

Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

3	<i>Oil Market</i>
4	<i>Foreign Exchange</i>
5	<i>Commodities</i>
6	<i>Money and Inflation</i>
7	<i>Capital Markets</i>
8	<i>Loans Market</i>
9	<i>External Trade</i>
10	<i>Special Focus: Tadawul Welcomes Foreigners</i>

Executive Summary

- The escalating events in the Middle East had initially pushed the global benchmark, Brent, higher, yet a reversal took place when president Barack Obama ordered selective airstrikes against militant held positions.
- The economic outlook of the 18-nation currency block has received a couple of setbacks with the Italian economy returning to recession and the German economy contracting for the first time since 2013 by more than analysts forecast.
- Looking ahead, there is no denial that fundamentals are pivotal, yet speculative outflows might cause a rout in commodities in the months leading to and following rate decisions by major central banks.
- As the US tapers their quantitative easing program and raise interest rates in the future, we expect time and savings deposits will attract more funds going into 2015.
- Corporate profitability will likely increase and balance the current rise of stock prices. The index might face a “profit taking” phase yet it should not reverse the positive trajectory.
- SAMA released updated regulations for consumer lending which include more transparency by creditors, ability to pay the loan in full early without bearing future interest payments, and limiting administrative fees to SAR5’000 or 1% of total loan whichever is lower. SAMA is proactively seeking the benefit of consumers and financial entities by proactively developing their rules and regulations.
- 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

As of August 21, Tadawul’s market capitalization reached USD583.6 billion making it the GCC’s and the Arab world’s largest. The global economic status of the Saudi economy will attract many qualified financial institutions to diversify their investments and penetrate the robust Saudi market. The gradual process of opening the market to foreigners will ensure stability. The CMA is expected to finalize the regulations within 2014 and welcome foreign investment by early 2015.

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	102.0
Average Daily Crude Oil Production, MMBD	9.2	8.2	8.2	9.3	9.8	9.6	9.6
GDP at Current Market Prices, SAR billion	1,949.2	1,609.1	1,975.5	2,510.7	2,752.3	2,806.7	2,863.4
GDP at Current Market Prices, USD billion	520.5	429.7	526.8	670.4	734.9	749.4	764.6
Real GDP Growth Rate	8.4%	1.8%	7.4%	8.6%	5.8%	4.0%	4.3%
Oil Sector GDP Growth Rate	4.3%	-8.0%	0.3%	11.0%	5.7%	-1.0%	0.0%
Non-oil Sector GDP Growth Rate	9.8%	5.3%	9.6%	8.0%	5.8%	5.4%	5.4%
Population, million	25.8	26.7	27.6	28.4	29.2	30.0	30.7
Population Growth Rate	3.4%	3.4%	3.4%	2.9%	2.9%	2.7%	2.5%
GDP /Capita, USD	20,184.2	16,116.2	19,112.7	23,625.3	25,172.6	24,986.4	24,869.4
CPI Inflation, Y/Y % Change, Average	6.1%	4.1%	3.8%	3.7%	2.9%	3.5%	3.0%
External Sector							
Merchandise Trade Balance, USD billion	212.0	105.2	153.7	244.7	246.6	222.7	206.1
Oil Exports, USD billion	281.0	163.1	215.2	317.6	357.1	324.9	303.1
Non-oil Exports, USD billion	32.5	29.3	35.9	47.1	51.0	54.1	57.7
Merchandise Imports, USD billion	-100.6	-86.4	-96.7	-119.0	-140.7	-152.0	-154.7
Net Unilateral Transfers, USD billion	-23.0	-27.7	-27.9	-29.4	-30.4	-35.9	-38.7
Current Account Balance, USD billion	132.3	21.0	66.8	158.5	164.8	132.6	124.3
Current Account Balance/GDP	25.4%	4.9%	12.7%	23.6%	22.4%	17.7%	16.3%
Net Foreign Assets with SAMA, USD billion	438.5	405.9	441.0	535.9	648.5	717.7	753.6
Fiscal Sector (Central Government)							
Budgeted Expenditure, SAR billion	410	475	540	580	690	820	855
Actual Revenues, SAR billion	1,101.0	509.8	741.6	1,117.8	1,247.4	1,156.4	1,085.6
Actual Expenditure, SAR billion	520.1	596.4	653.9	826.7	873.3	976.0	1,005.3
Expenditure Overrun, %	26.8%	25.6%	21.1%	42.5%	26.6%	19.0%	17.6%
Total Revenues/GDP	56.5%	31.7%	37.5%	44.5%	45.3%	41.2%	37.9%
Total Expenditure/GDP	26.7%	37.1%	33.1%	32.9%	31.7%	34.8%	35.1%
Overall Budget Balance, SAR billion	580.9	-86.6	87.7	291.1	374.1	180.3	80.3
Budget Balance/GDP	29.8%	-5.4%	4.4%	11.6%	13.6%	6.4%	2.8%
Break-Even Oil Price	40.2	60.8	64.1	75.3	73.9	82.6	87.5
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%	11.7%
Growth in Credit to the Private Sector	27.9%	-0.6%	4.8%	11.0%	16.4%	12.1%	9.8%
Average 3M SAR Deposit Rate	3.3%	0.9%	0.7%	0.7%	0.9%	1.0%	0.9%
Average 3M USD Deposit Rate	3.0%	0.7%	0.4%	0.3%	0.4%	0.3%	0.3%
Spread, in Basis Points, SAIBOR-LIBOR	37.4	26.4	39.8	40.9	55.2	68.7	60.0

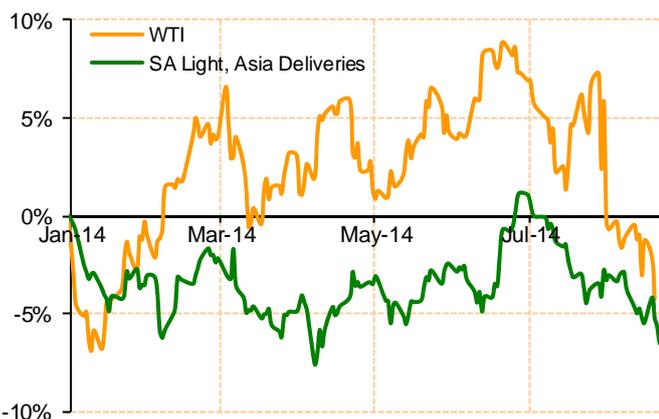
Oil Market

Geopolitics and the Middle East, Yet Again!

Oil benchmarks that peaked in June on the back of geopolitics have been pressured downwards since then, with the market at ease with the fact that the impact on Iraq's crude oil exports was relatively limited especially that the conflict was contained in the western and northern parts of the country and far from the south, which house three-quarters of Iraq's crude output. The three biggest oilfields, namely Rumaila, Majnoon and West Qurna-2, as well as the export terminal of Basra lie in the south, and as such a significant drop in output and exports did not materialize. Lately, however, geopolitical concerns had resurfaced with the ISIL militant group growing stronger and bolder to attempt an incursion on Kurdish held territories to seize refineries and oil fields.

At the beginning of this month, the escalating events in the Middle East had initially pushed the global benchmark, Brent, higher, yet a reversal took place when president Barack Obama ordered selective airstrikes against militant held positions. Recently, the European benchmark that is more sensitive to global events registered the lowest closing price in fourteen months around USD102/bbl. Nevertheless, we do believe that breaching the USD100/bbl support level is unlikely and the most plausible scenario is a range-bound movement between USD100-110/bbl. In its latest report, the International Energy Agency (IEA) emphasized that the oil markets are well supplied and underscored its confidence in the ability of OPEC, specifically Saudi Arabia, of satisfying any expected increase in demand in the second half of this year.

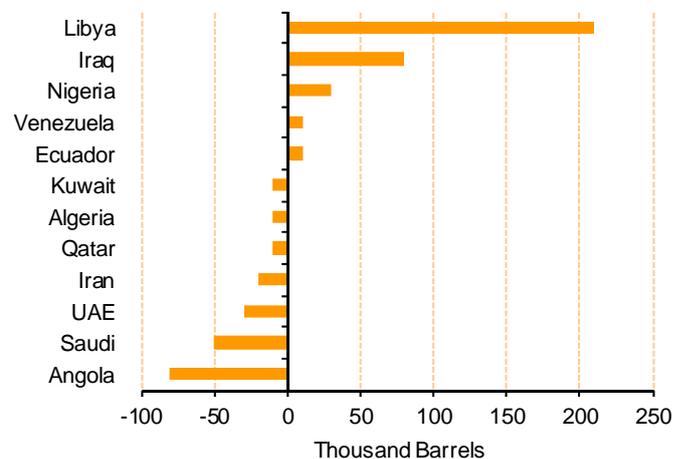
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

Recent data released by the IEA highlighted weakness in global oil demand growth, which might prove instrumental in balancing fears amid the aforementioned concerns to oil supplies, notably in the Middle East. The IEA brought down its estimates for demand growth in 2014 and 2015 after growth eased in 2Q2014 to the lowest since early 2012. The agency demand growth for both years were reduced by 180 and 90 thousand barrels a day, given the lower estimates for Russia and China. Inventories might also be pivotal in supporting oil prices going forward, with the OECD's stockpiles of crude and refined products increasing for a sixth month in June, which is bringing the forward demand cover closer to its five-year average.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

The downside potential might be limited, as explained, yet a rebound scenario is less likely as well. The upside potential was undermined by a global macroeconomic outlook that was negatively impacted as the Italian economy entered another technical recession, contracting by 0.1% in the second quarter following a drop of 0.2% in the first three months of this year. A strengthening greenback that have been appreciating of late, reaching a eleven-month high around USD1.32 per EUR, will undermine the attractiveness of commodities as a hedge against inflation. To conclude, geopolitical uncertainty will remain a hanging cloud on a region that has not experienced a semblance of normalcy in a long time, the Middle East.

Tamer El Zayat

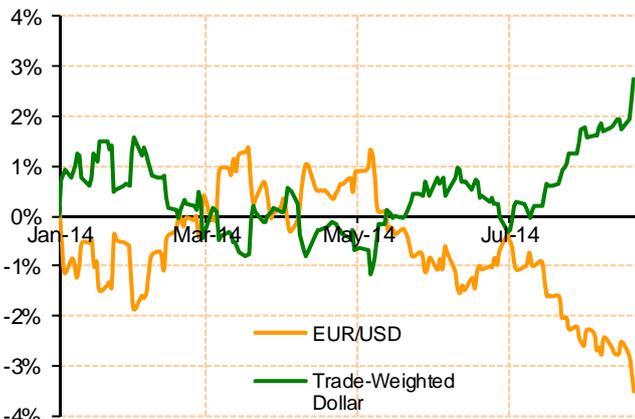
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Foreign Exchange

Another “Bernanke Shock” Might be Near

Economic divergence across the global economy is impacting advanced and emerging market currencies and it is widely anticipated that a decision by the Federal reserve to raise its benchmark, for the first time since 2006, will also intensify volatility. Evidently, we do expect a market response similar to last year’s reaction to Ben Bernanke’s comments of tapering asset purchases that saw a rout across emerging market assets. There is no denial that monetary accommodation has pumped trillions of cheap money that enabled investors to repair their balance sheets and income statements by making huge gains from interest differentials that was guaranteed by the rhetoric that the US policy stance will remain “exceptionally low” for a “considerable time”. A policy reversal will reignite another cycle of capital outflows that will surely weigh negatively on emerging market currencies especially those that suffer from structural deficiencies in their current and fiscal accounts.

Chart 3: Trade-Weighted Dollar and the Euro

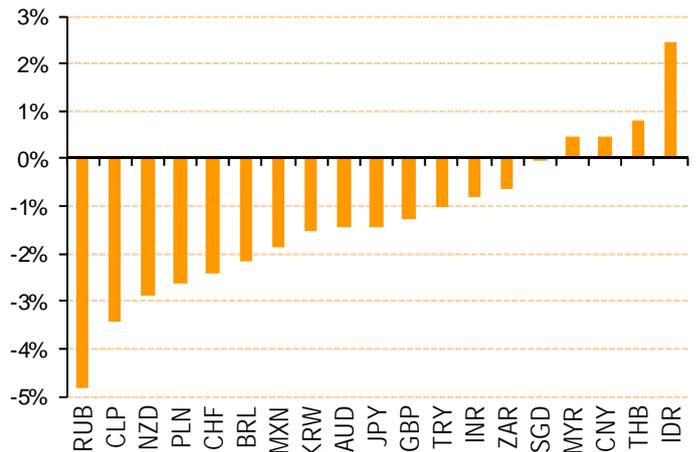


Source: Thomson Reuters

The aforementioned dynamics have clearly helped the greenback to break the unjustifiable weakness against the euro, with the world’s reserve currency registering around USD1.32 per euro of late. The economic outlook of the 18-nation currency block has received a couple of setbacks with the Italian economy returning to recession and the German economy contracting for the first time since 2013 by more than analysts forecast. The Ukrainian standoff, the slowest pace of inflation since 2009 and the accommodative stance of the ECB are bound to instill further weakness in the euro, with the Fed treading the path of less accommodation. Recent data from the Commodity Futures Trading commission (CFTC) have

clearly indicated that hedge funds and speculators have been wagering more on a decline in the euro, with the total net-short position reaching a two year high. In our opinion, breaking the USD1.30 threshold is not a distant possibility any more for an end of year target.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

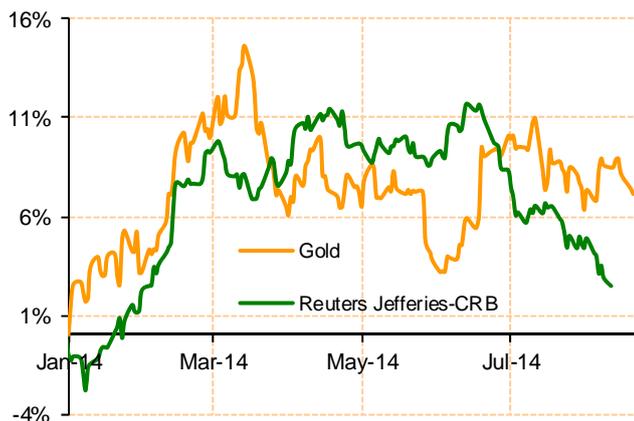
Another G7 currency that were under pressure lately was the GBP that fell precipitously on statements from the Bank of England that raising interest rates will hinge more on weak wage growth rather than unemployment and economic growth. After reaching USD1.7192 on July 15th, the highest since October 2008, the Sterling fell by more than 3%. The slower path of inflation in July that fell to 1.6%Y/Y from 1.9% in June might also be another near-term drag on the currency especially that it can be seen as a factor that will extend the BOE’s decision on when to lift the borrowing costs. Ostensibly, the UK’s economy is on a much stronger footing compared to the EU and as such it is expected that a rebound might materialize in the medium-term, with the GBP registering its most oversold level since 1Q2013 and with most analysts still predicting a rate hike as early as November. To conclude, it is quite clear that central bank decisions during the next couple of months will influence the FX markets, which will witness an increased level of volatility.

Commodities

Commodities Still Under Pressure

Commodity prices from precious metals to agriculture had been under pressure since the end of June on the back of a strengthening greenback, lack of inflationary pressures across the advanced economies, and expectations that supplies will climb during the next five years. We also expect that the anticipated rate increases by the Fed and the BOE might support this overall weakness in commodity prices, as investors unwind positions that have been built in the heydays of cheap money, a time that resulted in heated debates about the impact of investment flows and speculation on prices relative to the fundamentals of demand and supply.

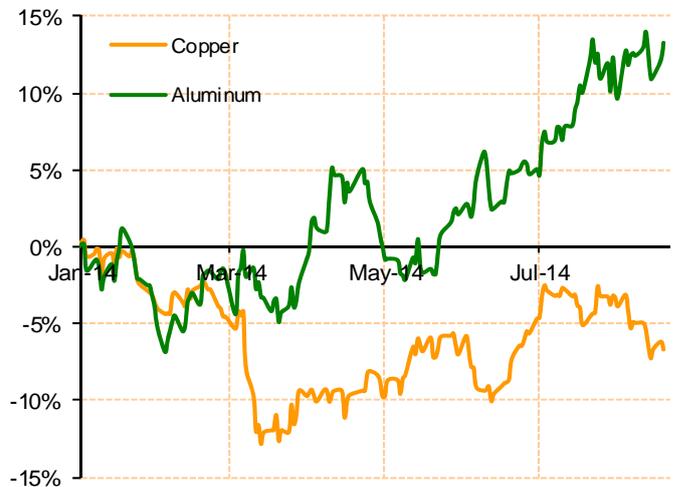
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

On the agriculture front, the S&P Goldman Sachs Agriculture Index had reversed earlier gains that stood at 3.1% by the end of 27th June to register a decline of 8.6% in August, with corn and soybeans currently trading at four-year lows. The extent of the decline can be attributed not only to the USD story, but also to a fundamental picture that points towards adequate supplies of wheat, rice and corn. As for precious metals, gold and silver continue to suffer from the abovementioned normalization talk, losing around 3% and 8% during the last six weeks of trading. It is not expected as such that gold will be able to reach USD1400/Oz and it is becoming increasingly likely that the yellow metal might settle within the USD1200-1300/Oz range by the end of the year, with most analysts predicting the persistence of such levels during the next couple of years. The fact the India that represents more than 25% of global demand might permanently maintain controls on gold imports to rectify its current account imbalances will surely contain any rebounds towards the historical high recorded in 2011.

Chart 6: Base Metals



Source: Thomson Reuters

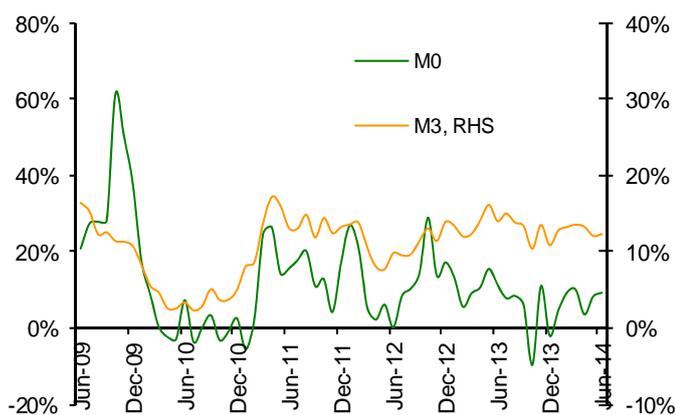
On the contrary, the outlook for base metals are improving amid signs of tightening supplies and a pickup in Chinese demand. Despite the fact that copper have lost 4.8% in 2014YTD, the main consumers of the red metal, China and the US, increased their demand, with the former's consumption reaching a record and the latter's use climbing to the highest since 2009, which will certainly underpin higher prices in the near to medium-term. Demand in China was driven by export growth that propelled its trade surplus to a record in July. Meanwhile, the housing sector and its higher demand for wiring had been the driving force in the US, with housing starts rising to an eight-month high in July. Global inventories will also be supportive of higher prices going forward, especially with them falling by around 50% in 2014 and being at the lowest level since 2008. Additionally, aluminum will continue to attain its positive stance that saw it register a gain of around 13.3% YTD based on robust demand conditions in the vibrant auto industry. Looking ahead, there is no denial that fundamentals are pivotal, yet speculative outflows might cause a rout in commodities in the months leading to and following rate decisions by major central banks.

Money & Inflation

Lower Imported Inflation Expected

The geopolitical tensions in neighboring countries, namely Iraq, have kept risk levels high which trickled towards oil prices. The Saudi government's planned finances are based on a break-even scenario, however, given the elevated level of oil prices during the first half of 2014, Saudi is set to record another fiscal surplus. The influx of revenues is reflected by the strong monetary status as M0, the monetary base, increased by 9.2% during June on an annual basis, rising to SAR324 billion. Currency outside banks picked up by 9.1% Y/Y during June as Ramadan started mid-way during the month. The main bulk of M0 resides in bank reserves which are mostly deposits with SAMA, they rose by 7.6% Y/Y. Meanwhile, cash in vault grew by 20.1% annually to bring total bank reserves to SAR172.5 billion by the end of August. M0's level is 8.8% below its peak in January, evidence of the prudent strategy adopted by SAMA to limit liquidity risks. Additionally, banks' excess reserves ratio which is represented by deposits with SAMA other than statutory deposits dropped to 38.5% as banks opt to utilize their assets given the healthy state of the credit market. SAMA's treasury bills recorded an annual increase of 30.7% to contain inflationary risks of excess liquidity in the market.

Chart 7: Growth in Monetary Aggregates

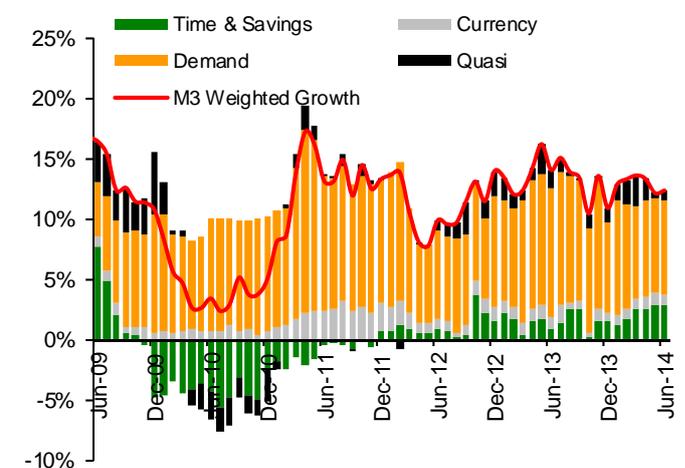


Source: SAMA, NCB Estimates

The broadest measure of money supply (M3) has maintained a strong positive trajectory for the past few years as it posted a 5-year compound annual growth rate of 10.5% by the end of June. The current annual rate is marginally higher at 12.3% Y/Y, risks of overheating are still benign and the pace is sustainable given the robust status of the overall economy. The main driver of M3 was demand deposits which gained 14.1% Y/Y in June.

Since the beginning of the year, the non-yielding deposit base added SAR81.8 billion as investors opt to park their assets in a readily accessible form. Additionally, time and saving deposits have been outpaced once more due to the suppressed interest rate environment as they only expanded by 12.8% Y/Y. As the US tapers their quantitative easing program and raise interest rates in the future, we expect time and savings deposits will attract more funds going into 2015. In addition, other quasi-monetary deposits accelerated by only 6.1% annually with a share of 11.9% of M3 by the end of 2014's first half.

Chart 8: Money Supply, Contribution



Source: SAMA, NCB Estimates

Consumer prices have been range-bound as the benchmark inflation rate recorded a rise of 2.7% in local prices. Inflation has been contained through proactive policies which subdued inflationary pressures. The largest category by weight, food and beverages, rose by 2.8% on an annual basis, the slowest pace in almost four years. Imported inflation majorly influences local prices as Saudi is import-oriented with regards to consumable goods. The US dollar has been improving against other major currencies and we expect the category to slow further. Real estate prices remain a bottleneck as the youth population seek to own their assets. The housing and utilities category accelerated at a rate of 4.1% Y/Y, slightly above the first half average. The inflation rate is expected to remain subdued despite the sustainable growth of credit and the liquid state of the economy. We do not foresee inflationary risks arising during this year as the underlying factors remain favorable domestically.

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Capital Markets

A New Dawn

Tadawul completed the holy month of Ramadan, which coincided with the academic holidays, without experiencing the summer trend that usually witnesses withdrawals. Stocks have been underpinned by strong corporate profitability and a healthy supportive economy. Towards the end of July, the market received a huge boost through the announcement of the much anticipated opening of Tadawul to foreign investors to directly trade in the market (see Special Focus). Last month, the main index climbed by 7.4% to end Ramadan trading at 10'214.73, a strong rebound from June's 3.2% drop. Gains were recorded across all sectors, the largest growth was posted by agricultural stocks as the sector gained 11.0% last month. The petrochemical sector also recorded a substantial monthly increase at 10.0% to bring its YTD gains by the end of July to 12.8%. Throughout the first seven months of 2014, all sectors recorded double digit growth rates with the exception of the media sector which contracted by 3.7%. The index maintained the positive momentum created over the past few months. The Council of Ministers issued the resolution for foreign traders on July 21, thus the market's reaction to the announcement is captured during August. As of August 21, Tadawul reached the highest level in over six years at 10'734.76, climbing by 10.1% since the announcement. The index breezed through resistance levels and is on the path of testing the 11'000 level in the next couple of weeks.

Chart 9: Tadawul All-Share Index

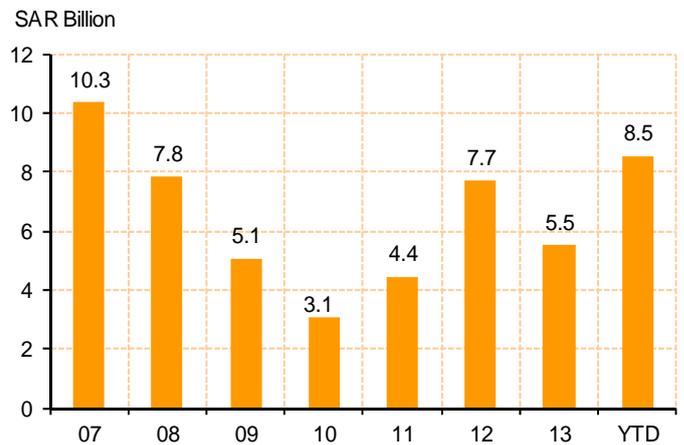


Source: Tadawul

As expected, investor appetite declined during July due to Ramadan. Daily traded volumes averaged SAR6.8 billion following June's SAR8.2 billion, a drop of 17.0% M/M. The lower trading levels did not deter the market

from its bullish trajectory. Despite recording 31.9% lower trading value and a drop of 22.7% in the number of transactions, the market increased its market capitalization to SAR2.1 trillion, an 8.0% monthly rise by the end of July. The market's predominant individual trading remains yet we have witnessed a growing level of activity for GCC, resident foreigners, and SWAP trading. During July, the combined share of trading for the aforementioned non-Saudi categories was 4.3% of the total market, their share rose to 5.7% for the following month. The value of SWAPs, which is currently the only viable option for foreign capital to enter the market, during June was 1.4% of the total market with a selling majority. During July, the net flow reversed to the buying side and the value of SWAP trading represented 2.1% of the market.

Chart 10: Average Daily Traded Value



Source: Tadawul

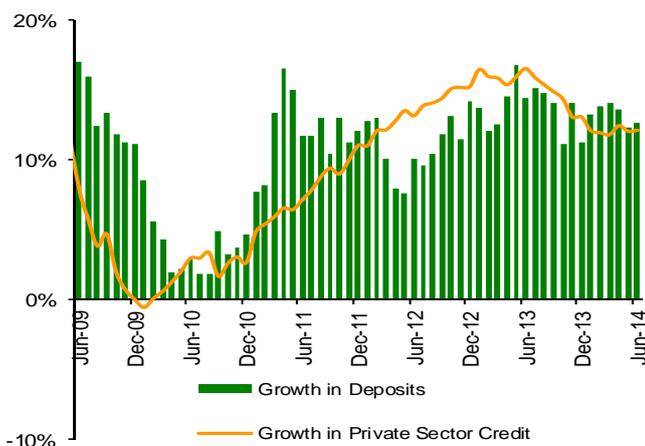
The rally of the stock market had reduced valuations given the rise of stock prices. Last month, the market's price-to-earnings (P/E) ratio increased to 16.95, up from 16.54 by the end of the first half. Where it might cause a concern as emerging market's P/E ratios are between 13-14, the Saudi economy is benefitting from elevated oil prices which have supported the expansionary fiscal policy. Furthermore, the government's efforts of diversifying away from the oil sector will continue to aid the private sector's growth prospects. Accordingly, corporate profitability will likely increase and balance the current rise of stock prices. The index might face a "profit taking" phase yet it should not reverse the positive trajectory.

Loans Market

Sustainable Growth on Credit Activity

Saudi banks have benefitted from the robust economy as they are able to extend credit lines to growing businesses, which in turn, translated to record profits for financial entities. The depositary base reached an all-time high at SAR1.5 trillion, increasing 12.7% on an annual basis by the end of June. Banks' total deposits have been growing at double digits for the past couple of years as oil prices remain elevated and supportive of a liquid economy. The majority of deposits are demand based with a share of 62.8% as they climbed 14.1% Y/Y during June. Businesses and individuals hold 93.8% of demand deposits while government entities make up the remaining 6.2% portion. However, government entities have been decreasing their demand deposits, 19.2% Y/Y during June. Meanwhile, the government's time and savings deposits have increased by 28.4%, adding SAR33.7 billion YTD to reach SAR183.7 billion in June. Opting for yielding assets reflects the willingness to utilize resources. On the other hand, businesses and individuals are more inclined towards riskier alternatives given that their level of time and savings deposits stagnated at SAR176.5 billion, an annual gain of 0.1%. The suppressed interest rate environment is unable to lure investment capital especially as Tadawul is on track to test the 11'000 level (See Capital Markets). Additionally, other quasi-monetary deposits grew by 6.1% annually as foreign currency deposits increased by 5.7% Y/Y annually during the month of June.

Chart 11: Private Sector Financing

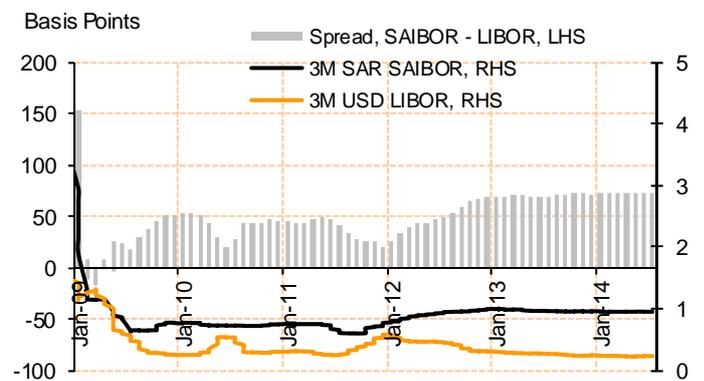


Source: SAMA, NCB Estimates

Assessing the other side of the balance sheet, total claims of the banking system, excluding T-bills and government bonds accelerated at an annual pace of 11.8% last June. The utilization of deposits is represented by the

loans-to-deposits ratio which climbed to 81% during the first half of 2014. In comparison, Qatar and UAE's L/D's ratios are above 100 and 90, respectively. However, SAMA favors a more conservative approach and prefers to limit potentially riskier positions. By maturity, the share of short term bank credit still represents the majority of credit with a share of 52.9%. The previous inclination towards medium and long term credit have faded as they grew by 11.7% and 11.8% on annual basis while short term credit outpaced both at 12.0% Y/Y by the end of June. Additionally, total claims on the public sector gained 24.9% as the government have been using Treasury bills to control liquidity levels. The government has accumulated an additional SAR53.5 billion worth of T-bills over the first half, indicating the proactive measures taken by SAMA to control liquidity levels.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

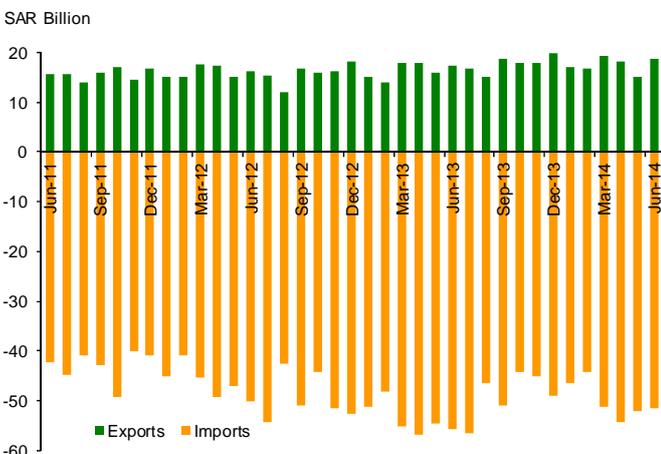
As for the private sector, fresh lending reached SAR87.8 billion this year, an increase of 12.4% Y/Y, to reach a record SAR1.16 trillion in June. The credit portfolio of Saudi banks continues to be largely comprised of the commerce sector which holds 20.2% of banks' total financing, SAR244.5 billion. The second largest sector, manufacturing and processing, grew at an annual 11.6% while the building and construction sector recorded a second quarter of substantial growth at 12.0% Y/Y. The mining and quarrying sector increased at 39.5% Y/Y to reach SAR20.0 billion, albeit being benign in size it is almost four times its level five years ago. Additionally, SAMA released updated regulations for consumer lending which include more transparency by creditors, ability to pay the loan in full early without bearing future interest payments, and limiting administrative fees to SAR5'000 or 1% of total loan whichever is lower. SAMA is proactively seeking the benefit of consumers and financial entities by proactively developing their rules and regulations.

External Trade

A Favorable Trade Balance

Over the past few years, a series of global and regional events supported higher oil prices. As the largest OPEC producer and being an economy that is heavily reliant on oil exports, Saudi has blossomed with fiscal surpluses. The growing economy created substantial investment opportunities for other economies and trade ties are constantly improving. Saudi is eager to diversify away from oil and implementing various projects to accomplish its goals of developing the non-oil sector. Building refineries to grasp a larger share of the value chain has facilitated growth in manufacturing for consumption and exporting to other regional and international markets. According to the Central Department of Statistics and Information, Saudi non-oil exports by value rebounded and recorded a 14.9% annual growth in June, compared to a contraction of 5.1% during the previous month. During June, exports by weight increased by 3.2% which indicates higher pricing for goods. The main bulk of non-oil exports are plastic products which account for SAR6.2 billion, a third of the total value. Expectedly, the second largest category is chemical products at SAR5.8 billion for the month of June, growing by 11.8% on an annual basis. By destination, the UAE is the largest recipient of Saudi goods, growing by a staggering 60.4% Y/Y as most of the goods are likely re-exported to reach international markets. The second largest recipient was China at SAR2.3 billion, a share of 12.2% of total exports by the end of the first half of 2014.

Chart 13: Saudi Non-Oil Trade Balance

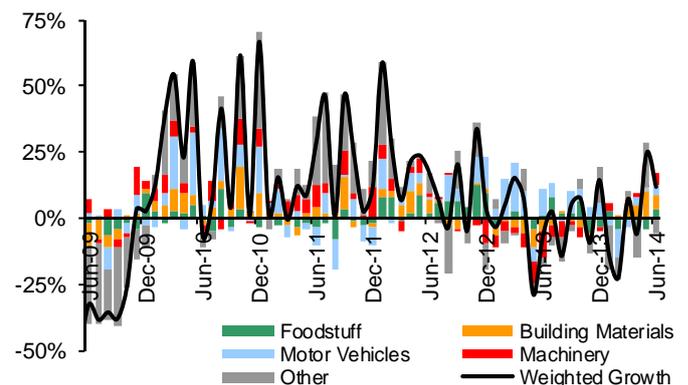


Source: CDSI, NCB Estimates

As for imports, the domestic economy imported goods worth a total SAR51.5 billion, an annual 8.2% decline during June. Furthermore, imports by weight recorded a

drastic drop of 20.9% annually, declining from 7.1 million tonnes in June 2013 to 5.6 million tonnes twelve months later. Over a quarter of Saudi imports consist of machinery and mechanical equipment at SAR13.2 billion, dropping by 10.0% Y/Y in June. Additionally, transport equipment imports' total value declined by 15.6% annually. As the Saudi economy is heavily reliant on imports for consumer goods, imported inflation influences local prices to a considerable degree. Imports from the European Union represented 27.8% of the total import bill during June, SAR14.4 billion. Consequently, the recent strength of the US dollar will positively impact Saudi's trade balance and reduce pressures on local consumer prices. China has recently overturned the US as the top source of Saudi imports. Their consistent growth over the past decade provided a competitive alternative for cheaper goods as they have the edge over advanced economies with regards to costs. Saudi Imported SAR7.5 billion worth of goods from China while SAR6.0 billion came from the US in June.

Chart 14: Attribution Analysis of Letters of Credit Opened



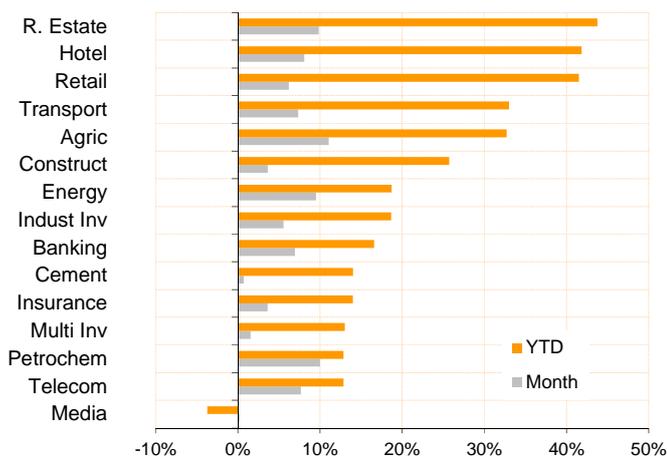
Source: SAMA, NCB Estimates

Forward looking, newly opened Letters of Credit (LC) represent consumer spending prospects as businesses import goods for future demand. The Saudi economy witnessed a robust year that has trickled down to the consumer which drove businesses to expand and grow to meet the rising demand. Newly opened LCs grew by 11.8% annually during June at SAR18.5 billion. Noticeably, opened LCs for building materials grew by 73.7% Y/Y in June and, over the first six months of 2014, settled LCs for building materials reached SAR12.5 billion, rising by 24.0% Y/Y. The economic environment is favorable for local businesses and the depreciation of currencies against the dollar will support a healthier trade balance.

Special Focus: Tadawul Welcomes Foreigners

The long anticipated decision to open the market for foreign investors has finally been approved. Last month, the Council of Ministers announced the decision and the Capital Market Authority (CMA) produced a draft to be followed by a 90-day period to provide a platform for concerned and interested parties to critique and suggest modifications. As expected the first phase will only allow qualified institutional foreign investors (QFI) to enter the market with certain limitations. The regulatory framework is likely to be amended according to the feedback the CMA will receive in the next three months. A QFI must either be a bank, brokerage or securities firm, fund manager, or an insurance company with an investment experience of 5 years or more. Furthermore, a QFI must have assets under management worth a minimum of USD5 billion with a possible waiver to a minimum of USD3 billion. CMA is keen on attracting long term investors and fend off speculative traders which has hindered the stock market in the past. The current dynamics of trading is predominantly comprised of local individuals, over 90%. Currently, foreigners are limited to access the market through SWAPs and GCC traders are benign with regards to their trading volume which translate to high fluctuations and a lack of a strong positive correlation with the economy.

Table 15: Tadawul Sectoral Performances

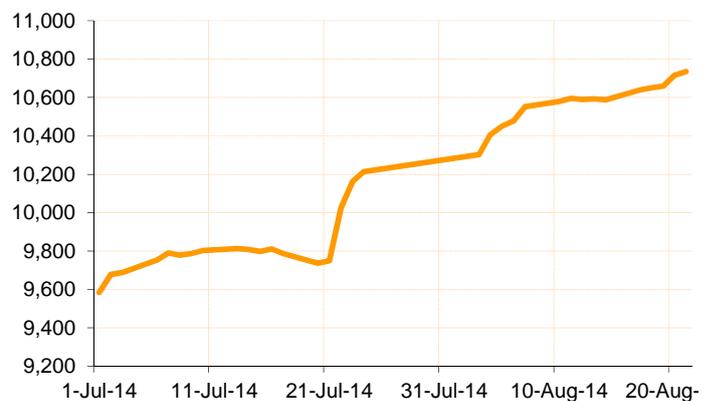


Source: Tadawul

As we have mentioned, this is expected to be the initial phase of adding depth and expanding the scope of the market. Accordingly, CMA have been selective in their preliminary regulations for QFIs. Following approval procedures, QFIs will face some trading limitations for CMA

to safely maintain and control this huge milestone for Tadawul. A single QFI and its affiliates can only own up to 5% of a listed stock. Additionally, a client may not aggregate more than 5% of a stock through multiple QFIs. However, multiple QFIs may own as much as 20% of the issued shares of a certain listed stock. Furthermore, all types of foreign investors may not be allowed to own more than 49% of a listed company to maintain the majority of ownership for Saudis. The exposure of foreigners to Tadawul will also be limited to 10% of the index's market cap which brings early estimates to a possible USD50-60 billion worth of capital finding its way to local stocks. The current bylaws on foreign traders will also be imposed on QFIs such as the inability to own in Makkah or Madinah based companies.

Table 16: Tadawul Index since June 2014



Source: Tadawul

Despite the limitations, the inflow of capital is beneficial for the market and traders have reacted positively since the announcement (see Capital Markets). A QFI will be able to directly trade and reduce trading fees in comparison to the current SWAP option. As of August 21, Tadawul's market capitalization reached USD583.6 billion making it the GCC's and the Arab world's largest. The global economic status of the Saudi economy will attract many QFIs to diversify their investments and penetrate the robust Saudi market. The gradual process of opening the market to foreigners will ensure stability. The CMA is expected to finalize the regulations within 2014 and welcome foreign investment by early 2015. Additionally, MSCI noted the possibility of including Saudi Arabia to the emerging markets gauge by 2017. Given the expanding nature of the domestic economy, the path for the local share market is positive barring any geopolitical unrest or other systematic risks.



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