

Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

3	Oil Market
4	Foreign Exchange
5	Commodities
6	Money and Inflation
7	Capital Markets
8	Loans Market
9	External Trade
10	Special Focus: <i>Banks Adopt Wait-and-See Approach</i>

Executive Summary

- Non-OPEC producers, who were also party to this November's deal, apparently have been less compliant. As a result, the overall compliance rate of OPEC and non-OPEC members was only 60% during Q1 2017.
- Asian currencies caught respite during April as they continued to rebalance following the greenback's ascent. In addition to receding concerns from North Korea, easing tension over the Korean peninsula offset expectations of softer manufacturing in China.
- The more ubiquitous use of aluminum and lower production allowed it to rally the most among base metals. China introduced new measures to reduce the environmental impact of smelters, consequently limiting output to 70% of capacity.
- Over the short-term, Ramadhan is expected to support prices during the religious/festive season, coinciding with the academic Summer vacation which should also spur expenditures.
- By the end of March 2017 the total holdings of QFIs still stand at a meager SAR1.9 billion, an insignificant 0.12% of total market capitalization
- The recent Royal Decree which restored public employees' allowances will spur consumer demand, albeit with limited upside growth as sentiment remains fragile.
- The sudden upturn in non-oil exports was underpinned by a double-digit surge in plastics and chemical products owing to the relative improvement in oil prices.

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

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

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

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

View of the Month

The twelve locally incorporated banks posted a drop of 5.4% in net income during 2016, the first decline since the financial crisis. Following the record SAR43.7 billion reached in 2015, banks' bottom-line settled at SAR41.3 billion last year. Early 2016, local businesses faced solvency difficulties as the government delayed payments, triggering a spike in the interbank rate to 2.4% by October.

Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016P	2017F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	40.9	50.6
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.4	10.1
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,799.9	2,836.3	2,444.1	2,398.6	2,525.5
GDP at Current Market Prices, USD billion	670.4	734.9	747.6	757.4	652.6	640.5	674.4
Real GDP Growth Rate*	10.0%	5.7%	2.7%	3.7%	4.1%	1.4%	-0.7%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	3.5%	2.5%
External Sector							
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-51.6	-53.4	-35.3
Current Account Balance/GDP	23.6%	22.4%	18.1%	9.7%	-7.9%	-8.3%	-5.2%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	529.3	489.5
Fiscal Sector (Central Government)							
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	612.3	528.0	700.0
Actual Expenditure, SAR billion	826.7	873.3	976.0	1100.0	978.0	825.0	890.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	28.7%	13.7%	-1.8%	0.0%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-55.6	-365.7	-297.0	-190.0
Budget Balance/GDP	11.6%	13.6%	6.4%	-2.0%	-15.0%	-12.4%	-7.5%
Break-Even Oil Price	75.3	73.9	82.6	99.1	82.9	62.6	66.8
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)	13.3%	13.9%	10.9%	11.9%	2.6%	0.7%	0.9%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	2.2%	2.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.1%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.7%	1.7%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	134.7	80.0

Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
 Note: Saudi Economic Review Data, April 2017 Update (Historical and Projections)

Oil Market

Global Inventories are Still Oversupplied

Crude oil prices began to weaken in April to reach USD48.0 a barrel for Brent crude in early May, on mounting signs that US crude oil production and the restart of oil production in Libya are offsetting OPEC's production cuts and expectations of the extension of OPEC and Non-OPEC deal. This has contributed to rising concerns that the global oil market is still over supplied, as traders have finally given up on early balancing of the crude oil market. The production cuts agreement of late 2016 between OPEC and 11 non-OPEC producers drove a rally in oil prices towards the end of 2016 and well into 2017. The implementation of the cuts since the beginning of 2017 helped keep prices high during January and February.

Chart 1: Oil Price Developments, YTD

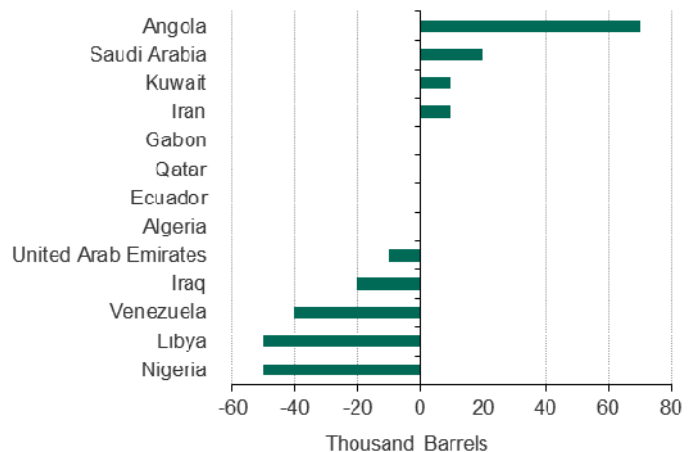


Source: Thomson Reuters

However, in March and April oil crude prices weakened amid suspicions about the level of compliance with the agreement and concerns about rising US shale production and inventory buildup. In addition, there are worries about demand in Asia, particularly China, as hedge funds are reducing their bets on a higher oil price. Given the most plausible scenario that OPEC and Non-OPEC producers will be extending the November's deal for the second half of 2017, it is expected that the crude market will begin to rebalance in the second half and accordingly will sustain prices around USD55.0 a barrel. On the production side, Baker Hughes reported that US drillers added rigs for the 15th consecutive week in late April. The rigs count is now 120% higher than their lowest point that was reached in 2016. Meanwhile, US crude production reached 9.25mb/d in April, as a result of higher production from shale oil fields as output respond rapidly to higher prices, according to the EIA, which is the

highest level since August 2015. In Libya, Sharara and El Feel oilfields, which has an output capacity of 0.4mb/d, already returned to production after protests blocking the pipelines ended. OPEC's compliance rate with the targets of production cuts was 100% in Q1 2017. However, much of this was attributed to Saudi Arabia, cutting output by more than the agreed amount of 0.48mb/d, while there was also a high compliance rate among other OPEC members. But the Non-OPEC producers, who were also party to this November's deal, apparently have been less compliant. As a result, the overall compliance rate of OPEC and non-OPEC members was only 60% during Q1 2017. Russia achieved nearly half of its targeted cuts, while others have actually increased production slightly. In Russia, oil output could climb to its highest rate in thirty years if OPEC and non-OPEC producers do not extend the cut agreement for the second half of 2017.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

Global demand growth for the 2017 is forecast at 1.3mb/d, according to IEA, the second consecutive annual decline. It is attributed to subdued gains in Russia and India, besides weaker growth momentum in OECD. In the US, demand declined by 0.49mb/d y/y in February, marking the largest fall since 2012. Consumption was weaker across much of the barrel, but gasoline and unfinished oils were exceptionally weak. US crude exports hit a record at 1.1mb/d in February, helped by a sharp uptick in shipments to China, exceeding Canada to become the largest purchaser of US crude oil during February, amounting to 0.34mb/d.

Foreign Exchange

The USD Maintains an Appreciating Bias

In the forex market, investors' preferences remain tilted towards the USD as US economic fundamentals and expectations are supportive. The anticipated expansionary fiscal policy which includes increased government spending, tax cuts and deregulation is likely to induce a stock market rally, reflecting positively on the greenback. On the other hand, the Federal Open Market Committee is adamant on normalizing monetary policy evident by the March hike of 25bps. The second hike since December is indicative of confidence in the jobs market and price stability. The latest jobs market figures continue to support a constructive bias for the dollar as unemployment reached a new post-crisis record of 4.5% in March, the lowest since May 2007. On the other hand, non-farm payroll posted sub-par figures of just 98,000 jobs, significantly lower than the previous two months of over 200k. After advancing to 14-year high in January, the USD consolidated gains through the rest of Q1. Based on the trade-weighted dollar, the DXY index stood at 99.05, down-turning by 3.1% YTD.

Chart 3: Trade-Weighted Dollar and the Euro

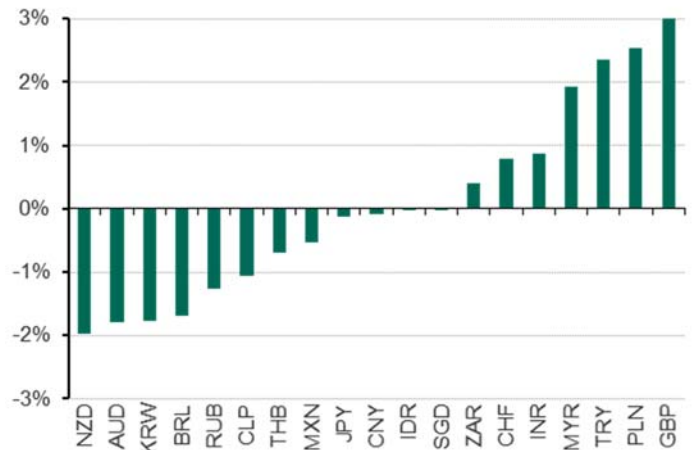


Source: Thomson Reuters

The situation in the Eurozone is showing signs of strength where growth momentum is expected to build. The 0.4% quarterly growth in Q4 is indicative that a growth acceleration is underway, potentially improving prospects slightly above estimates. Business surveys are increasingly surprising on the upside, and manufacturing growth expanded as output pace rose to the fastest since 2001. According to IHS Markit, the index for manufacturing activity rose to 56.7 in April from 56.2, reflecting a recovery in global trade and receding political risk. Despite the French elections, the EUR closed elevated by 3.6% YTD by the end of April at 1.08 dollars,

indicating an ongoing momentum against the greenback. The ECB is not likely to taper its stimulus program sooner than September, although, annualized inflation in the Euro area have shown a significant improvement, touching the 2% target in February and remaining at close levels in subsequent months.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

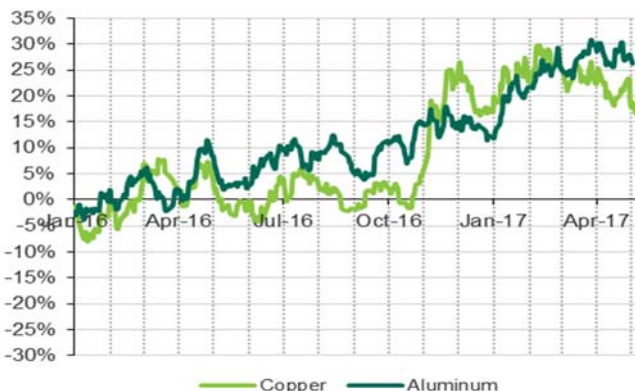
Asian currencies caught respite during April as they continued to rebalance following the greenback's ascent, in addition to receding concerns from North Korea. Easing tension over the Korean peninsula offset some expectations of softer manufacturing in China. Despite the Caixin China manufacturing PMI posting a seven-month low of 50.3, an expected contraction in Chinese manufacturing has been averted. However, the Chinese economy is expected to decelerate gradually on the back of ongoing structural reform. While the Chinese government continues to spend on infrastructure, the main focus is shifting towards consumer and household spending as a driver for economic growth. China is adamant on reducing the fiscal imbalance as well as deleveraging corporate debt in order to prevent the formation of asset bubbles. Furthermore, the incremental nature of the reform's execution is allowing policymakers to ease risk without affecting growth far below the 6.5% target for 2017. After falling by as much as 6.7% towards the end of 2016, the CNY remained range-bound in 1Q2017 and the month of April, standing at CNY6.9 for the dollar.

Commodities

Base Metals Continue to Edge Up

Commodities are generally still on a downward trajectory from the 2011 levels, with the S&P commodity index around 50% of the level reached five years ago. However, mixed data indicate that some commodities are gaining traction while others are lagging behind due to oversupply and weaker demand. The commodity market slump is owed to the oversupply which resulted from over investment during the commodity super-cycle. The European debt crisis, the Chinese slowdown, as well as a fragile US recovery put a dent on demand for global commodities. Meanwhile, the shale revolution introduced a new player into the oil industry which intensified the competition for market share and plunged oil prices down by over 50% from 2014 levels. Several exogenous factors pressured commodity prices up such as lower yield expectations due to unfavorable weather conditions. This short bounce in commodity prices is also owed to the OPEC production cut, a ban on ore export, and high-cost smelter closures. In addition, a weaker USD is allowing commodity exporting countries to benefit from higher trade values. Commodity rich countries such as Brazil and Australia are still suffering from the flattening of the commodity cycle which was driven by China; however, a lower base of production is likely to start a relative recovery for base metals and soft commodities in 2017. The Reuters/Jeffries commodity index stood at 181.7, indicating a 5.6% slide from the beginning of the year.

Chart 5: Reuters Jefferies vs. Gold

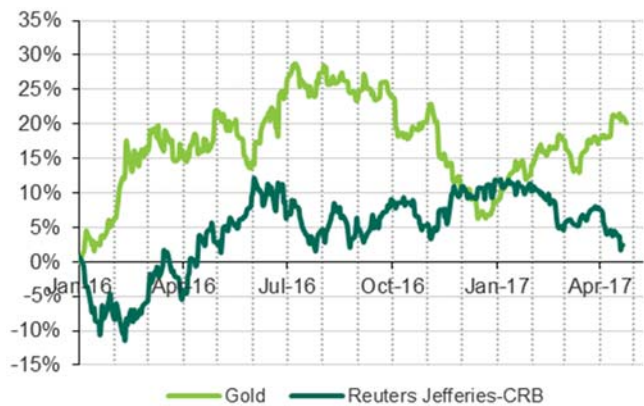


Source: Thomson Reuters

Copper prices continued to advance throughout April as supply deficits have become widely recognized. The lackluster performance we witnessed in the first half of 2016 was met by a rally in the second half which carried momentum into 2017 albeit at a slower pace. LME copper prices stood at USD5,735.5/ton, turning up by 3.6% YTD.

Since not much has changed in copper from a fundamental perspective, we expect the red metal to move in conjunction with China's industrial and construction activity. Furthermore, the campaign promise 1 trillion dollar infrastructure plan for President Trump is likely to offer a boost for base metal futures. Aluminum prices rallied at double-digits from the beginning of the year, closing at USD1,911.5/ton by the end of April, a surge by 12.9% YTD. The more ubiquitous use of aluminum and lower production allowed it to rally the most among base metals. China introduced new measures to reduce the environmental impact of smelters, consequently limiting output to 70% of capacity. The partial lifting of Indonesia's 2014 export ban is expected to ease off upside price pressures emanating from the shortage of bauxite. Meanwhile, gold prices regained traction after sliding notably following the Fed's interest rate decision. The reversal to the upside is underpinned by strong investment demand amid geopolitical and economic uncertainty. The US dollar's moderation, escalating tensions in Syria, North Korea and Afghanistan, in addition to the rising nationalist movement in Europe are increasing safe-haven bets. Physical demand in India is also supportive of gold prices due to higher incomes and marriage season. Gold prices stood at USD1,268.7/oz by the end of April registering a 10% YTD gain.

Chart 6: Base Metals



Source: Thomson Reuters

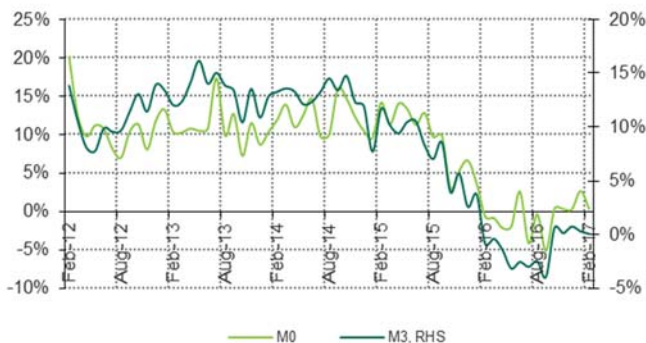
Agricultural prices remained broadly stable as inflationary prospects are improving globally. The Goldman Sachs Agriculture Index remained largely unchanged from January, thus ending April at 289.2 points. Mixed performance among agricultural commodities are due to several factors such as the geographical limitation of El-Nino's impact and the variation of crop yield. Wheat prices rose 2.6% YTD by the end of April, standing at 418 cents/bushel while corn edged up by 1.7% to 358 cents/bushel.

Money & Inflation

Inflation to Rise in the Second Half of 2017

The monetary situation in the largest economy in the GCC had stabilized recently following last year's deceleration, registering an annual gain of 0.3% in February. The reduced flow of petrodollars into the domestic economy had pressured the monetary system, registering nine consecutive annual declines from February through October 2016. The oil production accord between OPEC and non-OPEC producers lifted oil prices into the USD50/bbl range, thus, elevating oil revenues despite the reduced production. A possible extension to the deal for the second half of 2017 would support prices higher given that inventories subside which creates a more balanced market. The monetary base (M0) posted a benign pick up at 0.3% Y/Y during the month of February, albeit reaching the lowest level in 11 months at SAR297.9 billion. Technological penetration in the banking system witnessed a rapid expansion in point-of-sale (POS) terminals that registered an average annual gain of 40.8% since August 2014. Accordingly, currency outside banks, the largest component of M0, fluctuated marginally over the past year and posted a contraction of 0.7% Y/Y in February. The need for cash is alleviated by the vast network of ATMs and POS terminals domestically. We expect the global trend towards a cashless society will increase the dependence on electronic payment systems that paves the way for new and innovative technological advancements, thus, lessen the need for paper money in the future.

Chart 7: Growth in Monetary Aggregates

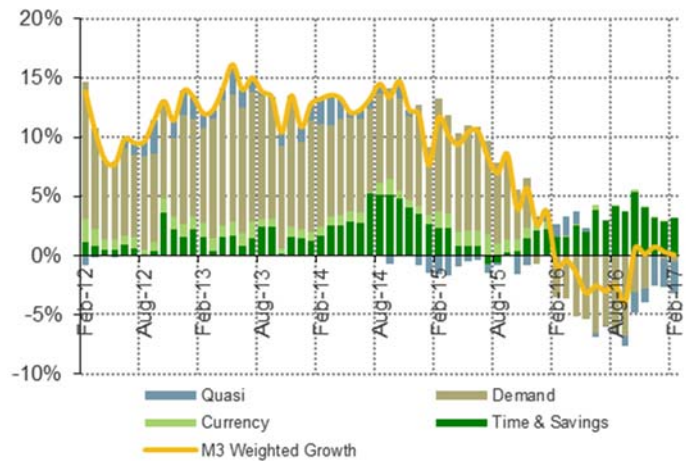


Sources: SAMA and NCB Estimates

The monetary supply followed a similar path to M0, gaining a marginal 0.1% to reach SAR1.75 trillion by the end of February. The non-yielding demand deposits have been on a downward trend, declining by 0.8% Y/Y, the

15th consecutive month of annual contraction. Meanwhile, the semi-available time and savings deposits upheld its robust growth momentum by increasing 13.7% annually. Bank's depositary base is maintained by attracting funds through lucrative time and savings rates, made easier by the current low interest rate environment. Furthermore, other quasi-monetary deposits contracted by 24.5% Y/Y as government entities' holdings of foreign currency reached SAR18.8 billion, the lowest level since May 2006 as the government manages cash flow needs. In our opinion, liquidity will find some respite given the recent Royal Decree to restore public employee allowances and the expected pick up in the oil market which will trickle down into the monetary system.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

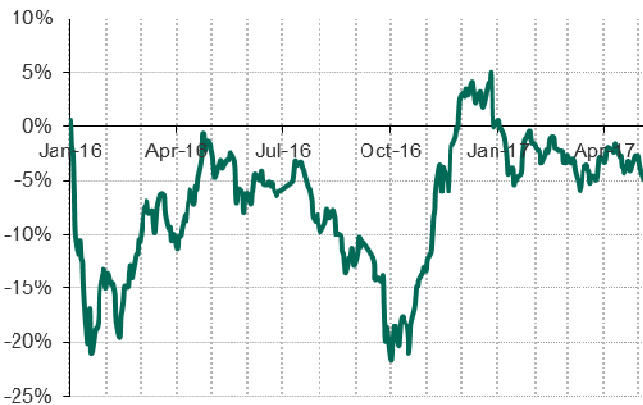
Consumer prices registered the second contraction in February, largely due to a base effect. The housing, water, electricity, and fuels sub-indices decelerated to 1.4% in February, down from 6.4% in December which pressured the main index as it represents a weight of 20.5% in the domestic basket. The sector is expected to rise slightly above previous levels in July as the new electricity and fuel pricing is implemented. The largest weight in the index is held by the food and beverage category, which contracted by 3.4% on an annual basis. Over the short-term, we expect prices to inch higher due to two factors: 1) The Shoura Council's recently approved taxes on harmful goods including soft drinks and tobacco to be imposed in the coming months which will spike sales before implementation. 2) Ramadan is expected to support prices during the religious/festive season, coinciding with the academic summer vacation which should also spur expenditures.

Capital Markets

Investment Funds: A Dying Business

There is no denial that the capital market is in need of a long-term plan to change structure from an individually-driven base to a professional one, where decisions are relatively long-term and fundamental in nature. Qualified Foreign Investors (QFIs) that were allowed to access the market in the first half of 2015 did not provide the institutional support expected yet. Suffice to say that by the end of March 2017 the total holdings of QFIs still stand at a meager SAR1.9 billion, an insignificant 0.12% of total market capitalization and the situation does not get any better if SWAP investments are added, with the total holdings raising to SAR15.2 billion, representing 0.94% of the market capitalization. In contrast to developed markets, where investment funds provide diversification and professional advice, they still play a marginal role in the local scene. Additionally, with the Saudi stock market suffering from huge volatility over the past two years with no clear direction, there was a negative spillover effect on the funds, as reflected by the end of year statistics that have been recently released by SAMA.

Chart 9: Tadawul All-Share Index

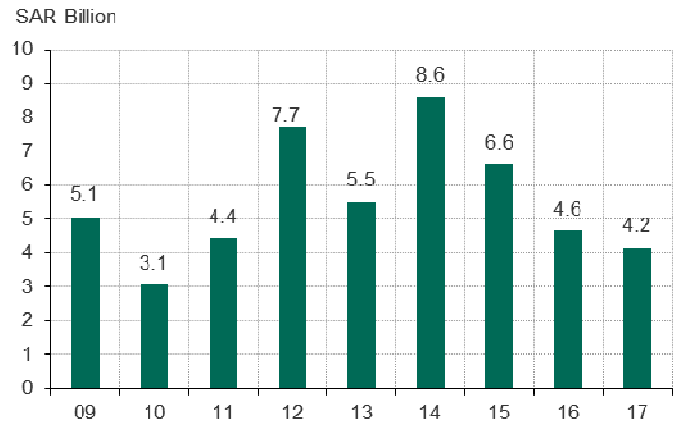


Source: Tadawul

A couple of factors will shed a light on the performance of investment funds in 2016 and challenges going forward. Ostensibly, the hanging clouds over Tadawul from the lack of fundamental upside drivers, given the weakening economy and lower corporate profitability had compounded their woes. By the end of last year, their total assets had fell for the second year in a row by a significant 14.6% to SAR87.8 billion, below the SAR100 billion mark for the first time since 2012. Interestingly, this annual decrease was registered despite the fact TASI ended the year with a

4.3% gain. On the composition-front, domestic assets continued to dominate, with their share steady at 80% of total assets, which amounts to SAR70.6 billion. Growth-wise, domestic assets and foreign assets shrank by around 6.9% and 36.3% Y/Y, respectively.

Chart 10: Average Daily Traded Value



Source: Tadawul

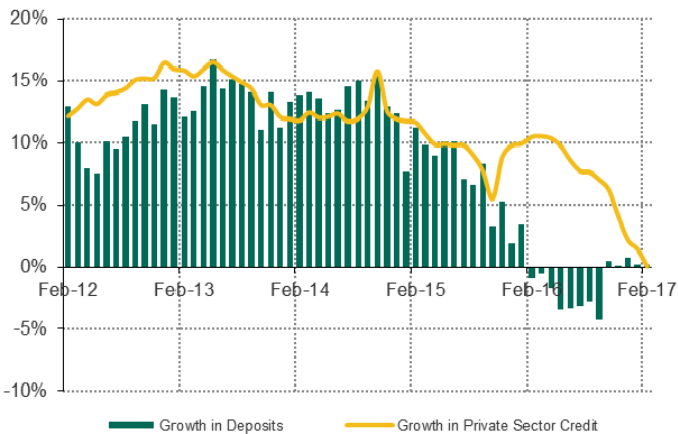
The most important trends from the data included the following: (1) a double-digit decline in the value of their holdings of domestic shares by around 18%, which came about despite the positive performance of the headline index and underscored the ineffectiveness of diversification strategies given the intensity of market volatility, (2) stagnation in real estate investments after the surge witnessed in 2013, falling by 4.9% to around SAR3.2 billion last year, and (3) an exodus seen from foreign investments in all forms, mainly the holdings of foreign shares that fell by 53%. Apparently, investment funds remain challenged by a client base that had been shrinking over the past eleven years, with the number of subscribers falling to just 224 thousand, 5.3% decline from 2015. The extent of the decline is accentuated when compared with the 568 thousand subscribers by the end of 2005. Ostensibly, the dominance of individual investors and the lack of investment prowess make the idea of investing through a fund exotic and unfathomable for most. In our opinion, there is no reason to believe that the abovementioned trend that continued unabatedly since 2005 will reverse course. Additionally, concerning Tadawul, the role of investment funds is insignificant due to: (1) an asset structure in which their portfolio of domestic shares represents a 0.01% of the overall market capitalization.

Loans Market

Extending the Maturity Curve

Saudi banks' asset/liability composition in the form of loans and deposits reflects the economy's current moderation cycle. The depositary base of the financial system reached its all-time record in September 2015 at SAR1.65 trillion, since then, banks have been struggling to maintain their total deposits, marginally growing by 0.1% annually in February. The deposit base in the Saudi financial system continues to be majorly composed of non-interest bearing liabilities. However, businesses & individuals have been shifting towards time and savings deposits which registered an increase of 13.7% Y/Y, compared to a contraction in their demand deposits by 0.4% Y/Y. Government entities reflected a similar trend, yet, their withdrawal from demand deposits has been also utilized to cover their cash flow needs rather than expand their interest bearing deposits. Over the last few years, the composition of foreign currency holdings has been shared equally between businesses & individuals and government entities, though in February, the shares registered 84% and 16%, respectively, as previously mentioned for government cash flow management. In addition, outstanding remittances continue their downward trend, contracting by 16.2% annually as the crackdown on illegal foreigners is intensified.

Chart 11: Private Sector Financing

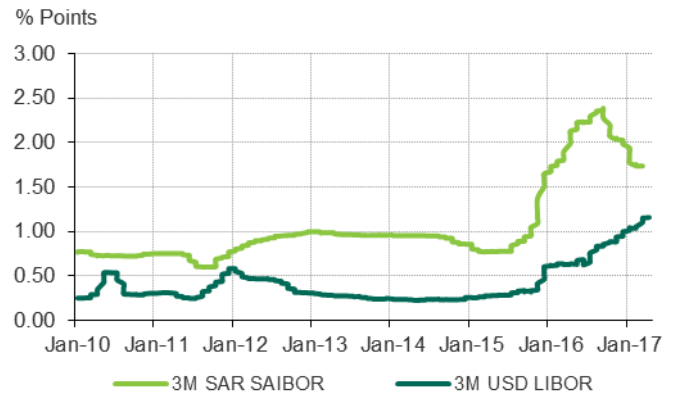


Sources: SAMA and NCB Estimates

Following 10 months of deceleration, total credit of the banking system registered a mere 0.1% gain on an annual basis in February. Assessing the assets side of the balance sheet by maturity, medium and short-term credit declined by 7.0% and 2.9% Y/Y, respectively, given the aforementioned depositary base narrative. Meanwhile, long-term credit registered a significant 9.7% hike as the

expansion in time and savings deposits mitigated banks maturity mismatch risk and allowed banks to extend their maturity curve. During February, the loans-to-deposits ratio reached 88.1%, below the 90% limit set by SAMA last year. The government recently issued USD9 billion international sukuk to finance its fiscal deficit. Going forward, we expect the government to balance international and domestic debt issuances to avoid crowding-out the banking system.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

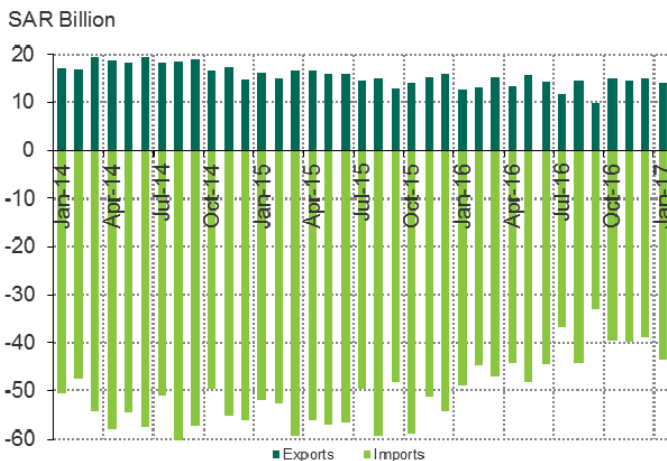
Credit to the private sector stagnated at 0.03% Y/Y as business and consumer sentiment decelerated sharply in the beginning of 2017. As the government reassesses the feasibility and economic benefit of SAR1.4 trillion worth of projects, the credit market suffered accordingly. Bank SABB and Alawwal have announced preliminary discussions for a merger to possibly create the third largest Saudi bank by assets. However, both banks corporate focus, unlike NCB and Alrajhi's retail orientation, will provide additional depth to the banking system. Furthermore, Saudi Vision 2030 projects such as the entertainment city in Qidyah which spans 334 sq km, and the myriad privatization initiatives will support the banking system going forward. Additionally, the recent Royal Decree which restored public employees' allowances will spur consumer demand, albeit with limited upside growth as sentiment remains fragile. As for the interbank rate (SAIBOR), liquidity risks have eased lately which drive down the SAIBOR to 1.73% by the end of the first quarter of 2017. The differential between SAIBOR and LIBOR has converged to settle between 50-60bps as the Fed continues its normalization policy. The IMF upwardly revised global growth to 3.5% in 2017 and 3.6% in 2018 according to their latest World Economic Outlook report which reaffirms the expectations of two more rate hikes by the Fed in 2017 and another three in 2018, pressuring SAMA to revamp their monetary policy toolbox.

External Trade

Non-oil Trade Rebounds in January

The Kingdom's economy is showing resilience despite the unfavorable economic cycle that started due to the collapse in oil prices since 2014. One of Saudi Vision 2030's main objectives is weaning the Saudi economy off of oil dependence in order to reduce the financial risk associated with oil markets' volatility. The government is also slashing spending and creating new revenue streams, in addition, diversifying the Kingdom's debt capacity by tapping international markets for the first time ever, raising USD17.5 billion in October 2016 and another USD9 billion worth of sukuk in March 2017. The success the government achieved so far in implementing its new policies has reduced the fiscal burden and is expected to continue improving over the coming years. In January, non-oil external trade showed sizeable gains as exports surged by 10.3% Y/Y to SAR14.02 billion. The upturn was underpinned by a double-digit surge in plastics and chemical products owing to the relative improvement in oil prices.

Chart 13: Saudi Non-Oil Trade Balance

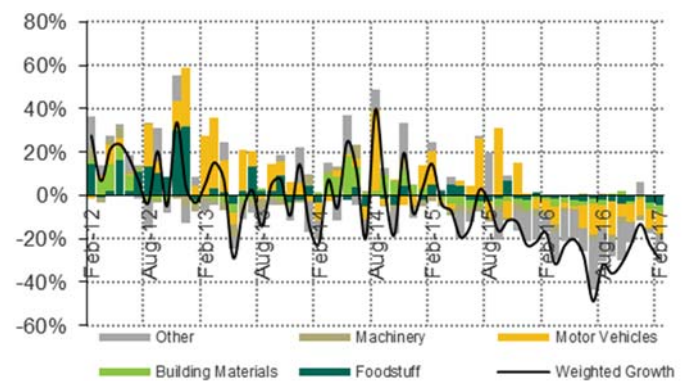


Sources: SAMA and NCB

Exports of plastics which account for 34.9% of the monthly total at SAR4.9 billion recorded a surge of 17.9% on an annual basis, gaining traction after eight months of annualized declines. The moderation of the Chinese slowdown and improved factory activity is directly correlated as China is the largest trading partner for the Kingdom. In a similar manner, exports of chemical products received a boost of 25.4% Y/Y, totaling SAR3.9 billion during the month. Exports of base metals recorded SAR1.2 billion, inching down by 1.4% compared to the same period last year. By export destina-

tions, the UAE tops the list with SAR2.1 billion, rising by 13.9% Y/Y and accounting for 15% of the monthly total. Interestingly, exports to China surged by 90.8% Y/Y to SAR1.8 billion, indicating a strong recovery in trade activity. Trade figures with India have been improving, overtaking Singapore as the third largest trade partner for the Kingdom. During the month, exports to India recorded SAR0.9 billion, surging by 43.4% Y/Y.

Chart 14: Attribution Analysis of Letters of Credit Opened



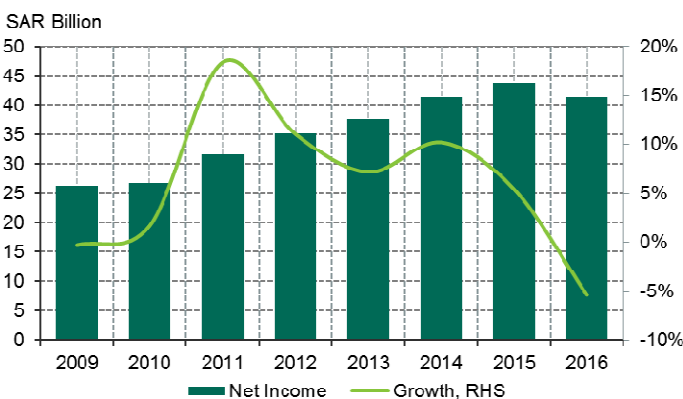
Sources: SAMA and NCB

On the import side, total imports have been down-trending in value terms in line with the Kingdom's direction of reducing fiscal spending. Total imports in January recorded SAR43.2 billion, falling by 11.6%. The largest import category which is machinery and electrical equipment accounts for over a quarter of the import bill at SAR10.8 billion. Compared to January of last year, machinery and electrical equipment tumbled 16.1% as infrastructure spending is reduced. Imports of transport equipment also saw a sizeable decline of 25.2% Y/Y at SAR6.8 billion. Imports of chemical products declined by 6.5% Y/Y to SAR4.2 billion. Moreover, imports by country show a decline across all countries of origin save the UAE, which surged by 36.6% Y/Y to SAR3 billion. Imports from China, declined by 9.1% Y/Y to SAR6.3 billion, whereas imports from the US declined by 11.9% to SAR6.2 billion.

Special Focus: Banks Adopt Wait-and-See Approach

The latest consolidated financial statements show that the 12 locally incorporated banks managed to grow their balance sheets in 2016. The banking system's total assets edged higher by 2.1% on an annual basis to reach SAR2.2 trillion, equating to 85.8% of GDP. The most liquid form of assets, cash and balances with SAMA, increased by 62.2% as banks opted to maintain higher liquidity levels following SAMA's interventions over the second half of 2016. Meanwhile, the investment portfolio had considerably decreased by 12.9% on an annual basis to SAR389.2 billion, investments in the European region registered the largest drop for a region at 39.8% Y/Y. As for banks' liabilities, the depositary base recorded a marginal 0.6% gain in 2016 (see Money & Inflation), raising total liabilities by 1.1% to reach SAR1.8 trillion. The transitioning economy relatively increased liquidity and credit risks over the past year, prompting a wait-and-see approach by Saudi banks. Accordingly, the excess reserve ratio increased to 53.7%, the highest level since January 2014. In addition, retained earnings have increased by 29.8% annually, supporting shareholder's equity to climb by 7.7% last year.

Chart 15: Local Banks' Profits

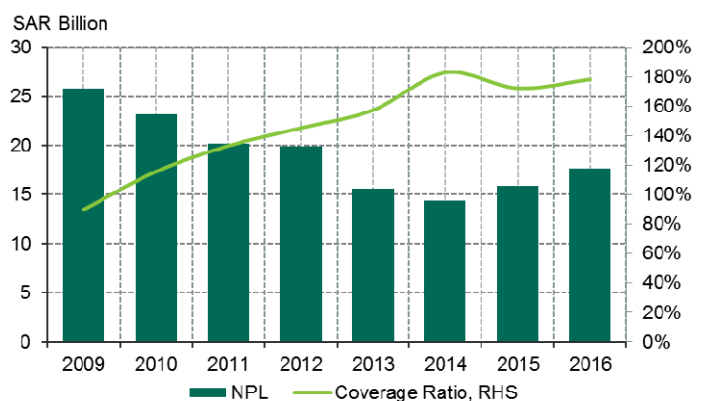


Source: Annual Financial Statements and NCB Estimates

The twelve locally incorporated banks posted a drop of 5.4% in net income during 2016, the first decline since the financial crisis. Following the record SAR43.7 billion reached in 2015, banks' bottom-line settled at SAR41.3 billion last year. Early in 2016, local businesses faced solvency difficulties as the government delayed payments, triggering a spike in the interbank rate which peaked near 2.4% by October. Despite the challenges for small and medium sized banks, the market benefitted from higher margins as net special commission incomes

recorded a growth of 8.7% on an annual basis. However, operating expenses have accelerated at a faster pace when compared to banks' operating revenue, registering 6.0% and 4.7%, respectively. The main drag on banks' net income was the commencing of a provisioning cycle to shield banks from possible default risks domestically. Total provisions jumped 15.4% Y/Y to reach SAR31.5 billion. We expect the banking industry's net income to remain muted in 2017 as core banking activities face challenges and costs of funds takes an upward trajectory.

Chart 16: Non-Performing Loans vs Coverage Ratio



Source: Annual Financial Statements and NCB Estimates

The domestic banking system capitalized on the buoyant economy and the oil market in the years preceding 2015, coupled with SAMA's prudent and countercyclical policies, banks were capable of maintaining large buffers to withstand shocks. Over the short-term, pipeline risk gauged by past due but not impaired loans indicates a substantial rise by 24.4%, largely due to reduced government spending and the temporary freeze of public employees' allowances. We do not expect much of the past due payments to become impaired given that the government pledged to settle any payments within 60 days and the recent Royal Decree that restored allowances. Furthermore, non-performing loans (NPL) have increased by 11.3% in 2016 to SAR17.7 billion, representing 1.2% of gross loans. However, the NPL coverage ratio has been bolstered to 178.3% by the end of 2016. Additionally, SAMA's early adoption of Basel III policies resulted in domestic banks raising their tier-1 and tier-2 capital adequacy ratios to 17.5% and 19.5%, respectively, comfortably above the minimum requirements.

The Economics Department Research Team

Head of Research

Said A. Al Shaikh

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

Ahmed Maghrabi

Associate Economist

a.maghrabi@alahli.com

Sharihan Al-Manzalawi

Associate Economist

s.almanzalawi@alahli.com

Sector Analysis

Yasser A. Al-Dawood

Economist

y.aldawood@alahli.com

Sultan Mandili

Economist

s.mandili@alahli.com

Amal Baswaid

Senior Economist

a.baswaid@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

Disclaimer:

The information and opinions in this research report were prepared by The Economics Department of The National Commercial Bank (NCB) and are only and specifically intended for general information and discussion purposes only and should not be construed, and should not constitute, as an advertisement, recommendation, invitation, offer or a solicitation of an offer to buy or sell or issue, or invitation to purchase or subscribe, underwrite, participate, or otherwise acquire any securities, financial instruments, or issues in any jurisdiction.

Opinions, estimates and projections expressed in this report constitute the current opinion of the author(s) as of the date of this report and that they do not necessarily reflect either the position or the opinion of NCB as to the subject matter thereof. NCB is not under any obligation to update or keep current the information contained and opinions expressed herein and accordingly are subject to change without notice. Thus, NCB, its directors, officers, advisors, employees, staff or representatives make no declaration, pronouncement, representation, express or implied, as to the accuracy, completeness or fairness of the information, estimations, opinions expressed herein and any reliance you placed on them will be at your own risk without any recourse to NCB whatsoever. Neither should this report be treated as giving a tax, accounting, legal, investment, professional or expert advice.

This report may not contain all material terms, data or information and itself should not form the basis of any investment decision and no reliance may be placed for any purposes whatever on the information, data, analyses or opinions contained herein. You are advised to consult, and make your own determination, with your own independent legal, professional, accounting, investment, tax and other professional advisors prior to making any decision hereon.

This report may not be reproduced, distributed, transmitted, published or further distributed to any person, directly or indirectly, in whole or in part, by any medium or in any form, digital or otherwise, for any purpose or under any circumstances, by any person for any purpose without NCB's prior written consent. NCB reserves the right to protect its interests and take legal action against any person or entity who has been deemed by NCB to be in direct violation of NCB's rights and interest including, but not limited to, its intellectual property.