markets

## Geopolitics Pressure Tadawul

GCC equity markets are among the top performers in 2014 as they have surpassed their peers considerably. The MSCI World index recorded a gain of 3.2% for the first five months of this year while the MSCI GCC index posted a staggering 28.8% for the same period. The gain was mostly driven by Dubai's DFM General index which has risen 51.0% by the end of May since the beginning of the year. As for the Saudi market, Tadawul rose a relatively moderate 15.1% during the same period. The market edged higher last month driven by strong appetite from investors to yield from the positive momentum. During May, energy stocks gained 9.3% M/M followed by the real estate sector which posted a 5.5% monthly increase. The worst performer was the transport sector with a contraction of 8.2% M/M. Going into June, the trajectory was carried over and the market peaked at 9'905.68 on June 10th, the highest level in six years. However, recent geopolitics have been worrying traders. Investors were hesitant through to the elections in Egypt and Syria, which turned out successful for Sisi and Assad, respectively. More recently, the Iraqi unrest was overwhelming for the regional markets and stock prices mirrored traders' discomfort. The market dropped to as low as 9'430.13 during 17 June trading session. Rising tensions will further hinder risky assets and delay the prospect of crossing the 10'000 level for the domestic equity index.

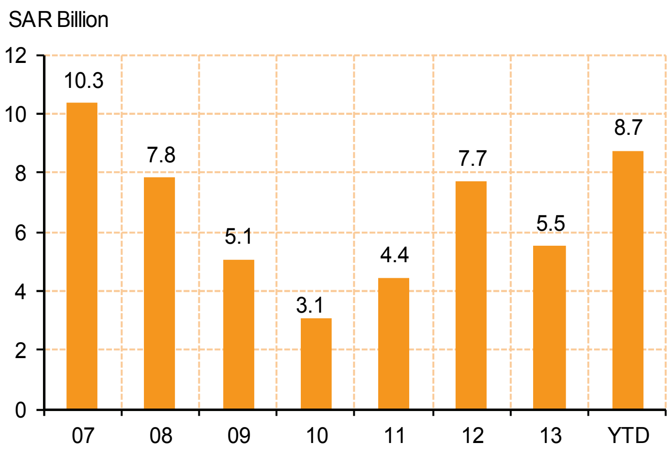
**Chart 9: Tadawul All-Share Index**




Source: Tadawul

The month of May recorded the highest monthly activity since April 2012. Investors exchanged stocks worth a total SAR242.5 billion which equates to a daily average of SAR11.5 billion, an increase of 9.4% over the previous month. Given the size of the sector, petrochemicals attracted 14.6% of total market trading by value, followed closely by insurance at 14.3% which refreshes the speculative preference of a significant portion of traders. The Saudi market is driven by domestic capital as Saudi individuals contributed 92.2% of total value traded last month, institutional and foreign trading (through SWAPS) represented 7.1% and 0.7%, respectively. The heightened level of activity raised market capitalization by 1.9% M/M to SAR1'989.64 billion by the end of May. Accordingly, stocks' price-to-earnings ratio increased to 16.86 last month, up from 16.57 by the end of April.

**Chart 10: Average Daily Traded Value**




Source: Tadawul

As for the primary market, Al-Hokair Group and Al-Hammadi Company concluded their initial public offerings (IPO) earlier in June. Both IPOs saw a combined influx of SAR2 billion (through individuals only), indicative of the strong appetite for primary market offerings. Al-Hokair offered 16.5 million shares, 50% dedicated to individuals, at SAR50 per share which received strong interest as the IPO oversubscribed by 329%. As for Al-Hammadi Company, the IPO was oversubscribed by 199% as investors sought ownership in 22.5 million shares, also 50% dedicated to individuals, at SAR28 per share. A total of four IPOs have been concluded this year with a total amount of SAR2 billion raised, surpassing 2013's total by 1.9% with expectations of more companies going public this year.

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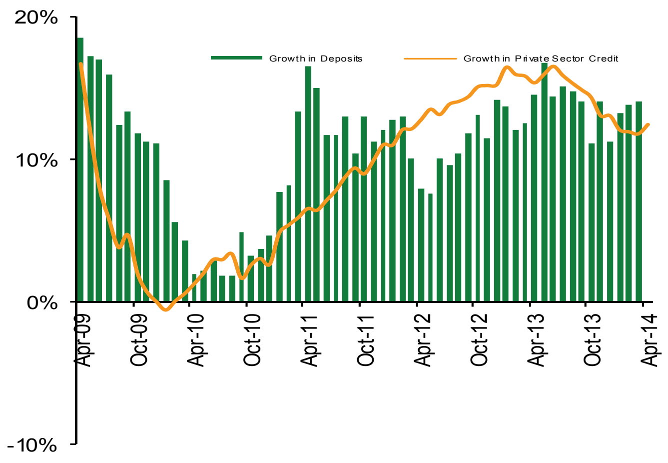
# Loans Market

## A Plateauing Credit Market

The local credit market is experiencing a relative tightening compared to what was witnessed in the past couple of years. SMEs aside, a market saturation is said to be approached in the private sector as growth in credit seems to be falling down to lower double-digit levels. Since May 2012, credit extended to the private sector grew by an average of 13%, falling to 11.8% in April, accumulating SAR1.17 trillion. Banks claims on government and quasi-government institutions surged however by 29.2% to SAR334 billion, indicating a considerable rate of expansion. With a 12.1% growth in banks' total assets to above SAR2 trillion, the consolidated balance sheet indicates moderation in excess reserve ratio to 46.1%. This is a result of the low exposure of local banks which allows them to meet SAMA's statutory requirements while utilizing current deposits. The loans to deposit ratio currently stands at 78.9%, a moderation we have been seeing since December of last year. The lower rate of credit expansion is a main contributor to the lower utilization ratio, although we noticed similar levels mid-2011 indicating a positive correlation between government awarded contracts and surges in credit activity.

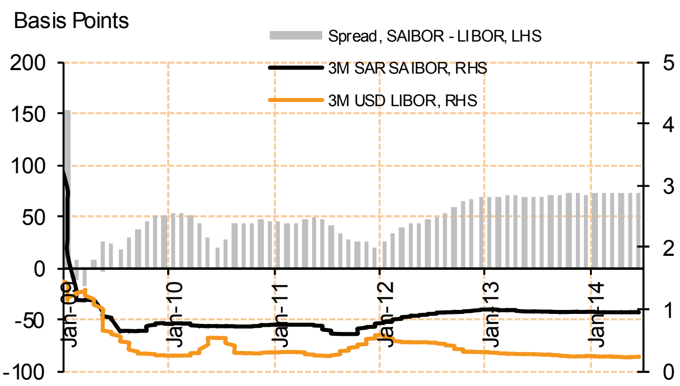
**Chart 11: Private Sector Financing**




Source: SAMA, NCB Estimates

In addition, the strong growth in bank deposits gives banks ample space to allocate their credit portfolios. The double-digit growth of 13.3% in money supply (M3) helps protecting banks from over-leverage during credit surges in the business cycle. Demand deposits, which make up over 57% of all deposits recorded an annualized 14.2% upsurge, followed by 11.6% in time and savings, and 14.3% in quasi deposits. On a year-to-date basis, fresh lending to the private sector reached SAR56.1billion, marking a 5% YTD, whereas fresh lending to government and quasi-government sectors surged by 22% YTD, reaching SAR61.1 billion. SAMA's liquidity management via open market operations has taken a front seat since late 2012. Despite the double-digit growth in T-bills issuances last year, SAMA still issued 37.7% more bills in April compared to the same period last year, absorbing excess liquidity from the market. The lockstep nature of the Saudi monetary policy with the US as dictated by the SAR/USD peg also predicts a tightening direction as interest rates begin to rise. The policies in place reflect SAMA's active monitoring of the situation of monetary aggregates in the Kingdom and the impact that pro-cyclical macroprudential policy in the US would have on the local economy. The decoupling of business cycles in Saudi Arabia and the US during the financial crisis allowed SAMA to identify and control pecuniary externalities.

**Chart 12: Liquidity and Risk Detector**




Source: Thomson Reuters

Longer maturity tranche of bank credit is nearing 30% of total loans; a growing trend we have been observing since last year. The shift from short term loans to higher tenors is a strong indicator of investors' confidence in the stability of the Saudi market. Despite the recent rise in insurgent activities in neighboring Iraq and Syria which shook up the oil market (see the Oil Market section), the risk of contagion is quite low as Saudi Arabia remains well-cushioned and internally sound. Short term loans still represent over 52% of total loans, and medium -term loans are about 18.3%.

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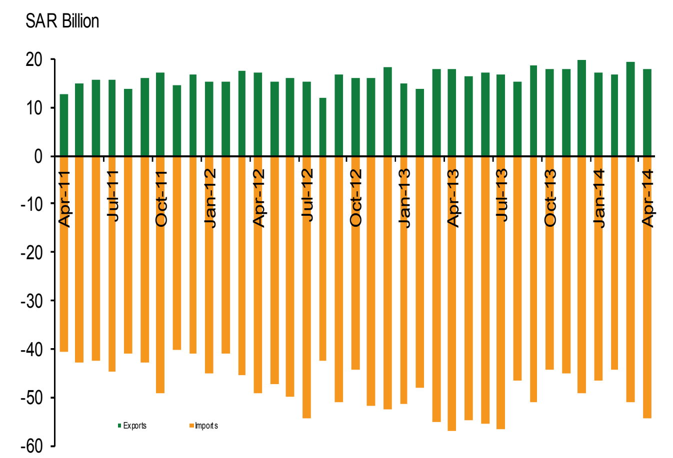
# External Trade

## Moderating Growth in Exports

Non-oil trade continued at healthy levels in April. Although exports have considerably moderated in value terms to an annualized growth rate of 0.4%, resulting in a total of SAR18.1 billion, the deceleration of growth in value terms was accompanied by a 4.2% increase in volume. This is indicative of a softening in export prices rather than in global demand. On the import side we find that the import bill trimmed 5% compared to last year, amounting to SAR54.4 billion. Volume-wise, import data indicates a 17.6% decrease Y/Y. The balance of trade gap shrunk by 7.5% in April compared to the same period in 2013.

**Chart 13: Saudi Non-Oil Trade Balance**



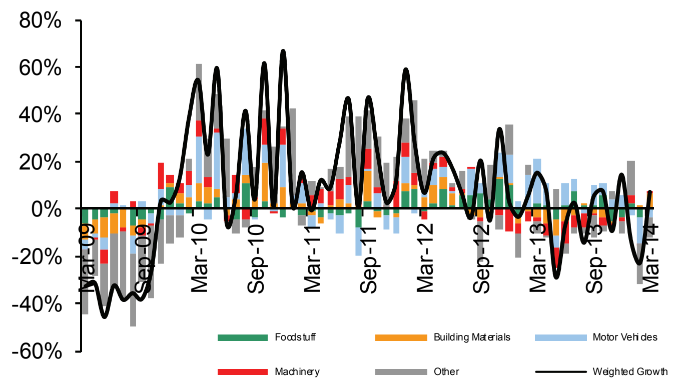

Source: CDSI, NCB Estimates

Exports of non-oil goods recorded a 0.9% decrease in chemical products, the largest category by weight. Accounting for 33.7% of non-oil imports, exports of this category created a return of SAR6.1 billion. Plastics, which is the second largest export category (around 31.6%), surged by 14.4% Y/Y to SAR5.7 billion. Exports of base metals reflected a 9.2% annualized growth to SAR1.1 billion. It is worth-noting that the downbeat overall figure of non-oil exports is due to adding returns from re-exports such as transport equipment and machinery to the value of non-oil exports. Transport equipment which amount to SAR1.7 billion, and machinery which amount to SAR0.8 billion have both tumbled respectively by 5.2% and 22.6% Y/Y.

Main trade partners are the UAE, China, and Singapore. About SAR2.7 billion or 14.9% of the Kingdom's non-oil exports headed to the UAE, declining by 4.6% by annual comparison. From a fundamentals' perspective, the explanatory variable is the slowdown in the Chinese economy that took place since the beginning of the year. The lower return from the UAE is most likely linked to a sluggish demand from China; as most of the Kingdom's exports to the UAE are re-exported to China. Direct non-oil exports to China suffered a sizeable downturn of around 23.8% Y/Y to a monthly total of SAR1.9 billion. Exports to Singapore displayed a strong doubt-digit growth of 16.6% Y/Y, reaching SAR1.2 billion.

Imports to the Kingdom were led by machinery and electrical equipment which contracted by an annualized 13.9% to SAR1.4 billion. The value of transport equipment breached SAR10.8 billion riyals, marking a 20% Y/Y increase. Upward price pressure for base metals globally are yet to weigh on the import bill, but as we expect from the recent copper and nickel deadlock, soaring global prices should have a noticeable impact along the short-term horizon. Base metals inched up by 1.6% Y/Y to SAR7.2 billion.

**Chart 14: Attribution Analysis of Letters of Credit Opened**




Source: SAMA, NCB Estimates

The main suppliers of imports are the US, China, and Germany. Imports from the US account for over 13.6% of the import bill, which slid by 10.7% Y/Y to SAR7.4 billion. Chinese imports to the Kingdom which make up as much of 11.4% of the imports by value also moderated by 6.7% compared to the same period last year to SAR6.2 billion. Imports from Germany which account to 7.8% of the import bill remained positive, recording SAR4.3 billion, a 4.9% upturn from last year.

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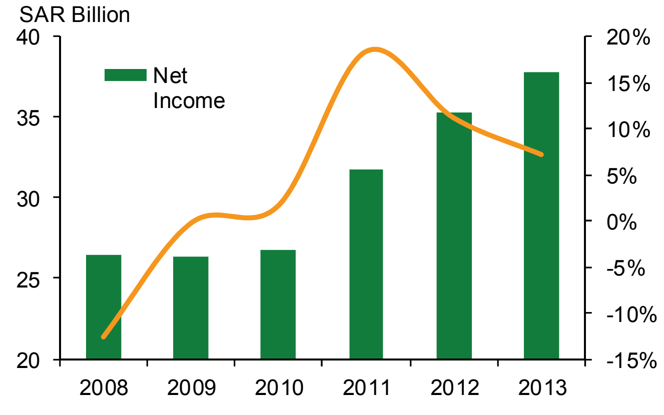
# Special Focus:

## How Safe are Saudi Banks?

Saudi banks maintained a positive trajectory during 2013 albeit at a slower pace caused by diminishing margins, accelerating costs, and a deceleration in the domestic economy. The twelve locally incorporated banks posted a record SAR37.6 billion in net profits, growing by 7.2% during 2013 in comparison to an 11.0% annual gain during the previous year. Nonetheless, banks were able to expand their balance sheets while maintaining ample levels of liquidity. The depositary base accumulated SAR135.1 billion through 2013 to reach SAR1.46 trillion, gaining 10.2% Y/Y. This facilitated the opportunity for banks to extend further credit lines as their loans portfolio grew by 12.4% annually. The varying paces reshaped the asset/liability composition reflected by the loans-to-deposits ratio which edged higher for our coverage universe to 77.4 by the end of 2013, up from 75.9 in 2012, indicative of further opportunities to grasp. Given its large weight, consumer lending provided SAR46.3 billion to banks' portfolios in 2013, however; the continued suppressed interest rate environment persistently diminished margins and profits from the segment over the past few years. Consequently, banks shifted their focus towards the corporate sector which now constitutes the largest portion of banks' net income sources, 37.3% of total 2013 net income.

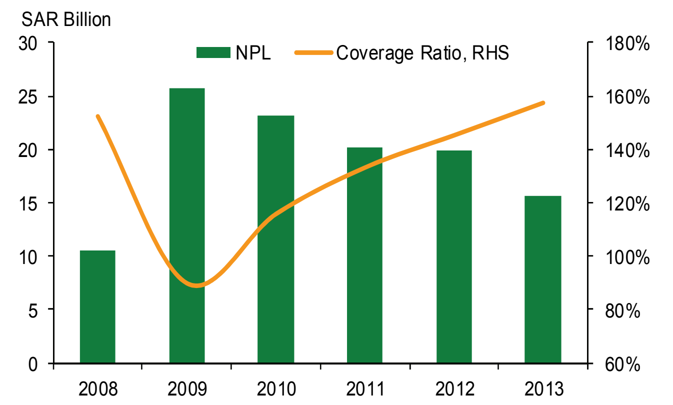
**Table 15: Global Sukuk Issuances, 2013**




Source: SAMA, NCB

Furthermore, net special commission income increased by 10.0% Y/Y last year while fee income generation almost stagnated at 1.5% Y/Y as SAMA restricted fees charged on retail customers. As such, we expect banks to continue increasing their exposure to the corporate sector with larger emphasis on small-medium enterprises. As domestic banks have been growing since 2010, risks and costs embedded in such growth have been efficiently mitigated in accord with SAMA's guidance towards a strong and stable financial system. Following the financial crisis, banks underwent rigorous cost control measures which contributed greatly to the positive growth trend. Local banks managed to reduce the cost-to-income ratio from 74.1% in 2010 to 65.6% in 2013. Although costs have marginally increased over the last year on an annual basis, it was largely undermined by the growth in revenue generation. Additionally, the aftermath of exposure to domestic family conglomerates is still evident as banks wrote off a record SAR11.9 billion of bad debt by the end of 2013. Pipeline risks have moderated as past due but not impaired loans for more than 90 days have declined by 29.9% on an annual basis.

**Table 16: Saudi Sukuk Market Growth**




Source: SAMA, NCB

The prudency of local banks translated into higher asset quality and controlled level of risks. Banks successfully reduced their non-performing loans (NPL) to SAR15.6 million, a 21.7% annual decline. Accordingly, provisions continue to reflect a downward trend, reduced by 15.1% last year to SAR24.5 billion. The NPL coverage ratio stands at 157.4% by the end of 2013, up from 145.3% in 2012, representing an ample buffer zone. Prior to the introduction of Basel III, SAMA was proactively seeking to shield the domestic market from possible future shocks. The implementation of Basel III principles started early 2013 and banks were well above the capital requirements. By the end of 2013, tier 1 and tier 2 capital adequacy ratios stood at 16.4% and 17.8%, respectively. Numerous banks have also boosted their capital ratios by tapping into the Sukuk market such as Saudi Hollandi Bank, Saudi British Bank, and National Commercial Bank. The Saudi financial system is well positioned for any future shocks, whether domestic or international as their continuous efforts to improve fundamentally and strategically bode well in a growing economy.

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