July, 2014
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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

Executive Summary

- As the global supplies continue to outpace the modest consumption increase, prices will likely edge downside, but the oil price geopolitical risk premium will remain, given some degree of uncertainty in the Middle East.
- The bond market in the Euro area on the other hand fell markedly after the ECB ushered in its new 4-year TLTROs in the "unsterilized" Securities Markets Program. German 10y bund yield lost 10 bps M/M, whereas a larger quarry encountered the Spanish bonos and Italian BTPs of 19bps, and 24 bps, respectively.
- The Indonesian copper ore tax, which is aimed towards encouraging local manufacturing, harmed copper shipments of the two mining giants Freeport-McMoRan and Newport, which together account for 97% of Indonesia's copper production for six months.
- Foodstuff prices remained on a downtrend; however, seasonally induced demand is expected to push prices higher in the next coming months, due to the Summer vacation and the holy month of Ramadan.
- Given the sustained rise of the local market, stock valuations have reduced as the market's price-to-earnings ratio increased from 13.95 by the end of June 2013 to 16.54 by the end of last month. Accordingly, market capitalization expanded by 29.9% Y/Y by the end of June to reach SAR1.95 trillion.
- Saudi banks are at ease expanding the maturity curve with minimal risk due to the stronger capital requirements set by SAMA. Therefore, more diversification should offer new investment opportunities to maintain the growth levels of their credit portfolios.
- In May, the CDSI announced the first negative growth of 5.1% Y/Y in non-oil exports to SAR15 billion, which, given the 12% contribution to the Kingdom's exports, could impact this year's economic forecasts

View of the Month

The next five years might prove to be a challenging time for policy making, with range-bound crude oil prices and contained production weighing negatively on oil revenues and, thus, reversing the hefty fiscal and current account surpluses of recent years. The Ministry of Finance estimates revenues and expenditures at SAR855 billion for each, projecting a break-even. Based on announced revenues, the government seems to have assumed the average oil price at USD73/bbl for this year.

Said A. Al Shaikh
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

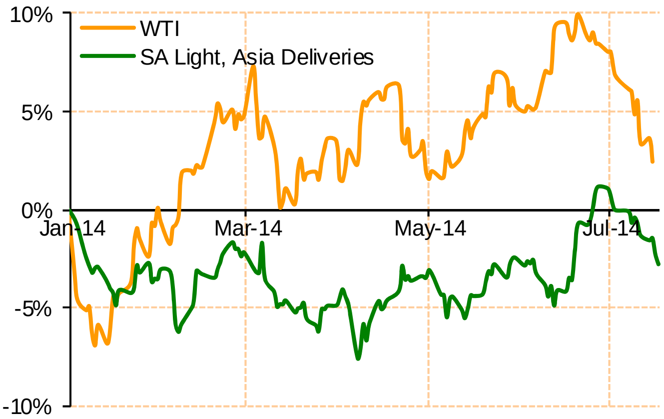
	2008	2009	2010	2011	2012	2013P	2014F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	94.9	59.2	77.6	108.1	110.2	106.4	100.0
Average Daily Crude Oil Production, MMBD	9.2	8.2	8.2	9.3	9.8	9.6	9.4
GDP at Current Market Prices, SAR billion	1,949.2	1,609.1	1,975.5	2,510.7	2,752.3	2,794.8	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

Subsiding Price Pressures

Brent crude prices have been retreating on signs that the insurgency in northern Iraq would not curtail output in OPEC's second-biggest producer, and also on expected increase of oil exports from Libya, thus reducing potential of supply tightness should Islamists militants extend their territorial gains in Iraq. The prospect that shipments of Libya's light, low-sulfur oil will recover will put pressure on the Brent benchmark, a similar grade used to price about half the world's crude. WTI dropped after US consumer spending grew less than expected. Brent for August settlement consolidated to around USD108.5 a barrel, while WTI for August delivery declined to around USD105 a barrel. Accordingly, WTI-Brent spread narrowed to USD5.5, the lowest in a month. As the global supplies continue to outpace the modest consumption increase, prices will likely edge downside, but the oil price geopolitical risk premium will remain, given some degree of uncertainty in the Middle East.

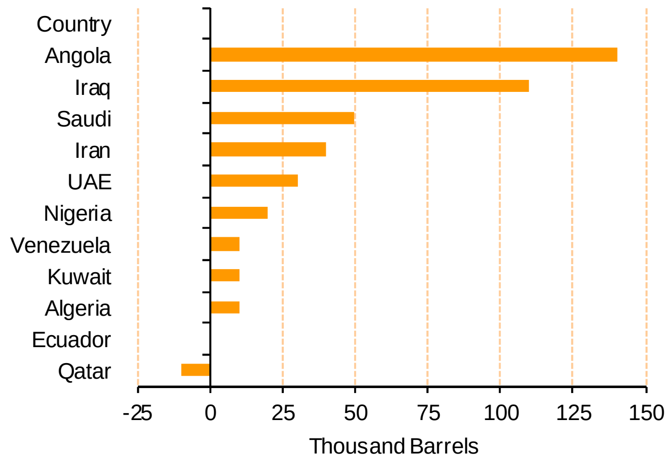
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the supply side, OPEC produced 29.7MB/D in June, down by 79.3 thousand barrels a day from May. Saudi Arabia increased its production to 9.73MB/D in June. Iraq's production dropped by 0.17MB/D in June to 3.16MB/D, reflecting the shut-in of northern oil fields, while production in Southern oil fields have so far been insulated from fighting in the north. In Libya, output is steady at 0.22MB/D, but Libya is reopening two crude-export terminals in the country's east after making a deal with rebels who have blocked oil shipments for the past year. The restart of the Es Sider and Ras Lanuf ports, which have a combined capacity of 0.56MB/D, would significantly increase Libya's exports. Elsewhere in the oil supply system, there isn't any indication yet of a marked progress between Iran and the west on its nuclear program. The oil market started the year concerned that US supply growth would outweigh demand growth to exert downward pressure on oil prices. However, over the past few months, the balance of the market appears tighter and the risk of an oil price spike has intensified. The increased potential risk to oil output, especially due to Iraq, combined with declining excess capacity and a recovery in global oil demand suggest the oil market is becoming more vulnerable to a supply shock.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

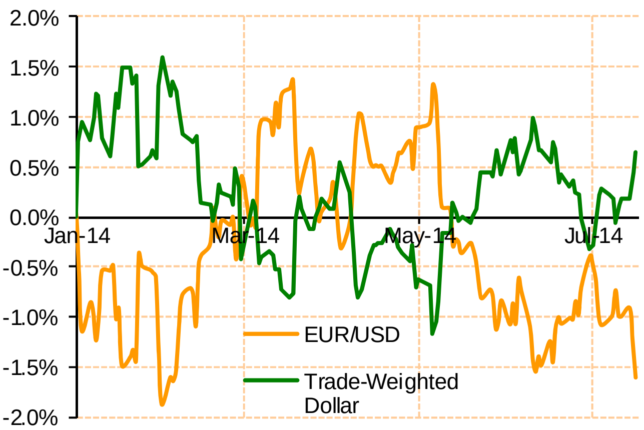
On the demand side, Global demand is projected to grow by 1.21MB/D in 2015 to 92.35MB/D compared to growth of 1.13MB/D in 2014. Chinese implied demand growth through May 2014 shows only marginal growth. Weak diesel demand, attributed to the slowdown in industrial activity and property construction since beginning of the year, has been the major reason of slowdown. However, easing policy measures, along with the recent strong data, will raise the prospect for improvement over the second half of the year. Slow economic growth in India has affected auto sales, but encouraging signs of economic momentum following the elections, are likely to stimulate demand for diesel. Elsewhere in Asia, Japan has had better than expected demand, and naphtha consumption in South Korea has been strong. Latin America is facing strong economic headwinds, as reflected in the oil demand data. Latest available auto sales numbers for the continent for May were generally weaker. Heading into the third quarter, demand growth is seen mixed, with stronger data from the OECD set to continue improving, while non-OECD demand gradually recovers, albeit at varying degrees between regions.

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

Foreign Exchange
Fed's Interest Rate Decision Clouded

In the forex market, the US dollar ended the month of June softer by 0.7% versus 13 of the 16 major peers in the DXY index, standing at 79.8. The underlying fundamentals include the Institute of Supply Management's (ISM) report of a weaker manufacturing and services activity than previously forecasted. The manufacturing sector growth recorded 55.3 in June from 55.4 in May, whereas expectations were leaning towards a more optimistic 55.7%. The ISM's index had also expected a 56.3% reading on the service sector on par with May, but contracted instead to 56%. In addition, the US trade deficit which narrowed to USD44.4 billion in May from USD47 billion a month earlier was due to an improvement in the petroleum deficit, while ex-petroleum deficit continued to widen. This led to a widespread speculation on whether or not 1Q GDP figures will exhibit an improvement on the previous quarter. The -2.9% annualized drop in 2Q GDP was seen to be impacted largely by a fall in exports, accompanied by a slowdown in overall output caused by the extraordinarily cold winter season. The labor market improvement, however, is regarded somewhat as a precursor for a rise in productivity, and should reflect positively on net foreign trade.

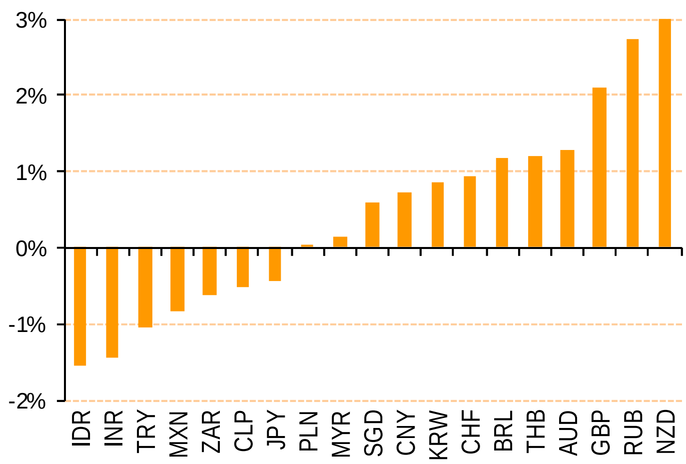
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

The US Bureau of Labor Statistics announced a further slide in unemployment rate to 6.1% in June, the lowest in six years, as non-farm payroll rose by 288,000, above market expectations. The Bank of International Settlements has recently warned that financial markets have become detached from the real economy, and encouraged central banks – including the Fed – to unwind their extraordinary counter-cyclical measures as the rebound in capital markets and real estate is built on fragile foundations.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

Moving onto July, the dollar strongly rebounded on upbeat data stimulating risk appetite which also reflected on the equity market as the composite indices climbed to fresh highs. The Dow advanced by over 2% throughout June, recording the longest streak since 1998, breaching 17,000 points on July 3rd. S&P 500 joined the equity market rally in their 4th consecutive year of positive returns out of the 5 years following the Great Financial Crisis, upturning by 2% M/M to 1,960. The Fed's meeting in June bore the decision of the 5th consecutive round of tapering in July despite the unsettling IMF cut of 2014 growth forecast to 2%. US Benchmark 10-year yield rose by 6bps to 2.5%. The bond market in the Euro area on the other hand fell markedly after the ECB ushered in its new 4-year TLTROs in the "unsterilized" Securities Markets Program. German 10y bund yield lost 10 bps M/M, whereas a larger quarry encountered the Spanish bonos and Italian BTPs of 19bps, and 24 bps, respectively. Goldman Sachs revised forecast for 10y bund yields down to 1.6% from 2.25% by year end, and 2.25% from 2.27% by the end of 2015.

Chinese manufacturing made a turning point in June growing at the fastest rate in six months. The HSBC/Markit PMI posted 51 from 50.8 a month earlier, indicating relative stability. As the People's Bank of China eases loans/deposit ratios required by banks, it is contributing towards easing financial conditions in order to manage some of the imbalances in the banking system. The Chinese yuan strengthened versus the dollar in June, inching up by 0.7% to 6.2/USD.

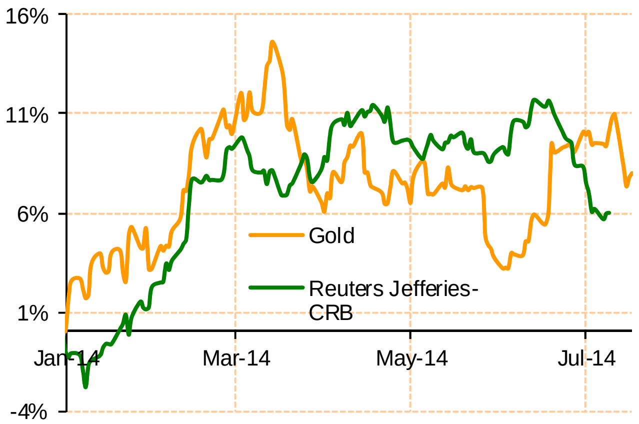
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

Commodities

Copper Higher As China Rebounds.

In the month of June, the Thomson Reuters/Jeffries CRB commodity index inched up by 0.9% to 308.2. The rally of industrial and precious metals was countered by a subdued performance for grains. The easing of monetary policy in China and Europe alongside the rebound in factory activity in the former bodes well for industrial metals. The over-invoicing of copper inventories in Quingdao, China weighed on prices throughout the month, which edged up by 2.5% M/M to USD7,015/ton. As manufacturing in China accelerates, given the opening up to foreign investment and shifting from export dependence to a more consumption driven model, copper prices could possibly reach USD7,500/ton during July. Aluminum prices also upturned, reaching USD1,891/ton, a 2.9% monthly gain. The LME warehouse stock movement reports a decline in copper feedstock by 2.2% during June, and by 9.4% in aluminum, indicating a rebound in manufacturing activity. The seasonally adjusted HSBC/Markit Business Activity Index for China rose to 53.1 in June from 50.7, a 15-month high. This created a positive feedback loop, reflecting on a more optimistic 12-month business outlook in China.

Chart 5: Reuters Jefferies vs. Gold

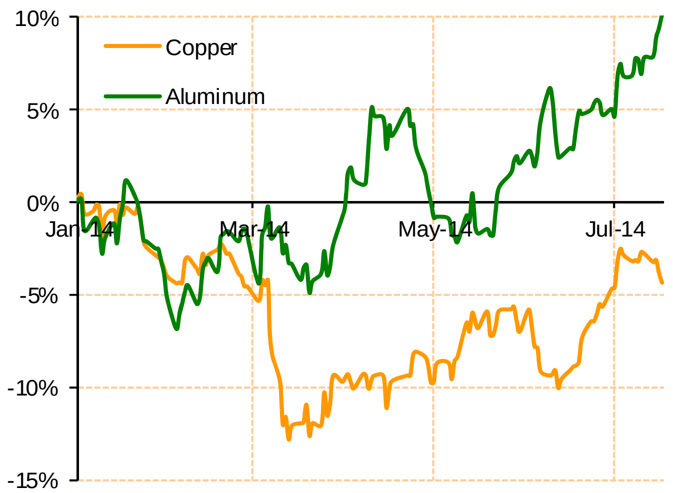


Source: Thomson Reuters

Foreign copper miners continue their dispute with the Indonesian government regarding the controversial tax imposed on shipments of copper ore and unprocessed metals. The tax, which is aimed towards encouraging local manufacturing, harmed copper shipments of the two mining giants Freeport-McMoRan and Newport, which together account for 97% of Indonesia's copper production for six months. Several efforts are made by the government to push the miners to invest in building local processing plants, including escalating the tax up to 60% in the second half of 2016, and a total concentrate export ban in 2017. Industry officials speculate that with the undergoing presidential elections taking place, securing a deal prior to year-end is a ruled-out possibility.

In contrast to the manufacturing in China, the subpar performance of the manufacturing sector in the US alleviated the last string of hope in an eminent interest rate hike. Although the Fed is adamant on normalizing its unconventional monetary policy, expected to be phased out by October, it reassured markets in the July FOMC meeting that rates will remain near 0% so long as the recovery remains fragile. The monitoring of economic indicators which took a more qualitative dimension has shifted away from headline unemployment to wage growth and participation rate. Consequently, precious metals regained some of their allure, with investors flocking towards bullion away from the low yielding bonds. In June, gold prices came under pressure initially as the Russia/Ukraine tension relatively subsided, trading near the USD1,200/oz. support level. It, however, recovered robustly as the ECB cut rates and introduced a round of targeted long-term refinancing operations to induce bank lending. The soaring insurgent activity in Iraq also fell in favor of gold which rose by 6.1% to USD1,327/oz. in the 30-day period. Silver posted remarkably positive, surging by 12.2% on a monthly basis to USD21.1/oz. The dual effect of China's factory rebound, and the PBoC's reserve ratio cuts benefitted cyclical commodities such as silver which continues to be a cross between industrial and precious metals.

Chart 6: Base Metals



Source: Thomson Reuters

Soft commodities tumbled sharply in June amid abundant supply. The Goldman Sachs Agriculture Index downturned by 10.2% M/M to 349.8. A bearish USDA WASDE report sent wheat, corn, and soybean prices lower as forecasts of global supplies were revised higher for the 2014/2015 yield. However, a potential El-Nino weather event which was pushed back into the year might disrupt yield projections, resulting in a rebound in agricultural commodities.

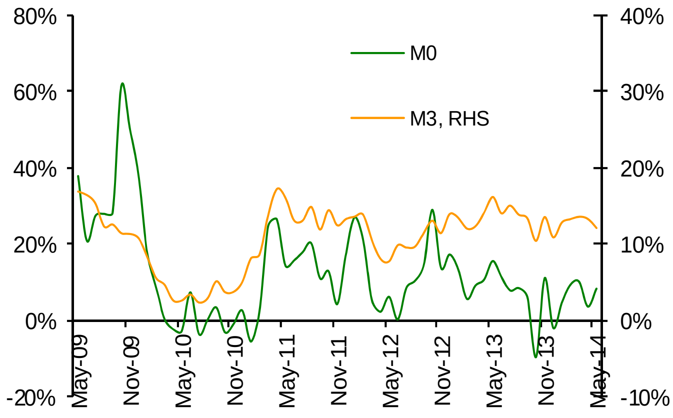
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

Money & Inflation

Subdued Inflation Despite Seasonality

Annual growth in liquidity levels in the Kingdom continues to be range-bound on a lower double-digit, partly due to high base effect. The broadest measure of money, M3, surged by an annualized 12.1% in May in contrast to 16.2% on the same period of 2013. SAMA's liquidity management is keeping a tight lid on money creation in the economy in order to control inflation and reduce incentives for credit misallocation. After the stock market crash in the onset 2006, investors rushed to park their assets in real-estate and other alternative investments, leading to a credit bonanza mid-2007 which stoked inflation a year later up to 11.1%. Since then, SAMA has been adopting a prudent, more active approach in order to protect price stability and the purchasing power in the kingdom. A credit crunch took place the following year until the second quarter of 2011 when the mega-project spurt occurred. Although growth in money supply returned back to double-digits, it is kept below pre-2008 levels.

Chart 7: Growth in Monetary Aggregates

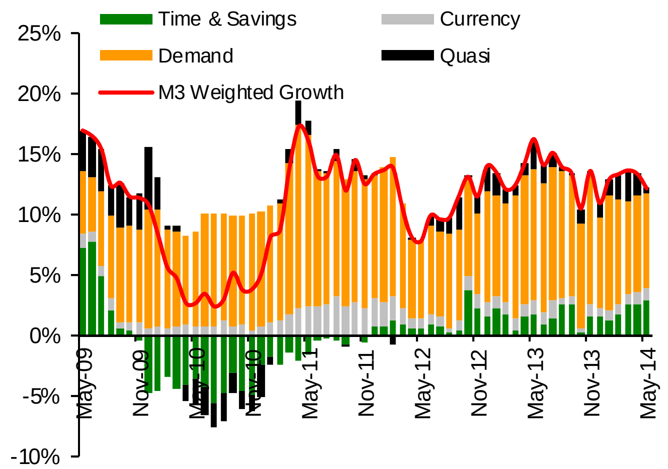


Source: SAMA, NCB Estimates

The monetary base, M0, rose by 8.3% in May, supported by a 7.2% increase in bank reserves and an upturn of 9.6% in currency outside banks. The rising level in currency outside banks is correlated with seasonal factors such as the end of the academic year and the beginning of Summer vacations. The consistent rise in bank reserves indicates the direction towards increasing capital buffers in compliance to SAMA's rigorous policies. Cash-in-vault expanded rapidly since November of last year, and recorded the largest growth levels among bank reserves components, in line with the sizeable growth in demand deposits. Money supply in the Saudi economy currently stands at SAR1.65 trillion.

Narrow money, M1, grew by an annualized 13.2% in May, mainly driven by strong levels of demand deposits which surged by 14.1%, reaching SAR938 billion. Since March, time and savings deposits, albeit small in absolute terms given the unattractive low yield, began to rival their demand counterparts in growth levels, recording a 13.5% Y/Y surge to SAR360.6 billion. This anomaly is explained by a plateau in government construction projects coupled with lower trading activity the local stock market after reaching six-year highs. Risk aversion have also resurfaced among some investors who worry that a negative spillover effect from Egypt, Iraq, and Syria might erode their investments rushed to the low-yield, low-risk savings accounts as they re-allocate their portfolios. Quasi monetary deposits decelerated back to a single-digit growth of 3.3%, after growing rapidly since the beginning of this year, peaking in March at 21.1%.

Chart 8: Money Supply, Contribution



Source: SAMA, NCB Estimates

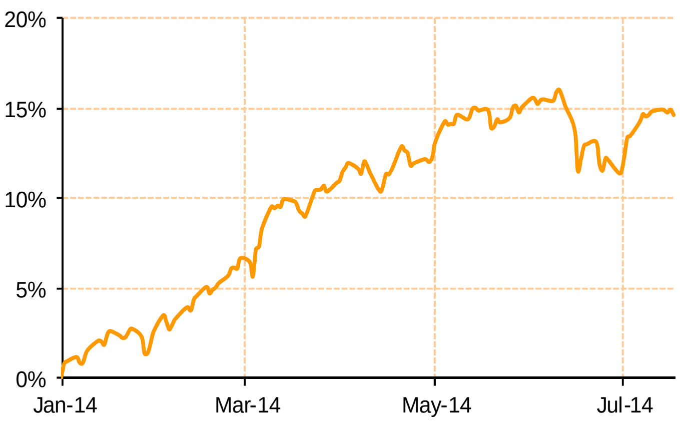
Inflation levels remain at 2.7%, below the forecasted average of 3% for this year. The main drivers in the consumer price index are food stuff and housing and utilities. The sub-index reading for foodstuff in the month of May was 3.15, contrasting with last year's 6.4. Although foodstuff prices remained on a downtrend, seasonally induced demand is expected to push prices higher in the next coming months, due to the Summer vacation and the holy month of Ramadan. Housing, and utility rose at their slowest pace since January, climbing by 3.7%. compared to last year. The communication and transport sub-indices show a continued easing in prices, declining by 0.09% and 0.07%, respectively.

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

Capital Markets
Ramadan Subdues Trading

The Iraqi turmoil intensified geopolitical worries as ISIS pose a major threat to any sign of normalcy in the region. The local market faltered last month and declined by 3.2% as investors reduced their exposure to risky assets. Tadawul posted the largest monthly drop since November 2012 as it settled at 9'513.02 by the end of June. On a sectoral basis, Media and Publishing was the top performer during the first five months of this year, gaining 66% during the period. However, as the gains were driven by speculators in the same manner to that of the Insurance sector, prices plummeted and the sector collapsed by 42.1% last month to end the first half of 2014 with a 3.9% contraction. The only sectors to record gains during June were Transport and Cement, growing by 1.3% and 1.0% M/M, respectively. The regional political unrest serves as a double-edged sword for an oil-exporting country such as Saudi. The risks emanating from rebels, coupled with supply disruptions, increase premiums into oil prices which bodes well for the Saudi economy, the swing producer for OPEC given its production capacity. Additionally, the flow of positive corporate earnings announcements for the second quarter aided a strong rebound for the local equity market, gaining 3.0% by since the beginning of the month through July 15. As they await the remaining profitability announcements, investors will be keen to reassess their portfolios according to valuations which will determine the pace of the index going into the second half of 2014.

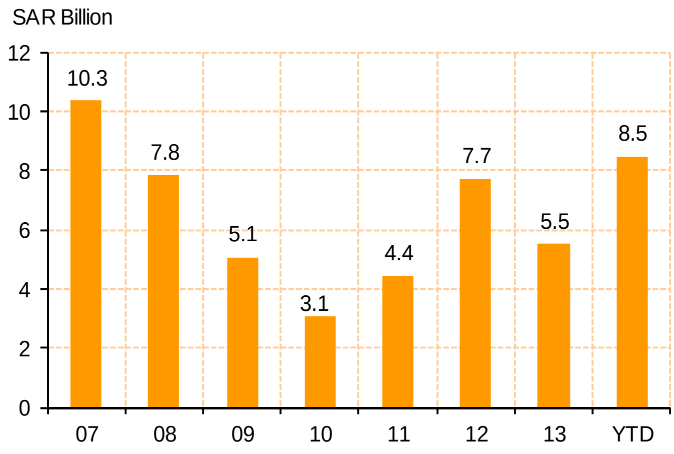
Chart 9: Tadawul All-Share Index



Source: Tadawul

Investor appetite deteriorated for the month of June as daily traded volumes averaged at SAR8.2 billion following May's SAR11.5 billion, a drop of 29.1% from the highest monthly activity since April 2012. The weaker appetite can be attributed to growing concern over regional geopolitics and the anticipation of second quarter corporate earnings, which occurs during the peak of the summer holidays. Furthermore, the anticipation and preparation for the holy month of Ramadan also contributed to the diluted level of trading. Trading hours are kept the same for Ramadan, however, Ramadan sessions have recorded an average of SAR6.1 billion by the end of July 15's session, 29.7 % below 1H2014's average. Given the sustained rise of the local market, stock valuations have reduced as the market's price-to-earnings ratio increased from 13.95 by the end of June 2013 to 16.54 by the end of last month. Accordingly, market capitalization expanded by 29.9% Y/Y by the end of June to reach SAR1.95 trillion. The composition of trading between different types of investors, Saudis, GCC citizens, Arabs, and foreigners, holds relatively the same weights and the distribution is not expected to change anytime soon.

Chart 10: Average Daily Traded Value



Source: Tadawul

The Capital Market Authority (CMA) seeks to develop the local market and have recently implemented rules and regulations for listed companies which have accumulated 50% or more of its capital. The CMA have emphasized the need to reduce risks, protect investors, and enhance the quality of listed stocks in the market. The range of processes vary from a two-hour trading suspension to possible delisting for companies with accumulated losses of 75% or more of their capital. The new regulations indicate the willingness of the CMA to improve and maintain higher quality stocks for traders to invest their capital.

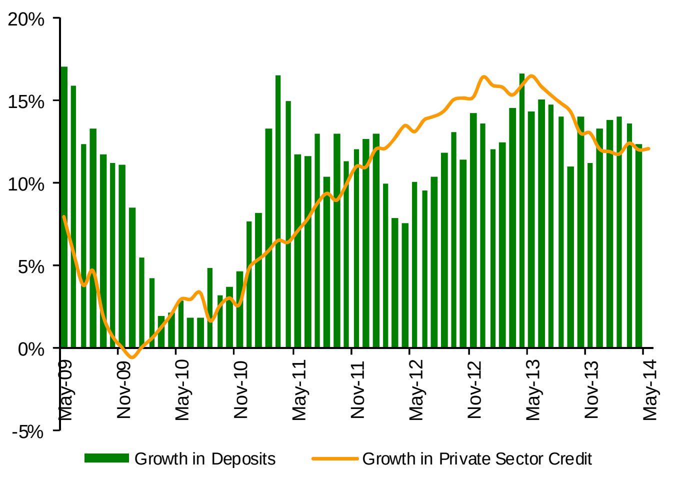
Majed A. Al-Ghalib
Senior Economist | **m.alghalib@alahli.com**

Loans Market

A Mellower Market Amid Growing Deposits

The consolidated balance sheet of Saudi commercial banks indicates that total deposits have reached SAR1.5 trillion in May, advancing by 12.3% over last year. Growth in the depositary base continues to provide opportunities to expand the financing capabilities of Saudi banks while maintaining the adequate coverage mandated by SAMA. Since the largest portion of deposits are in the form of demand deposits, of which only 6.8% are owned by government entities, maintaining high levels of liquidity is essential to cater for this type of deposits which is highly subject to varying consumption and investment appetites. Growth rate in demand deposits remains strong at 14.1%, due to the staggering growth in businesses and individuals contribution which reached 16.3% Y/Y. Government entities' share of demand deposits have been dwindling since the beginning of the current year, falling by 8.7% in May. Time and savings deposits, although small by comparison to demand deposits, have gained momentum, growing at 13.2% with a more leveled allocation between government entities and their private counterparts. Contribution analysis reveals that the converging gap between the private and public sectors tends to fluctuate as private investors decrease their time and saving deposits when other more lucrative opportunities arise. Government entities, however, have a long-term priority, obvious in the more consistent growth in time and savings.

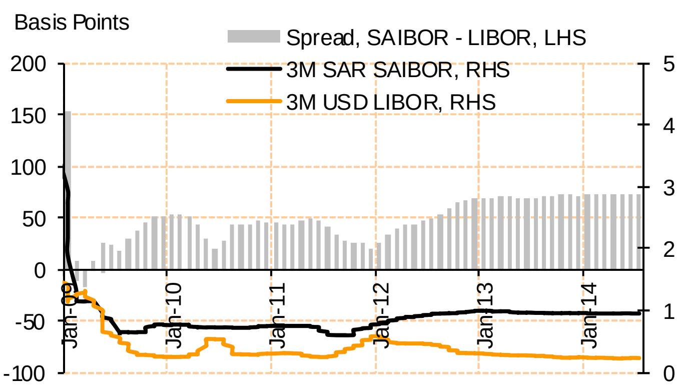
Chart 11: Private Sector Financing



Source: SAMA, NCB Estimates

On the assets side, total claims on banks, excluding T-bills and government bonds, reached 11.5%, a notable moderation from last year's growth rates. Growth in deposits marginally outpaced loans, resulting in a loans-to-deposit ratio of 79.6%. As of the end of May, about 52.3% of loans were short-term, although there is a growing inclination towards longer maturities as medium -term loans accounted for 18.4% and long-term loans accounted for 29.3%. In comparison to last year, where short-term loans posted the slowest growth of 5.2%; we notice that the pace is picking up this year at 9.6%, albeit at a distance from medium and long term loans which grew by 12.5%, and 14.1%, respectively. Ostensibly, Saudi banks are at ease expanding the maturity curve with minimal risk due to the stronger capital requirements set by SAMA. Therefore, more diversification should offer new investment opportunities to maintain the growth levels of their credit portfolios.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

Fresh lending extended to the private sector in 2014 reached SAR69.7 billion, with the month of May accounting for SAR15 billion. On an annual basis, credit to the private sector surged by 12.1%. Meanwhile, fresh lending to public enterprises reached SAR60.4 billion since the beginning of the year, dropping by SAR715 million in May. The bulk of lending in the public sector is in the form of treasury bills, which is used by SAMA as a tool for liquidity management if deemed necessary. The current level of liquidity called for a minor issuance of T-bills worth SAR175 million in May. In regards to the interbank rate, SAIBOR, the subdued interest environment continues to aid banks in avoiding any liquidity shortage by allowing them cheap access to funds. However, in May we notice that interest rate differentials between the SAIBOR and LIBOR reached the highest levels to-date of 74 bps due to larger liquidity movements.

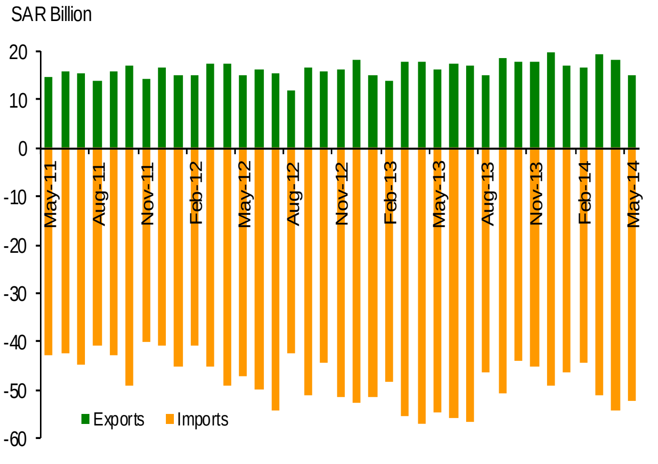
Yasser Al-Dawood
Economist | **y.aldawood@alahli.com**

External Trade

Moderating Growth in Exports

Saudi non-oil exports made an inflection point towards negative territory in March after five months of moderation. In the month of April, non-oil exports saw a meager growth of just 0.4% on an annual basis; an alarming point to the current account surplus. In May, the Central Department of Statistics and Information announced the first negative growth of 5.1% Y/Y in non-oil exports to SAR15 billion, which, given the 12% contribution to the Kingdom's exports, could impact this year's economic forecasts. The rise of non-OPEC oil supply, diminishing risk-premium, in addition to easing sanctions on Iran, rendered growth levels on par with that of previous years unattainable. And with Saudi crude production expected to fall by an average of 40 thousand b/d, the kingdom placed more emphasis on non-oil and private sector growth to cover the shortfall. However, the multi-stage, uneven growth in the global economy had a dismal effect on many of our trade partners, namely China. By weight, non-oil exports fell to 3.45 megatons, a 5.9% downturn on a monthly basis. NCB's report "Saudi Economic Perspectives" highlights a theme of moderation to dominate the outlook going forward this year and onto the next.

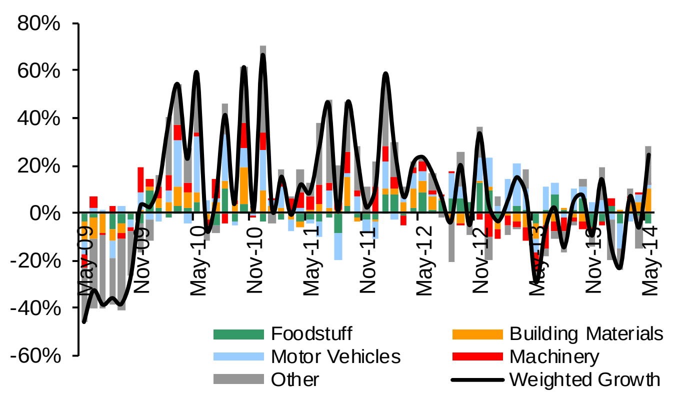
Chart 13: Saudi Non-Oil Trade Balance



Source: CDSI, NCB Estimates

According to the NCB Business Optimism Index, which dipped from 54 points in 4Q2013 to 50 points in 2Q2014, downsized expectations for the non-hydrocarbon sector. However, manufacturing is expected to be supported by steady demand, while supply remains impacted by the late labor reforms. Based on output growth and new orders, the SABB/HSBC Saudi Arabia PMI reports a seasonally adjusted score of 59.2, up from 57 a month earlier, signaling that private non-oil firms are still in the expansionary phase. The two main export categories, plastics and chemical products, which together account for almost 60% of non-oil exports fell by 10.6% and 13.9%, respectively. On the other hand, base metals, which account for 7.3% still maintained a positive trajectory of 12.6% Y/Y. The export by destination data reveals a contrast between the UAE, which maintained a strong annualized 11.8% upsurge, and China and Singapore, which both posted double-digit declines of 13.3% and 25.3%, respectively.

Chart 14: Attribution Analysis of Letters of Credit Opened



Source: SAMA, NCB Estimates

On the import front, demand for imports also moderated by 5% on a year-to-year basis, amounting to SAR52.2 billion. as machinery and electrical equipment, the category which makes up a quarter of imports by value, recorded a 6.3% annualized decline. This sharp fall was partially countered by a 6.9% surge in transport equipment which constitutes 15.9% of the import bill. Imports of base metal receded by 4.7% making as much as 13.5% of the import bill. Imports from China maintained a 5.3% growth compared to last year, posting SAR7.2 billion, thus accounting for 13.7% of the import bill. Imports from the US, which account for 12.3% of imports slid by 9.1% in May to 6.4 SAR. German imports were also impacted, inching down by 2% to SAR3.8 billion, around 7.2% of the value of imports.

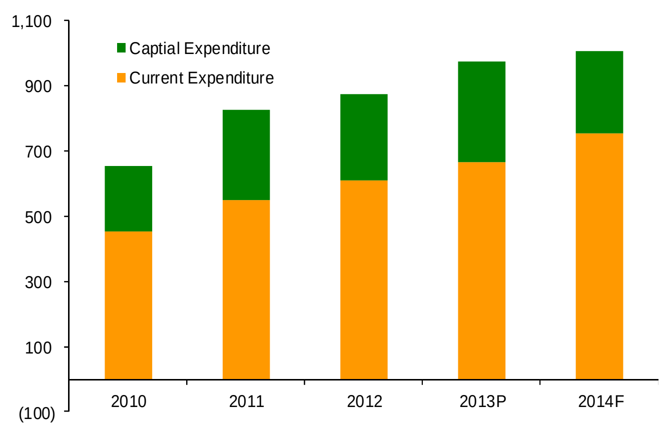
Letters of Credit (LCs) settled for the month of May declined for the seventh consecutive month by an annualized 6.6%, posting SAR19.4 billion. Building materials, which account for 15% of total monthly LCs grew by 23.9% in a reversal to last year's downtrend. Motor vehicles, which account for 13% of LCs moderated by 16.2%, whereas LCs for machinery inched down by 3.3%.

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

Special Focus:
Growth Moderation on the Horizon

The Kingdom's stable macroeconomic backdrop and the move towards streamlining regulations continue to be widely and positively recognized by renowned institutions. Accordingly, Standard and Poor's had affirmed the Kingdom's sovereign rating at AA- with a positive outlook in 2013 and Fitch upgraded it in March 2014 to AA with a stable outlook. The decisions by the rating agencies were prompted by strong government finances, which have largely withstood oil price volatility and the global economic crisis. This enhanced ability to contain shocks and smooth business cycles will continue to support Saudi Arabia's positive economic outlook, going forward. Public domestic debt was reduced further from SAR98.85 billion to SAR75.1 billion in 2013, amounting to 2.7% relative to GDP. We believe that government debt will remain below SAR100 billion threshold for this year and next.

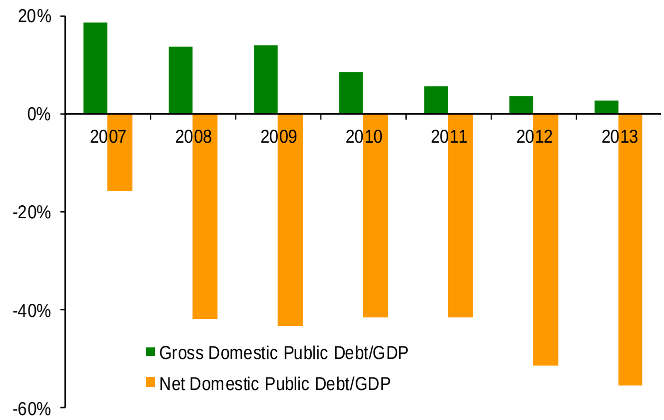
Table 15: Government Expenditure, SAR billion



Source: SAMA, NCB

The next five years might prove to be a challenging time for policy making, with range-bound crude oil prices and contained production weighing negatively on oil revenues and, thus, reversing the hefty fiscal and current account surpluses of recent years. The Ministry of Finance estimates revenues and expenditures at SAR855 billion for each, projecting a break-even. Based on announced revenues, the government seems to have assumed the average oil price at USD73/bbl for this year. With our forecast of USD102/bbl for the average Arabian light spot prices and 9.6 MMBD for average oil production, we project a budget surplus of SAR84 billion, or 2.9% of estimated GDP in 2014. The decline in the surplus will be largely due to a fall in actual revenues, expected at SAR1090 billion, with oil revenues registering SAR965 billion, which is 6.8% below actual level in 2013. Additionally, on the expenditure side, the government will most likely exceed budgeted expenditures, albeit at a mere 3%, to breach the SAR1 trillion mark, as has been historically the case, however, this figure will be the lowest budget overrun since 1998. According to our forecast, actual capital expenditures will likely end up above the budgeted figure of SAR248 billion to reach SAR251 billion in 2014. Against this backdrop of projected higher expenditures and lower revenues, the breakeven oil price required to balance the budget will rise from USD83/bbl last year to USD87/bbl in 2014.

Table 16: Domestic Public Debt



Source: SAMA, NCB

Systemic macro and banking sector risks are at an all-time low. Sizable fiscal surpluses have boosted the ability of the government to smoothen cyclical vagaries and withstand negative terms of trade shocks. The current standing of the Kingdom that includes one of the lowest net debt levels on a global scale, 2.7% out of GDP, and the world's third-highest net foreign assets that amounts to USD717.7 billion contrasts with an economy that was mired in debt at 103.5% to GDP and held meager net foreign assets of USD37.9 billion by the end of the 1990s. Ostensibly, the Saudi government had learned from the unfavorable business cycle that remained in place from the end of the 1980s throughout the 1990s, becoming more prudent in managing finances and investing assets. Additionally, in comparison to other countries, the Saudi banking system had a comfortable loan to deposit (L/D) ratio of 78.9% by the end of April 2014, a level that reflects excess capacity to lend and a lower systemic risk. Meanwhile, the capital adequacy ratio at 17.8% is another signal of an ample cushion to match the embedded risk in assets, especially after taking into consideration the lower capacity utilization compared to regional and international counterparts, with the UAE, Kuwait and Russia near 90%, 92% and 124% L/D ratios, respectively. The improvement in asset quality since mid-2011 is another plus for the domestic banking system, illustrating the prudent management and supervisory practices that have been applied by banks and SAMA.

Tamer El Zayat
Senior Economist / Editor | **t.zayat@alahli.com**

Economics Department

The Economics Department Research Team

Head of Research

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

Macroeconomic Analysis

Tamer El Zayat
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
Economist
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