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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- Prices continued to remain subdued through August due to concerns over rising levels of US and global petroleum products inventories coupled with a rebound in US oil rig counts.
- Further BOE accommodation may be necessary in order to avoid a slowdown, especially that an exit will require two years after Article 50 is triggered by Theresa May's government.
- Monetary policies have aided global commodities as continued Fed accommodation alongside the UK, Europe and Japan led to lower exchange rates against commodity currencies. The declining trend of the USD this year led dollar-denominated assets, including commodities, to appreciate.
- As a proxy for consumer demand, the volume of point-of-sale transactions is in a clear deceleration as it upturned by 2.7% Y/Y, contrasting with last year's average of 13.5%.
- The much anticipated entry of Qualified Financial Investors has largely been burdened by the economic slowdown and stringent regulations for entry into the domestic market.
- The rising risk specter in the domestic economy derailed long-term credit expansion as local business activity significantly moderated on the back of prolonged low oil prices, leaving long-term investment prospects marred by uncertainty.
- Non-oil exports to the UAE edged down by 1.1% annually during 1Q2016, contrasting with exports to China and India which tumbled by 41.5% Y/Y and 25.6% Y/Y, respectively.

View of the Month

The construction sector contracted by 1.9% during 1Q16 in real terms, settling at SAR31.4 billion. However, the substantial investments over the past 5-years, amounting to over SAR1 trillion which are currently under execution, underpinned the construction sector and limited the contraction in the sector.

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Macroeconomic Indicators

	2011	2012	2013	2014	2015P	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	45.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.2
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,449.6	2,322.3
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	654.1	620.1
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.4%	1.7%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	4.5%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-53.5	-63.7
Current Account Balance/GDP	23.6%	22.4%	18.2%	9.8%	-8.2%	-10.3%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	539.0
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1044.4	608.0	586.3
Actual Expenditure, SAR billion	826.7	873.3	976.0	1140.0	975.0	897.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	33.3%	13.4%	6.8%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-95.6	-367.0	-310.7
Budget Balance/GDP	11.6%	13.6%	6.5%	-3.4%	-15.0%	-13.4%
Break-Even Oil Price	75.3	73.9	82.6	103.6	79.2	69.2
Financial Sector						
USD/SAR Exchange Rate	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%	2.5%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	5.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.9%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	160.0

Sources: Thompson Reuters, SAMA, and NCB

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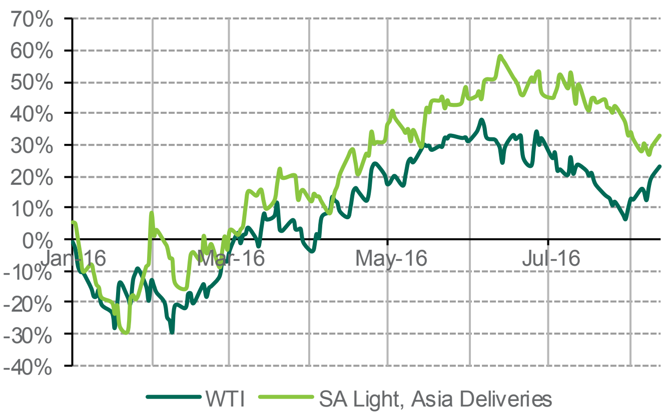
Oil Market

Rebalancing on the Horizon

Oil prices started 2016 on a downward trend, falling below USD30/bbl in January, due to an oversupply market and heightened worries pertaining to weakening global economic growth. Prices, however, recovered in the second quarter, averaging around USD43/bbl for the Arabian Light Crude, as the significant outages of non-OPEC supply contributed to rising prices. In July, oil prices retreated back to USD40/bbl, declining by 16.0% during last month, following uncertainties related to the Brexit vote and the easing of supply disruptions in Canada and Nigeria. Prices continued to remain subdued through August due to concerns over rising levels of US and global petroleum products inventories coupled with a rebound in US oil rig counts. According to Baker Hughes, oil rig counts in the US increased for six consecutive weeks in July and early August. The continued crude supply overhang is expected to keep oil prices from rallying too strongly. Although Russia expressed its openness to participate in the current deliberation between OPEC members for stabilizing oil prices, reviving an output freeze is currently an unlikely scenario as Iran continues to increase production to meet its pre-sanction levels. Meanwhile, with the rebalancing in oil markets currently underway, supported by relatively strong demand, especially from emerging economies, oil prices are expected to average USD45/bbl in 2016, up from the first half's average of USD36.8/bbl.

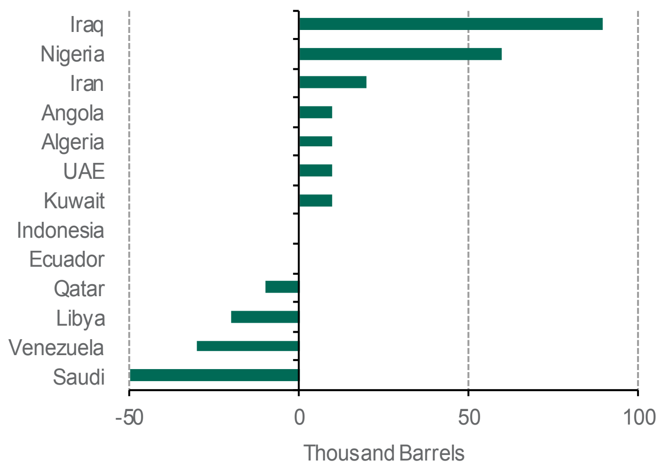
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the demand side, the IEA expects global demand growth in 2016 to reach 1.4MMBD, up from its previous forecast of 1.2MMBD. This rise in demand is predicted to be largely coming from emerging economies, especially China and India, as the responsiveness of gasoline demand to lower retail prices has increased. In addition, Europe is proving to be resilient, despite heightened economic uncertainty following the Brexit referendum, as demand for oil was not impacted. The incremental demand of this year is expected to absorb some of the excess supply in the oil market, estimated by the IEA at 1.7MMBD. While this should speed up rebalancing, the forecast of slower demand in 2017 at 1.2MMBD due to underlying support from low oil prices fades away, the rebalancing will ultimately continue through the first half of 2017.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the supply side, global output increased by about 0.8MMBD in July, as both OPEC and non-OPEC production increased. According to IEA, output was 0.215MMBD lower than a year earlier, as declines from non-OPEC more than offset an 0.84MMBD annual gain in total OPEC production. Non-OPEC production is forecast to drop by 0.9MMBD in 2016 before bouncing back by 0.3MMBD in 2017. In July, OPEC's crude oil output rose by 0.15MMBD to 33.4MMBD, as levels of production in Saudi Arabia, Iraq and Iran reached their record highs. According to EIA, US crude stockpiles unexpectedly expanded, keeping inventories at their highest seasonal level in more than three decades to reach 523.6 million barrels last week. Meanwhile, EIA estimates US oil production for July at 8.6MMBD, down by 1.1MMBD from the 9.7MMBD reached in April 2015.

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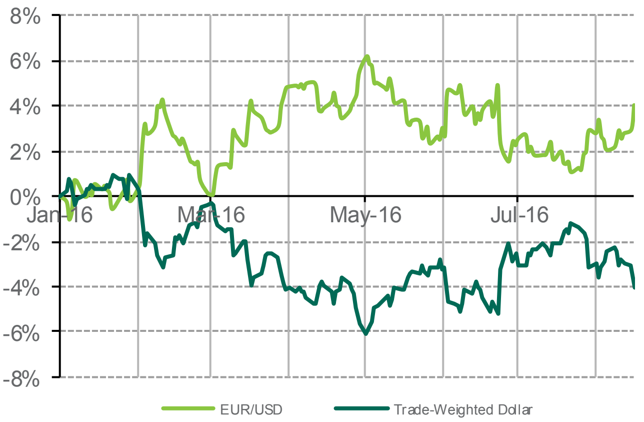
Foreign Exchange

Uncertainty Fogging Currencies' Outlook

Foreign exchange markets were riled up by the Bank of England's (BOE) surprise cut, the decision which came contrary to earlier expectations this year. The outcome of the Brexit vote casts a degree of uncertainty across financial markets coupled with the deteriorating British pound, settling at USD1.29 last week. Due to its solid economic performance, the UK was seen as the only G20 candidate, apart from the US, to move towards normalizing monetary policy. However, in the wake of the UK's EU membership vote and cutting the benchmark interest rate to by 25 bps to 0.25% early August, the pound was pummeled by heightened uncertainty, forcing downward revisions for the currency outlook which could possibly edge even lower by the end of 2016. Since the beginning of this year, quarterly annual growth data fell below last year's average, posting 2.2% Y/Y in the second quarter of 2016. Further BOE accommodation may be necessary in order to avoid a slowdown, especially that an exit will require two years after Article 50 is triggered by Theresa May's government.

Chart 3: Trade-Weighted Dollar and the Euro

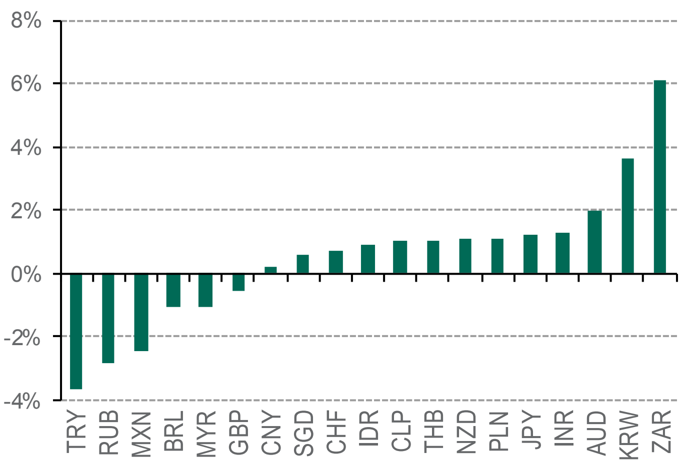


Source: Thomson Reuters

The annual Jackson Hole symposium will likely be pivotal in determining whether or not the Fed will opt for another hike this year, although after underperforming 2Q growth, inflation, and low inflationary expectations, we doubt that the tone of the Fed will reflect much hawkishness. In addition to Brexit's ripple effect, China's weakening economic performance will imply a goldilocks outlook at best for the global economy, keeping near-term risks undiminished. Global financial developments are critical for the Fed's direction going forward, namely after the negative rates imposed on European and Japanese banks led them to diverge away from US banks. The Fed will likely change its tone in response to the election outcome and the policies that will ensue. On a YTD basis, the trade-weighted USD recorded a 3% slide by mid-August, standing at 95.6.

Post-Brexit European Union is expected to receive big swings in data as they emerge, elaborating on renewed downside risks. Despite the moderation we saw in 2Q, which recorded a 1.6% Y/Y gain, inflation struggles to remain in positive territory as it registered a mere 0.2% in July. Given the lag effect, the Brexit aftermath will linger and vary across data in the coming months, and the Fed's accommodation may keep the EUR afloat, but we maintain a medium-term negative outlook for the currency. Widening interest rate differentials will keep pressure on the EUR, further deteriorating its position, and we expect the European Central Bank to remain data-dependent and have a wait-and-see approach as it decides on extending its QE beyond 2017. As of mid-August, the EUR gained 2.8% YTD against the dollar, standing at USD1.1.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

Meanwhile, the Bank of Japan decided to maintain easy monetary policy following its July meeting, staying in course with its plan to increase the monetary base by JPY80 trillion via asset purchases. Negative 0.1% interest rate on excess reserves will continue to be applied as inflationary pressure remains low. By the end of 2016, we expect inflation in Japan to remain below 0.5% on an annual basis. The JPY continues to appreciate against the USD, strengthening by 19% since the beginning of the year at 101.1 yens for the dollar last week.

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Commodities

US Dollar Aiding Prices

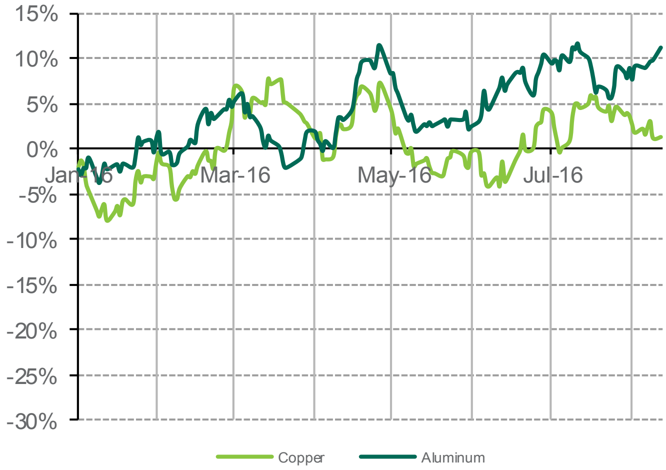
Commodities continued to rally underpinned by gold and base metals, leading the Reuters/Jeffries CRB index to post a gain of 4.4% YTD by mid-August to 183.9. Heightened economic uncertainty propped demand for safe-havens such as gold, whereas soft commodities inflected mid-June on the back of improving supply prospects. Supply cuts and inventory restocking in China provided a boost for base metals such as copper and aluminum despite lackluster economic performance. Copper prices inched up 1.2% between January and mid-August, standing at USD4,761/ton. As China's aluminum production began to fall, prices remained buoyant, closing in mid-August at USD1,655/ton, thus surging by 9.8% YTD. Base metal prices which rebounded from first quarter lows continue to appreciate and China's construction and fixed asset investment will underpin prices.

Chart 5: Reuters Jefferies vs. Gold

Source: Thomson Reuters

On the supply side, the shut-down of high-cost smelters in China, Malaysia, and Indonesia are constraining supply and bidding prices. The recent price rally is largely attributed to this factor, namely for aluminum. China's consumption, which accounted for over 50% of the global demand in 2015, is a main driver, although the transition from a manufacturing/export-based economic model to an investment/consumption-based one will likely cap the country's insatiable appetite for base metals. Monetary policies have aided global commodities as continued Fed accommodation alongside the UK, Europe and Japan led to lower exchange rates against commodity currencies. The declining trend of the USD this year led dollar-denominated assets, including commodities, to appreciate. Base metal prices are projected to become subdued as China's stockpiling slows down and producers adjust to lower cost smelters. China's economic growth is expected to be the slowest in 25 years, and the with the Chinese property slump, we expect to see some downward pressure.

Chart 6: Base Metals



Source: Thomson Reuters

Spot gold prices surged by 26.2% YTD mid-August to USD1,340.2/oz on the back of investor-driven gains. Lower-than-expected US economic data, the UK exit and rate cut, in addition to dovish ECB and BOJ created opportunities for investors who sought to hedge against inflation and currency depreciation. We see gold as a mainstay for investors through the second half of the year, especially with the odds of a second Fed hike falling below 50%. Downside risks include India and China's curtailed physical demand due to higher prices. In addition, labor strikes in India against a 1% jewelry tax is expected to hit 40% of India's jewelry sales which will likely harm its demand for physical gold.

After much uncertainty over the yield of soft commodities this year, El-Nino's geographically limited effect was overcome by ample global supply. The Goldman Sachs Agriculture index retreated to 297.4, upturning by 4.9% YTD after it surged by 18% early June. By mid-August, Chicago Board of Trade (CBOT) wheat tumbled by 12.8% YTD, standing at 429 cents/bushel, while CBOT corn fell by 2.5% YTD to 328.5 cents/bushel. Soybeans, on the other hand remained a relatively strong performer, surging by 16.3% YTD, standing at 1'023 cents/bushel. The energy-intensive nature of agriculture under the current oil market dynamics undermine upward price pressures for food grains; thus, we expect the performance of soft commodities to remain largely muted.

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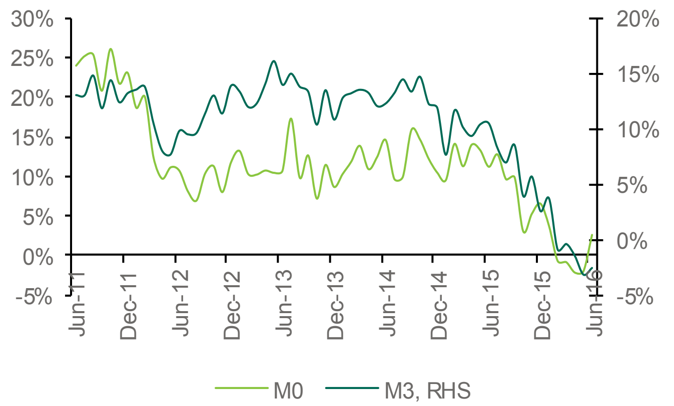
Money & Inflation
Subsidy Cuts Elevating Domestic Prices

In the month of June, broad money supply recorded the fifth consecutive decline of 2.6% Y/Y, standing at SAR1.77 trillion. The monetary base saw a modest recovery of 2.6% Y/Y on the back of a significant and abrupt surge in currency outside banks and cash in vault by 4.5% and 34.1% Y/Y. Currency outside banks and cash in vault stood at historical highs of SAR181.8 billion, and SAR42.7 billion, respectively. Deposits with SAMA continued to dwindle on the back of heavy withdrawals by public financial institutions and declining bank deposits. Public financial institutions' deposits tumbled 81.2% Y/Y to just SAR1.2 billion while bank deposits slid 5% Y/Y to SAR95.7 billion. Total deposits with SAMA which account for 30.2% of the monetary base fell 9.7% to SAR97 billion.

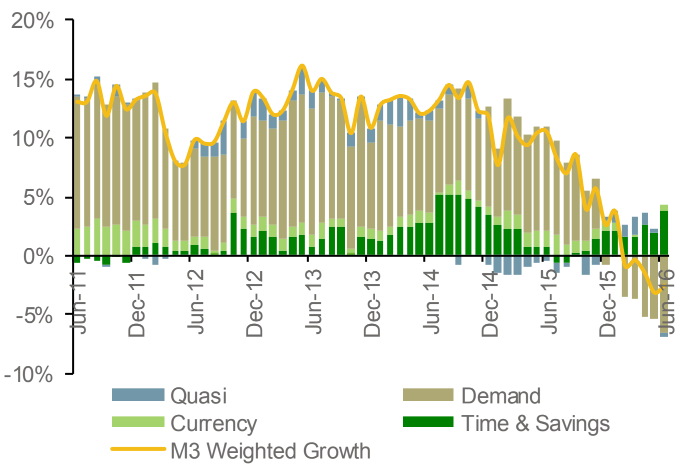
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

Demand deposits posted the first double-digit annualized decline of 11% Y/Y to SAR963.9 billion, highlighting an acceleration in withdrawals. As demand deposits make up 60.6% of broad money supply (M3), of which 94.4% is attributed to deposits of business and individuals. On the other hand, time and savings deposits surged by 18.9% Y/Y to SAR443.5 billion, marking the strongest annualized growth since October 2014. Businesses and individuals' inclination towards saving accounts reflect the economic reality of slowing demand and higher interest rates, thus; M2 money supply slid 2.5% Y/Y to SAR1.59 trillion. Quasi monetary deposits fell to negative territory for the first time in six months affected by a strong moderation in foreign currency deposits, and letters of credit, in addition to drastic declines in outstanding remittances. Foreign currency deposits inched up 0.9% Y/Y to SAR160.8 billion while letters of credit recorded the weakest growth since November 2015, rising by 3.9% to SAR13.1 billion. Furthermore, outstanding remittances recorded the largest annualized decline to date, dipping by 48.6% Y/Y to SAR9.3 billion. As a proxy for consumer demand, the volume of point-of-sale transactions is in a clear deceleration as it upturned by 2.7% Y/Y, contrasting with last year's average of 13.5%.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

Inflation in the Kingdom remains elevated, posting 4.1% Y/Y on June. Upward pressure came mainly from the housing and utilities, and transport sub-indices. The main driver for the increased price level in these categories is the reduction of government energy and water subsidies at the beginning of the year. Average water supply cost rose 217% Y/Y, while fuels upturned by 60.3% Y/Y. On the other hand, low commodity prices helped ease off inflationary pressures from food and beverages which inched up by 0.1% Y/Y. Negative pressure also came from the restaurants and hotels sub-index, mainly driven by a decline in the prices of accommodation services by 5.3% Y/Y and restaurants, cafes and their likes by 2.8% Y/Y. We expect a base effect from last year to support this year's headline inflation which will remain above 4%, and expect to see a moderation in the following year as the new base effect takes place. Upside risks include a continued recovery in global commodity prices, which could likely retain inflation at elevated levels.

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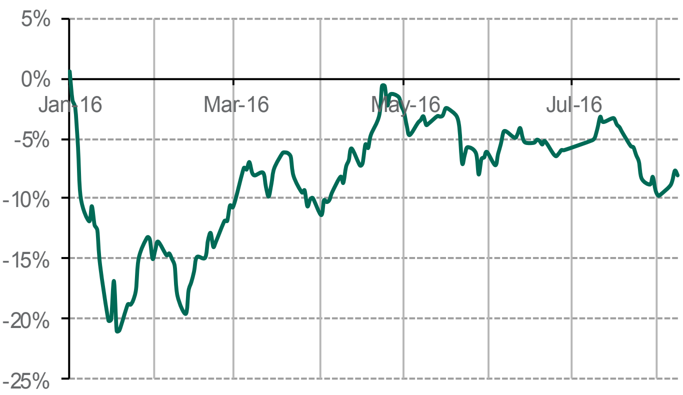
Capital Markets

Proactive CMA Tackling Low Activity

During the month of July, prices for Arabian Light crude oil tumbled by 16.0% on a monthly basis, while WTI prices declined by 13.9%. As oil prices continue to be pressured by the supply glut, oil-exporting economies have been suffering from a lower-for-longer oil price environment. For Saudi Arabia, lower government expenditures, the main driver for growth, has hindered the ability for businesses to expand locally and increase profits amidst the slowing economic cycle. The recent corporate profitability figures for the second quarter of this year is indicative of the macroeconomic backdrop. Tadawul's profitability declined by 11.3% on an annual basis as net profits settled at SAR27.6 billion in comparison to 2Q15's SAR31.1 billion. While the faded effects of the 2-month salary bonus given in 2015 have resulted in lower consumption expenditure, lower subsidies have weakened profit margins for the majority of companies and specifically for energy-intensive sectors such as cement and manufacturing. Tadawul registered a 3.0% drop last month with the telecommunications sector losing the most at 7.3% on a monthly basis. Additionally, the media, cement, and retail sectors lost 7.0%, 6.9%, and 5.8%, respectively. By the end of July, Tadawul had lost 8.8% since the beginning of the year. Given an expected weakness in the oil outlook throughout the second half of 2016, Tadawul might well be on the path to record a third negative year following 2014's and 2015's contractions of 2.4% and 17.1%, respectively.

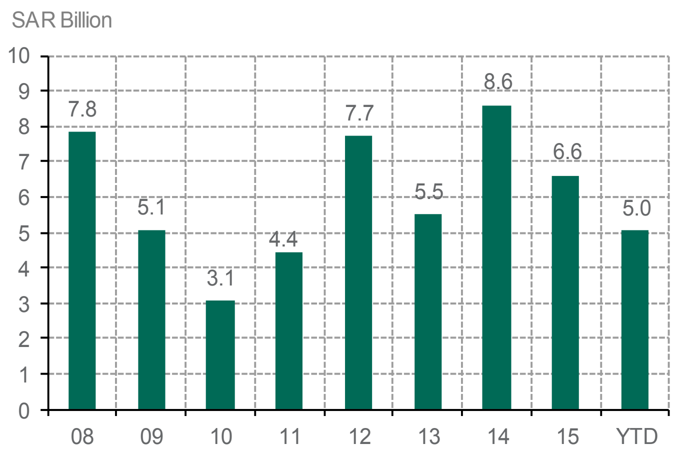
Chart 9: Tadawul All-Share Index



Source: Tadawul

Over the past couple of months, the level of activity has significantly subsided as economic uncertainties overwhelmed the will to invest in the stock market. The average daily traded value declined by 3.0% on a monthly basis to settle at SAR3.7 billion, the third consecutive monthly drop. Over the twelve trailing months, Tadawul had plunged 30.7% by the end of July. The fall in prices reduced the price-to-earnings ratio from 17.05 by the end of July 2015 to 12.94 by the end of last month. Accordingly, market capitalization had a similar drop of 27.9% to settle at SAR1'459.8 billion, losing over SAR560 billion over the past year. Trading in the local market remains dominated by Saudi individuals with over 90% of total trading value. The much anticipated entry of Qualified Financial Investors has largely been burdened by the economic slowdown and stringent regulations for entry into the domestic market. Since mid-June 2015, QFIs have invested SAR1.4 billion, representing around 0.1% of the market's total value.

Chart 10: Average Daily Traded Value



Source: Tadawul

In response to the muted activity of QFIs, the Capital Market Authority (CMA) announced in May a set of revised regulations to ease entry to Tadawul and increase its attractiveness for international investors. The new regulations were planned for implementation during the first half of 2017. However, the disappointing activity level prompted the CMA to enforce the changes by September 4, 2016. These amendments include widening the scope of institutions under the QFI definition to include sovereign wealth funds, university endowments among others. Additionally, the minimum value of assets under management has been lowered to USD1 billion from USD5 billion. Also, the previous limitations on trading have been unified under one constraint which is that one QFI investor may not reach 10% ownership of a single listed company. Meanwhile, the limitation on all foreign ownership (resident and non-resident) will remain at 49%. The proactiveness of the CMA indicates their desire to develop the local market into a recognized international investment destination, however, challenges remain as oil prices pressures the local economy.

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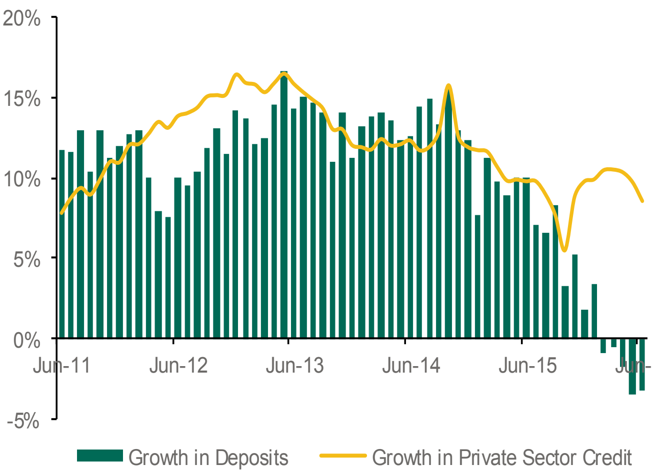
Loans Market

Unconventional Liquidity Solutions

In the month of June, growth in private sector credit rose 8.6% Y/Y, contrasting with deposits falling by 3.3% on an annual basis. Although credit performance is still positive, it is showing signs of moderation. As a result of SAMA's decision to hike the loans-to-deposits ratio (L/D) from 85% to 90%, private sector credit received a brief boost, averaging 10.5% Y/Y for the three months following January. However, May and June's figures show a deceleration in the performance of private sector credit as the L/D ratio stood at 90.2% by the end of June. Given the liquidity strains in the market, SAMA has additional room to maneuver and further ease the L/D higher on par with other Gulf states in order to accommodate funding needs of the market under tighter liquidity. The liquidity buffers and funding stability which SAMA had built in recent years will allow it to have some space for monetary easing, including the reduction of reserve requirements. Statutory deposits by the end of June stood at SAR94.8 billion which is down by 5.1% Y/Y while excess reserves are at SAR24.5 billion, surging by 23.1% Y/Y.

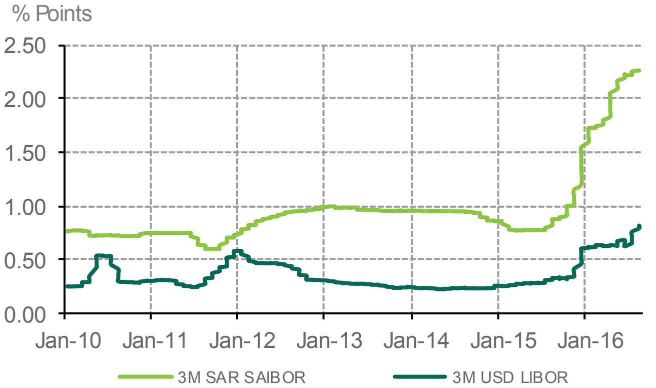
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

Claims on the public sector tumbled 20.3% Y/Y on the back of a significant drop in T-bill levels, recording the fifteenth consecutive month of decline. Credit extended to public sector enterprises rose 18.5% Y/Y to SAR47.8 billion while bank holdings of government securities dwindled by 25.8% Y/Y to 209.4 billion. Annual growth in government bonds surged by 191.6% to SAR156.6 billion, whereas bank holdings of T-bills nose-dove by 76.9% to SAR52.8 billion in order to free-up some liquidity for the longer maturity issuances. Looking at bank credit we note that, on maturity basis, short term credit accounts for 51.7% of total bank credit while medium and long-term credit account for 19.5% and 28.8%, respectively. The rising risk specter in the domestic economy derailed long-term credit expansion as local business activity significantly moderated on the back of prolonged low oil prices, leaving long-term investment prospects marred by uncertainty.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

The interest rate environment in the Kingdom remains pressured by the tighter liquidity which resulted from the sale of large development bonds to local banks, standing at SAR156.6 billion by the end of June. The 3-month average Saudi Interbank Offered Rate stood at 2.26 by mid-August, exceeding SAMA's 2% Repo rate. SAMA's efforts to curb the surge in the interbank market are not without caveats. Given the fixed exchange rate regime, SAMA is unable to use the benchmark interest rate to control money markets, however, tools such as scaling back T-bills and loosening macro prudential policies can ease the pressures of the market. In addition, SAMA offered some banks short-term loans of around SAR15 billion late June, in order to aid with short-term liquidity constrains. Such resolution, however, does not correspond to the nature of the liquidity crisis likely to become prolonged. We expect to see further measures such as reducing the reserve requirement ratio and/or increasing the L/D ratio in the near future, especially with SAMA remaining adamant on maintaining the USD/SAR peg.

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External Trade

Faltering Demand of Emerging Economies

Preliminary non-oil trade estimates for the first quarter of 2016 indicate a decline in non-oil exports by 12.1% Y/Y to SAR42 billion, while imports fell by 14.3% Y/Y to SAR140.5 billion. The consolidation measures undertaken by the government to reduce the fiscal deficit are having a sizeable impact on imports. On the other hand, the tides of the global economy are disadvantageous to Saudi exports, namely with weaker demand in China and a stronger USD. During 1Q, non-oil exports accounted for 29.9% of imports in value terms, and the balance of trade gap shrunk by 15.2% in comparison to 1Q2015.

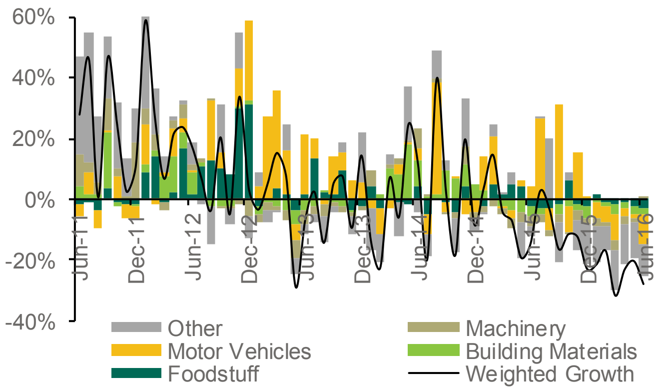
Chart 13: Saudi Non-Oil Trade Balance

Sources: SAMA and NCB

By composition, plastics accounted for 31.4% of total non-oil exports during the quarter, valued at SAR13.2 billion. Compared to 1Q2015, exports of plastics dropped by 12.2%, affected by weaker global demand. Exports of chemical products, which make up 26.5% of the quarterly total, tumbled by 18.3% Y/Y to SAR11.1 billion. Furthermore, exports of base metals which make up 8.6% of non-oil exports declined by 10.3% Y/Y to SAR3.6 billion. By destination, 15.1% of non-oil exports during 1Q headed to the UAE, valued at SAR6.3 billion, whereas about 8.1% of the non-oil exports share, valued at SAR3.4 billion, headed to China. In addition, 5.7% of non-oil exports, valued at SAR2.4 billion, headed to India. By annual comparison, non-oil exports to the UAE edged down by 1.1%, contrasting with exports to China and India which tumbled by 41.5% and 25.6%, respectively.

On the imports side, machinery and electrical equipment accounted for 26.3% of the import bill in 1Q. Valued at SAR36.9 billion, imports of this category slid 18.6% Y/Y. Imports of transport equipment which make up 18.1% of the import bill at SAR 25.5 billion, declined by 13.4% Y/Y. Furthermore, imports of base metals which make up 9.4% of the import bill slid by 10.8% Y/Y to SAR 13.1 billion. As for imports by country, China accounted for 14.4% of imports by value in Q1 at SAR20.2 billion. The USA accounted for 13.9% of the bill at a value of SAR19.5 billion while Germany accounted for 6.9% at SAR9.7 billion. Annualized comparison shows that imports from China declined by 18.2% while imports from the USA and Germany fell by 10.3% and 14.2%, respectively.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

Private sector imports financed through banks reflect a sizeable moderation in 2Q2016. Settled letters of credit (LCs) tumbled 21.5% Y/Y to SAR47.4 billion. LCs of motor vehicles which account for 22.6% of total LCs fell 12.6% Y/Y in the second quarter on the back of cooling demand, standing at SAR 10.7 billion. Foodstuff LCs which make up around 15% of total LCs by value at SAR7.1 billion inched up 1.3% Y/Y, reflecting easing disinflationary pressure on soft commodities. LCs for building materials and machinery suffered huge declines, in line with falling government contract awards. Building materials LCs were valued at SAR4.4 billion which is down by 27.8% Y/Y. Machinery LCs were down 30.5% Y/Y, standing at SAR 3.1 billion.

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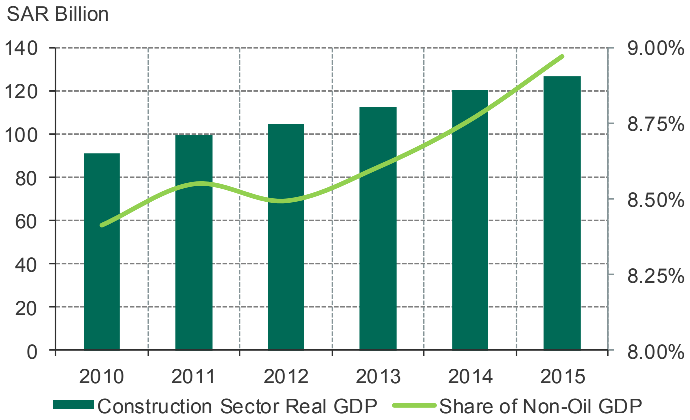
NCB الأهلي

Special Focus:
Construction Sector Outlook

The construction sector constitutes a major share of the Kingdom's domestic economy. The sector recorded high annual real growth rates over the last five years, recording 5.6% in 2015, on the back of larger public and private spending. However, the low level of oil prices and lower government expenditure in 2016 brought about numerous project delays and cancellations. As a result, the construction sector contracted by 1.9% during 1Q16 in real terms, settling at SAR31.4 billion. However, the substantial investments over the past 5-years, amounting to over SAR1 trillion which are currently under execution, underpinned the construction sector and limited the contraction in the sector.

Chart 15: Construction Sector Real GDP



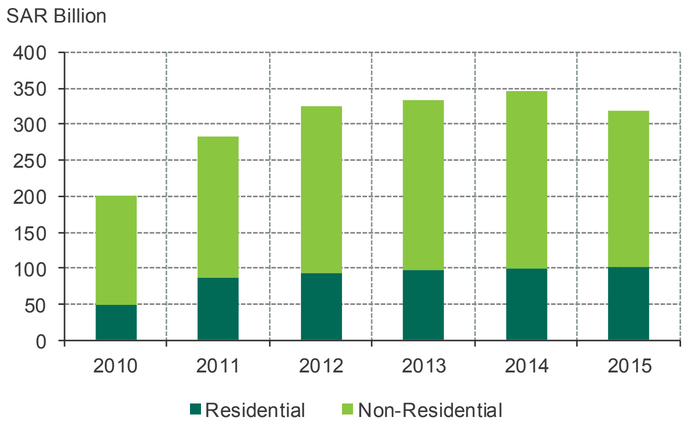
Source: General Authority for Statistics, NCB

Significant investments made by the government, semi government and other private institutions between 2010-2015, alongside moderate levels of inflation, led to a compounded annual growth rate (CAGR) of 6.9% in the construction sector during the period. In the midst of this robust growth, the sector's share of the kingdom's GDP rose to 5.04% in 2015. Meanwhile, following the collapse of oil prices since 2014, along with decreased government expenditure, the sector's share of real GDP is estimated to have declined to 4.89% in the first quarter of 2016.

According to General Authority for Statistics (GAS), the Kingdom's real GDP growth rate decelerated to 1.5% in the 1Q16, as adversely affected by the contraction of 0.7% of the non-oil sector. However, due to higher oil production and improved oil prices compared to the first quarter, the Kingdom's real GDP is expected to grow by 1.7% for the whole year of 2016, and is set to rise to 2.4% in 2017. Moreover, inflation is expected to average higher at 4.5% in 2016, as the government implemented the reduction of energy subsidies since begging of the year.

The NCB Construction Contracts Index (CCI) reached 117.5 points by the end of the second quarter of 2016, while the total value of awarded contracts amounted to SAR20.3 billion, falling by 27% from the same period a year ago. Accordingly, total expenditure in the Saudi construction sector, as measured by the level of Gross Fixed Capital Formation (GFCF), where residential and non-residential construction accounted for the largest share, is estimated to have fallen by 20.1% to SAR145.6 billion in 1Q16 compared to SAR182.1 billion in 1Q15. Therefore, a strong decline is expected for the construction sector which is forecasted to contract by 3% to settle at SAR156 billion by the end of 2016. As non-oil GDP is expected to stagnate in 2016, the construction sector's share of non-oil GDP is expected to decline to 8.7% in 2016 from 9.0% in 2015.

Chart 16: Construction by Type



Sources: General Authority for Statistics, NCB

According to the KSA Business Optimism Index (BOI), conducted by Dun & Bradstreet in cooperation with NCB, the construction sector composite BOI edged up to 12 in 3Q16, gaining a single point from last quarter's series low of 11. The outlook for the construction sector remains weak as crude oil prices continue to remain low, which has suppressed the pace of awarding new projects. Given the vital role that projects market plays in keeping the Kingdom's economy growing, a further suspension of contracts awards would surely have an adverse impact on the construction sector in the near to medium term.

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