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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- US production has climbed in nine out of the last ten months, with the IEA projecting growth in the Permian, Eagle Ford and Bakken formations. Increased supplies from Libya and Nigeria that are exempt from production cuts might also derail rebalancing efforts.
- Another interest rate hike is expected to take place this year pushing the benchmark interest rate by another 25 bps to range between 1.25% and 1.50% which could pressure stocks and treasuries.
- Headwinds to base metals' price appreciation are manifested in a reversal of the USD's weakening and the relaxing of supply constraints.
- During 2017, a total of SAR132.6 billion have been withdrawn from net foreign assets to compensate the shortage in oil revenues, yet we believe the government will balance utilizing net foreign assets and debt issuances over the second half of 2017.
- Tadawul gyrations continue to be influenced by the hanging clouds over the market, mainly in terms of the anticipated removal of subsidies and the introduction of the value added tax in 2018.
- Further interest rate hikes by the US Fed will be mirrored by SAMA but we do not expect the interbank market to fully factor the increase due to domestic liquidity dynamics.
- Relatively low feedstock cost, economies of scale, access to cheap capital, and unwavering government support are key enablers for the sector, allowing the Kingdom to become the 9th largest polymer producer in the world.

View of the Month

Our long-term view on the local cement industry remains positive as the Saudi demographic will remain supportive. Furthermore, the recently announced Qidyah entertainment city, spanning 334 sq km, and Al Faisaliah city which will cover 2'540 sq km, as well as the Red Sea project with an estimated area of 34'000 sq km will spur the construction industry beyond 2020.

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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	10.5	10.1
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,799.9	2,836.3	2,453.5	2,424.1	2,549.0
GDP at Current Market Prices, USD billion	670.4	734.9	747.6	757.4	655.1	647.3	680.6
Real GDP Growth Rate	10.0%	5.4%	2.7%	3.7%	4.1%	1.7%	-1.0%
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	-56.7	-27.6	-15.3
Current Account Balance/GDP	23.6%	22.4%	18.1%	9.7%	-8.7%	-4.3%	-2.2%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	529.3	475.6
Fiscal Sector (Central Government)							
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	615.9	519.4	676.4
Actual Expenditure, SAR billion	826.7	873.3	976.0	1109.9	978.0	830.5	890.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	29.8%	13.7%	-1.1%	0.0%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-65.5	-362.1	-311.1	-213.6
Budget Balance/GDP	11.6%	13.6%	6.4%	-2.3%	-14.8%	-12.8%	-8.4%
Break-Even Oil Price	75.3	73.9	82.6	100.1	82.6	61.6	70.0
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%	2.5%	0.8%	0.9%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	2.2%	-0.8%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.1%	2.0%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.7%	1.5%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	134.7	50.0

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

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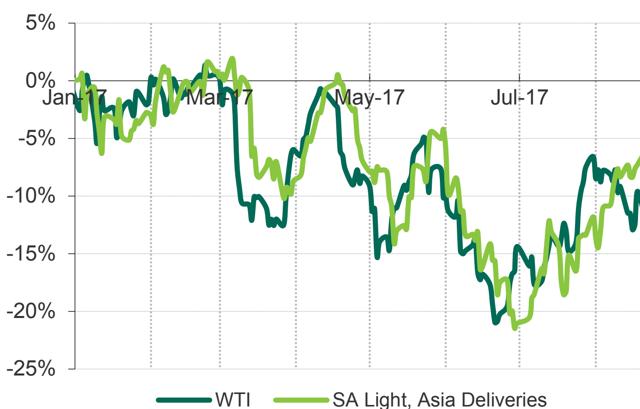
Oil Market

Rebalancing in the Offing

Oil benchmarks have been range-bound since the beginning of the year, contained within the USD40-55/bbl range. The three benchmarks, Brent, WTI and the Arabian Light continue to languish in the red, falling by 6%, 10% and 11% in 2017YTD, respectively. The oversupply theme that had been a hanging cloud over oil markets despite OPEC's first cut in November had forced an extension to the cut up until the first quarter of 2018. Nevertheless, the OPEC-led strategy to reduce global crude inventories to the industry's five-year average and thus rebalance the markets is finally showing signs of success.

Chart 1: Oil Price Developments, YTD

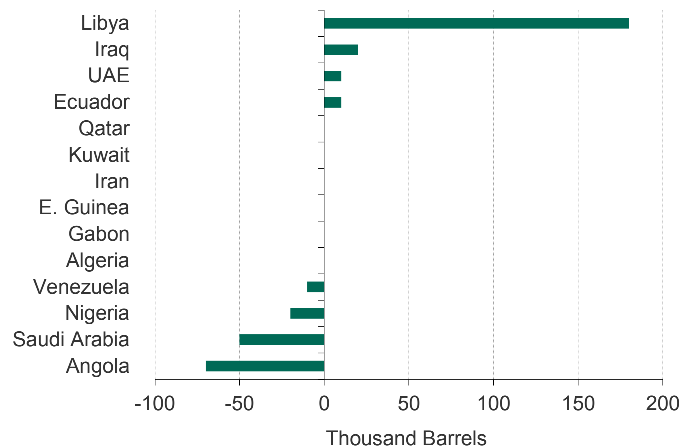


Source: Thomson Reuters

The supply side had a positive net effect on the price direction, with recent data showing US crude stocks falling rapidly. Last week, the Energy Information Administration (EIA) reported a decline by 7.6 million barrels in crude inventories compared to analysts' expectations for a mere 2.9 million barrels drop. Notably, this was the largest decline since the week that ended September 4th 2016. Additionally, crude inventories at Cushing Oklahoma, which is the delivery hub for US crude futures, had declined by 1.9 million barrels to 57.6 million barrels, the lowest level since November 2015. Data pertaining to oil rigs had also shown a decline by five rigs, as reported by Baker Hughes. Even though it is clearly too early to call a success based on one week's data up until there is a solid trend, OPEC and its allies were in dire need of an inflection sign for them to continue their aforementioned strategy. Critically, these signals of tighter supplies have changed the structure of the crude price curve towards backwardation rather than contango that indicates oversupply.

Furthermore, the outlook for global oil demand is improving amid signs of a resilient Chinese economy that is evident from the higher than expected headline GDP growth rate of 6.9% in the first half of 2017 that is above the government's annual target of 6.5%. Accordingly, the IMF, in its July 2017 World Economic Outlook update, had revised upwards growth for the World's second-largest economy in 2017 and 2018 by 0.1% and 0.2%, respectively. Forward looking indicators for China are buoyant, with the manufacturing purchasing managers' index (PMI) above 51 for 10 months in a row. Emerging markets are also projected to expand at 4.6% this year, a 0.1% revised figure by the IMF. Given these favorable dynamics, the International Energy Agency has upwardly revised global oil demand by 100 thousand barrels per day to 1.5 MMBD this year.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

In our opinion, a dent in the supply glut is appearing, yet several headwinds might contain an upside movement in crude prices. US production has climbed in nine out of the last ten months, with the IEA projecting growth in the Permian, Eagle Ford and Bakken formations. Increased supplies from Libya and Nigeria that are exempt from production cuts might also derail rebalancing especially that Libya had crossed the 1 MMBD production in July and Nigeria is close the 1.9 MMBD mark. We do believe that overshooting USD60/bbl is highly unlikely; however, the most important development over the last few weeks is that fundamentals are becoming relatively supportive.

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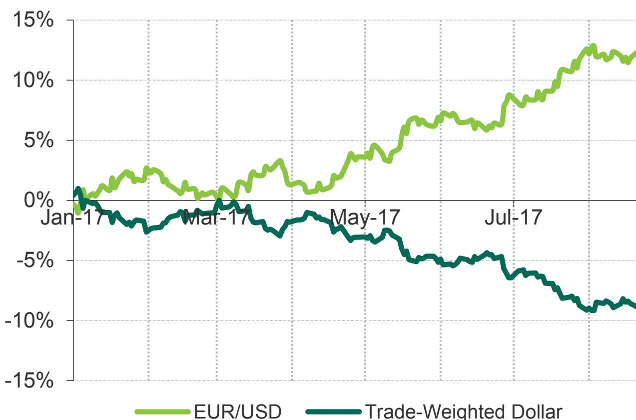
Foreign Exchange

Euro Advances on Improved Outlook

Global economic growth momentum is positive and a number of central banks are reassessing their monetary policy prospects, possibly following the US Fed. The withdrawal of exceptional monetary stimulus and the hawkish tone in the Bank of England and the European Central Bank are indicative that their respective economies are now less reliant on policy support. Thus, economic risks in advanced economies are diminishing and growth is underpinned by improving labor market conditions, rising consumption and recovering capital expenditure. Political risks, however, remain heightened in North Korea, feeding into investors' preference for the Japanese Yen and Swiss Franc.

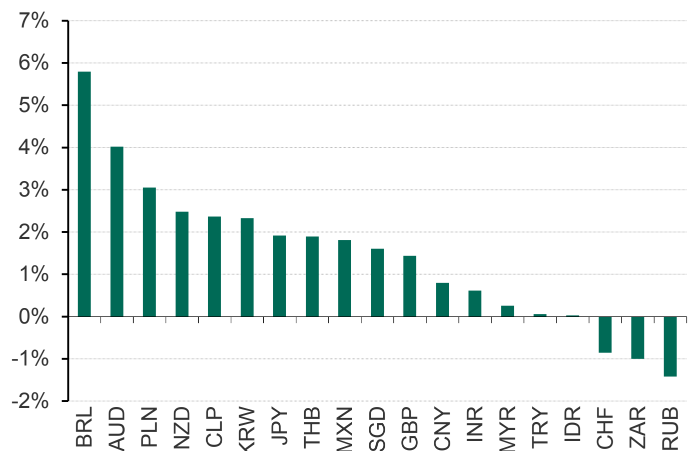
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

The backdrop of a generally positive domestic economy in the US has had a pull effect on prices, with core PCE peaking at 1.9% Y/Y in February, almost touching the 2% Fed target. However, it fell rapidly in the months that followed to stand at 1.5% Y/Y by June. The labor market conditions remain positive albeit the Fed labor market condition index (LMCI) appears to have reached this year's peak in April at 3.8, moderating by June to 1.5. The underlying factors behind the slowdown are mainly a 0.5% wage growth in the second quarter of 2017 which is a regress from the 0.8% we saw in the preceding quarter. Moreover, the unemployment rate fell down to pre-crisis levels at 4.3% in the month of July and non-farm payroll registered the creation of 209,000 new jobs during the same month. The Fed will likely begin to trim its USD4.5 trillion balance sheet in September while retaining a hawkish tone on interest rates. Another interest rate hike is expected to take place this year pushing the benchmark interest rate by another 25 bps to range between 1.25% and 1.50% which could pressure stocks and treasuries. In the absence of fundamental drivers for the greenback, we expect the weakness to be mainly attributed to geopolitics and uncertainty over the advancement of Trump's policy agenda. By mid-August, the trade-weighted USD index stood at 93.4, declining by 8.7% YTD.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The EUR has led advanced economies' currencies against the USD since the beginning of the year owing to an improvement in economic outlook. Flash preliminary annualized GDP growth for 2Q2017 posted 2.1%, up from 1.7% a quarter earlier. Lower geopolitical risks and strong business sentiment played a major role in the recent rebound. The Eurozone industrial sentiment index for the month of July recorded 4.5, the highest reading since April 2011. Although the Eurozone inflation touched 2% earlier this year and has moderated since then, the rate has remained above 1% in the months that followed. In July, it stood at 1.3% Y/Y, matching the pace of the previous month. Unemployment is currently at the lowest levels since February 2009, standing at 9.1% as of June. We expect labor market conditions to improve in the 19-country block. Owing to improving economic fundamentals, the ECB dropped reference to future rate cuts, holding the refinance rate at 0.0%. The EUR continued to surge on the back of falling interest rate differentials, strengthening by 12% YTD against the greenback by mid-august at USD1.2.

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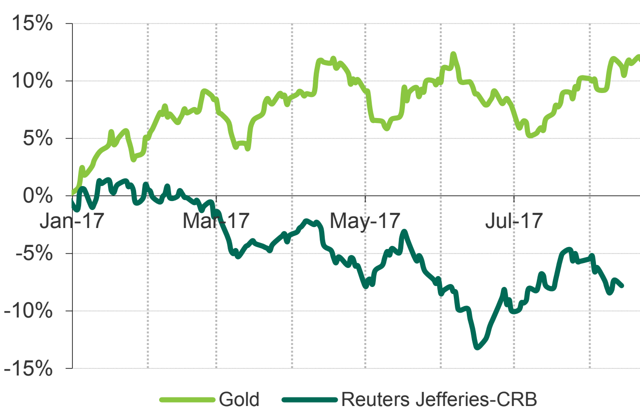
Commodities

US-North Korea Exchanges Lift Gold

As US shale production continues to advance for the nine out of the last ten months, commodities remained in the negative territory. The Reuters/Jeffries CRB index sunk in comparison to last year, bottoming out late June, to fall by 13.5% YTD. However, the weakening of the greenback and improvement of economic fundamentals globally have provided a cushion for the index which rebounded by around 5% since June, standing at 177.6. Hence, on a YTD basis, the index has declined by 7.8%. Industrial commodities enjoy a double-digit rally mainly due to a weaker USD, improving global industrial prospects, and expectations of lower inventories. China, the largest aluminum producer in the world has embarked on a policy of shutting down non-compliant smelters; smelters that are either high cost or excessive in polluting the environment. Past structural excess capacity and oversupply created a base effect for the current rally which is marked by lower supply prospects and smaller production capacity. The Department of Commerce in Shandong detected a significant amount of illegal capacity in the province totaling at least 3.2 million tonnes, including 2.7 at Hongqiao. As a consequence, however, the legal smelters will have to operate at full capacity to smooth out the resulting shortage. Aluminum prices surpassed 20% YTD by mid-August, breaking the USD2,000/ton level.

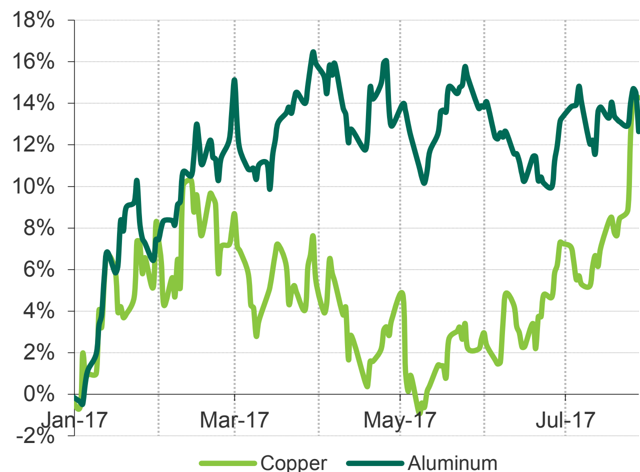
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Copper prices jumped sharply in the final quarter of last year, peaking at USD6,046/ton in November, thus marking the highest price point since June 2015. This marked a turnaround for the red metal which is vital in construction and manufacturing. Chinese demand for the metal had surpassed expectations and a market upswing was underpinned by the Trump fiscal expenditure plan which aims to spend 2 trillion dollars on new infrastructure. Chinese consumption registered a 5% Y/Y increase as the real estate crisis was abated. That momentum carries well into 2017 with copper prices rising by double-digits, marking a 15.6% YTD gain. Chinese consumption growth is projected to reach 3% this year although supply is also expected to edge lower. On balance, copper is expected to remain in surplus through 2017, dampening down the price rally enjoyed in the first half. Headwinds to base metals' price appreciation are manifested in a reversal of the USD's weakening and the relaxing of supply constraints.

Chart 6: Base Metals



Source: Thomson Reuters

With the proliferation of gold exchanges around the world, notably in Asia; the London Metal Exchange developed a model in conjunction with the World Gold Council along with six other partners in order to accommodate the interests of the full range market stakeholders. This new model is dubbed LMEprecious and will be offering more capital efficiency, transparency and accessibility in a London-based precious metal platform. Spot gold prices continue to rise on risk aversion as geopolitical rollercoasters from the US and North Korea has kept the yellow metal afloat with the troy ounce surpassing 10% increase YTD, standing at USD1,268.6/oz.

Soft commodities prices remain subdued with oversupply dominating the outlook, overcoming the upside pressure from a weaker USD. Corn prices stood at 359 cents/bushel, inching up by 2% YTD while wheat prices moderated from a double-digit surge of 31.3% in July to just 6.8% by mid-August at 435.8 cents/bushel. We expect the oversupply theme to continue in the lack of global yield concerns.

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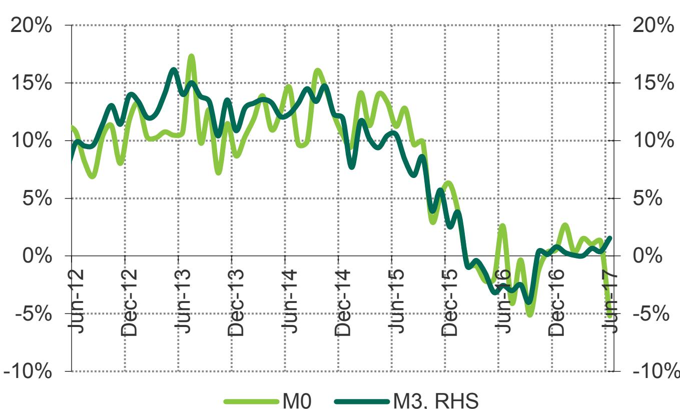
Money & Inflation

Muted Monetary Situation

Despite a grand transformative strategy to diversify away from oil, the volatile commodity remains pivotal for the country's financials as OPEC and non-OPEC oil producers attempt to rebalance the oversupplied market by extending their production cuts till March 2018. The Saudi government's quarterly budget statement, an unprecedented and transparent announcement, reveals oil revenues for the first half of 2017 contributed 69.2% of total revenues. The rationalization of government spending, the only channel to convert the country's oil wealth into economic development, has adversely affected domestic liquidity. The narrowest measure of money supply (M0) contracted by 5.2% on an annual basis during the month of June, the largest decline since the eruption of the global financial crisis in September 2009. Cash withdrawals from local banks registered a drop of 11.4% Y/Y, the eighth consecutive decline. Accordingly, currency outside banks, which represents 54.6% of M0, fell by 8.5% annually in June to settle at SAR166.4 billion. In addition, cash in vault registered a similar slide at 8.5% Y/Y, declining to SAR39.1 billion. Meanwhile, deposits with SAMA have increased by 2.4% annually as banks' excess reserve ratio remains elevated at 51.4% by the end of June.

Chart 7: Growth in Monetary Aggregates

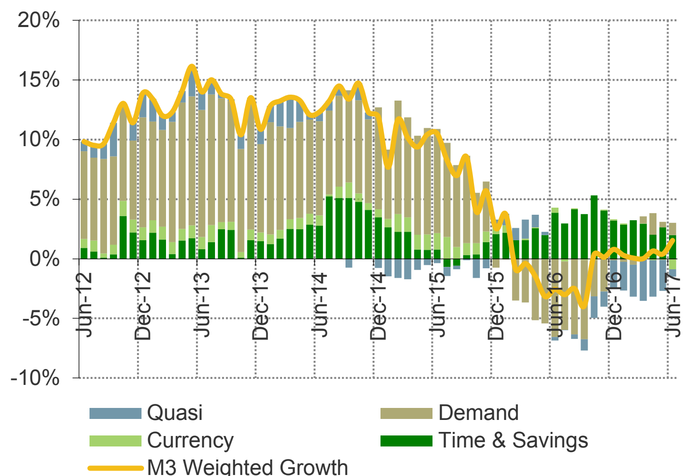


Sources: SAMA

The broadest measure of money supply (M3) grew by 1.5% on an annual basis in June, the largest gain since January 2016. The main drag on M3 stemmed from a drop in demand deposits over the past year as the government reduced its holdings of demand deposits to plug the fiscal deficit. The rebound of oil prices during the first half of 2017 in comparison to the same period of 2016, somewhat alleviated monetary pressures domestically.

During June, demand deposits recorded an increase of 1.9% Y/Y while time and savings deposits registered a rise of 8.0% annually to reach SAR478.8 billion. Additionally, the smallest component of M3, other quasi-monetary deposits, contracted by 6.0% Y/Y. Furthermore, SAMA's reserve assets have halted a downward trend as net foreign assets posted a marginal monthly increase by 0.3% to reach SAR1.85 trillion. During 2017, a total of SAR132.6 billion have been withdrawn to compensate the shortage in oil revenues, yet we believe the government will balance utilizing foreign reserves and debt issuances over the second half of 2017.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

Consumer prices remained in the negative territory for the sixth consecutive month by the end of June, registering a 0.4% decline on an annual basis. The food and beverages sub-index continued its downward trend by contracting 2.2% Y/Y despite an 11.3% rise in soft drinks and juices due to the recent excise tax on harmful goods. The second major sub-index, housing and utilities, marginally increased by 0.4% as rental prices were subdued with an annual rise of 0.7% during June. Meanwhile, subsidy removals for water, electricity, and fuel prices will possibly be postponed till 2018 despite being scheduled for implementation in July. The setback is caused by the delay of the Citizen's Account program which aims to provide cash grants to Saudis in order to minimize the effects of the government's fiscal consolidation efforts.

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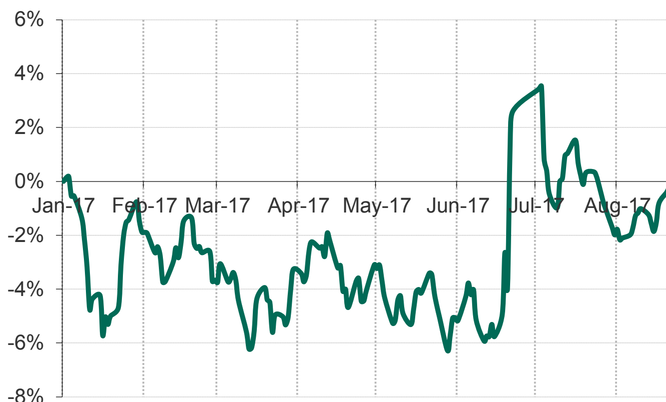
Capital Markets
Range-Bound Movement

Tadawul disconnect from its international counterparts continued with the headline index registering a year to date near zero performance, with 12 out of the 20 sub-sectors in the negative territory. In contrast, global equities had maintained their upside momentum, with the benchmark indices for the world, G7 and emerging markets respectively registering year to date gains of around 12%, 10% and 22%, according to the MSCI World indices. A case in point is S&P 500 registering 30 records till date.

During July, the market declined significantly by 4.5% to close at 7,094.2, which follows an 8.1% increase in June. The monthly fall materialized despite the strong gains for crude oil benchmarks, with WTI and Brent rising by 11.7% and 9.9%. These gyrations continue to be influenced by the hanging clouds over the market, mainly in terms of the anticipated removal of subsidies and the introduction of the value added tax in 2018. Additionally, Saudi individuals continue to shrug any good news like MSCI's recent announcement of adding TASI to its watch list for a possible inclusion in the emerging markets index next year.

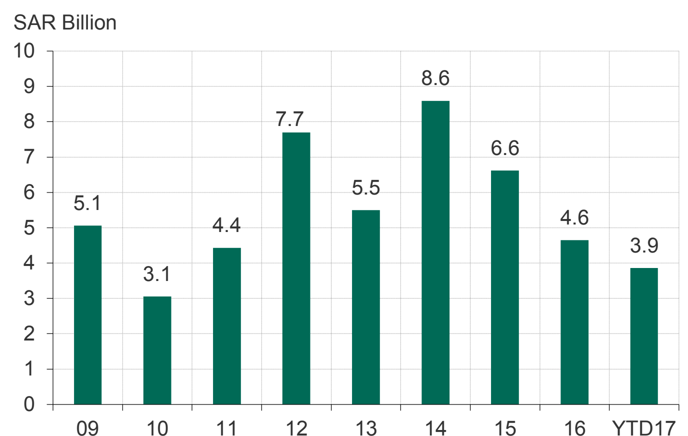
Chart 9: Tadawul All-Share Index



Source: Tadawul

Regarding the sectoral performance, the heavyweight sectors remained in the red, namely energy, materials, and banks that registered monthly declines by around 7%, 3%, and 5%, respectively, by the end of July. The weakest sector was transportation, recording a decline of around 24% since the beginning of the year, followed by the energy sector, which fell by 20%. Investors' appetite, represented by the average daily trading volumes, fell during July to SAR2.7 billion from SAR3.4 billion a month earlier and last year's average of SAR4.6 bn. The majority of trading continues to be attributed to Saudi individuals, representing around 79.5%. Individuals, GCC and SWAP investors were net sellers while Saudi institutional investors, government funds and QFIs were net buyers. Notably, QFIs maintained their net purchases for the fifth month in a row, yet the amount was a meager SAR34 million, much lower than June's net investment of SAR149 million. Ostensibly, much of the improvement in QFI holdings can be attributed to foreign investors shifting their indirect ownership via SWAPs to the more direct venue.

Chart 10: Average Daily Traded Value



Source: Tadawul

In line with the volatile secondary market, the primary market witnessed just five activities since the beginning of the year, all of which are REITs. Ostensibly, IPOs for this year and next will be delayed, with companies factoring in the current dynamics in the secondary market and the broader moderate business cycle. Yet, the government's privatization program might counter the slowdown on the part of businesses, especially that the National Center for Privatization was established with the aim of privatizing sectors such as utilities, healthcare and education. Going forward, developments concerning government funds will be critical to the market in terms of not being net sellers especially that their total holdings are around 40% of the market capitalization, an amount that stands at SAR684.4 billion by the end of July. In our opinion, portfolio investments at this juncture might be held back up until structural changes take place and the fog of this transition phase clears.

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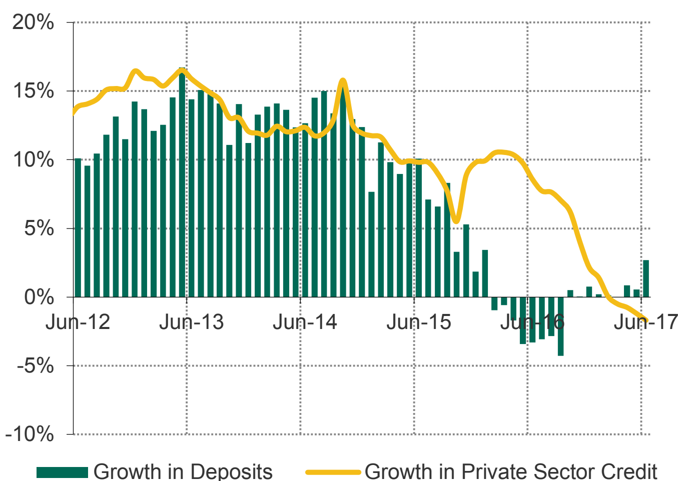
Loans Market

Deposits Rise on Debt Issuance

The depositary base in the Saudi financial system is majorly composed of non-interest bearing liabilities. Demand deposits represented 60.1% of total deposits by the end of the first half of 2017. Businesses and individuals hold over 90% of demand deposits which have been hovering around the SAR900 billion level over the past two years. Government entities have largely utilized their most liquid form of assets to finance the economy's balances. However, the debut issuance of international Sukuk in April, followed by a domestic issuance, have supported government entities' demand deposits, rising by 81% in June to reach SAR97.0 billion. Furthermore, time and savings deposits held by government entities have also registered a gain in June to reach SAR234.2 billion, a record level. King Salman recently announced a decree to restore public sector employee benefits retrospectively to support citizens' standard of living given the current macroeconomic slowdown. The influx of the accumulated benefits will provide a much needed boost for the depositary base, which posted an annual increase of 2.7% during the month of June.

Chart 11: Private Sector Financing

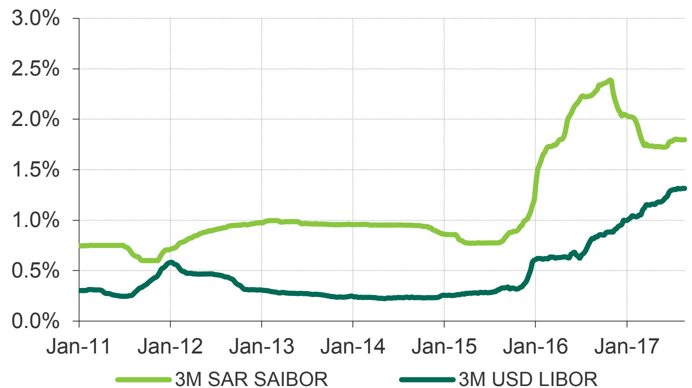


Sources: SAMA and NCB Estimates

Assessing the other side of the balance sheet, total claims of the banking system, excluding T-bills and government bonds declined for the fourth consecutive month, posting a dip of 1.7% annually. The economic slowdown has weighed on the credit market as business activity is subdued. As a proxy, settled and newly opened letters of credit have both decreased by 27% during the first six months of 2017 over the same period in 2016. The decline in credit resulted in lowering the loans-to-deposits ratio to 86.4%, the lowest since February 2016. Banks' maturity distribution is noticeably shifting towards long term credit which has expanded by 8.4% on an annual basis, reaching SAR447.6 billion by the end of June. Meanwhile, medium term and short term credit recorded an annual decline of 9.9% and 4.2%, respectively.

Fresh lending in 2017 has only reached 1.0% YTD for the private sector, adding SAR13.3 billion to reach a total of SAR1.36 trillion by the end of June. In assessing credit to different economic activities, the commerce sector is the largest recipient of funds in the local market, growing by 4.1% to reach SAR309.7 billion. Meanwhile, the manufacturing and processing sector registered a decline of 5.9% to settle at SAR171.8 billion. Additionally, the building and construction sector continues to face difficulties as the pace of government projects has been rationalized which reduced credit by 9.5% Y/Y by June. Furthermore, claims on the public sector gained 1.3% annually to reach SAR260.5 billion. Treasury bills declined by 74.9% Y/Y to settle at SAR13.3 billion, as banks shifted their assets towards government bonds which gained 28.0% annually to reach SAR200.4 billion, a record high.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

As for the Saudi interbank rate (SAIBOR), liquidity risks have eased lately which drove down the SAIBOR to average around 1.75% during June. The spread between SAIBOR and LIBOR has dropped below 50bps as local liquidity pressures relatively eased compared to 2016. The US Fed is expected to continue its normalization policy with another 25bps interest rate hike this year as inflation remains below its 2% target. Further hikes in 2018, as always, will be mirrored by SAMA but we do not expect the interbank to fully factor the increase due to domestic liquidity dynamics.

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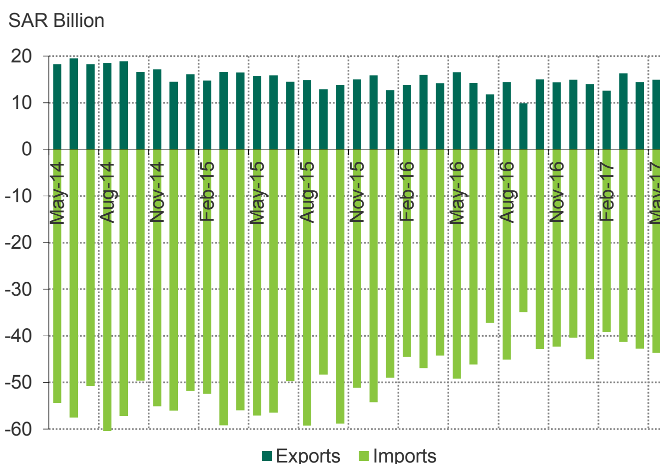
External Trade

Fiscal Constraint Reduces Imports

In the month of May, non-oil trade moderated in comparison to last year as cheaper oil prices continue to impact the monthly bottom line. Over 60% of non-oil exports are essentially oil derivatives such as plastics and chemical products which are highly correlated with oil market dynamics. Total non-oil exports reached SAR15.0 billion, sliding by 9.8% Y/Y. On the other hand, total imports recorded SAR43.7 billion, tumbling by 11.3% compared to the same period last year. In addition, the National Transformation Plan and Vision 2030 mandates exacerbate and reinforce this trade pattern as a consequence of the structural change underway. The Kingdom is moving more rapidly away from oil reliance; a transition that proves challenging under the current circumstances. Moreover, the Kingdom's adamancy to reduce government deficit resulted in tighter control over fiscal spending and a higher focus on efficiency; thus, the import bill is expected to continue declining on the back of lesser government expenditure.

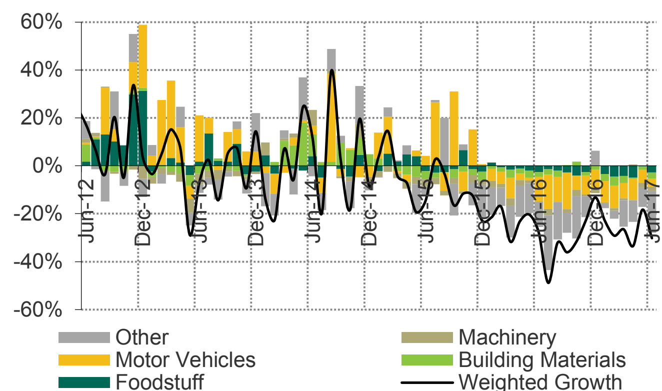
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB Estimates

By composition, exports of plastics which account for 30.5% of the monthly total stood at SAR4.6 billion, declining by 5.7% Y/Y. Global demand for plastics has been resilient in the past despite the slowdown in China, and with global manufacturing improving, it is possible to see an upturn for this export category in 2017. Exports of chemical products continued to decline on an annual basis, sliding by 5.7% to SAR4.2 billion. The early vertical diversification of hydrocarbons puts the Kingdom at a key global advantage, extending the chain of production for the largest holder of proven oil reserves in the world. In addition, relatively low feedstock cost, economies of scale, access to cheap capital, and unwavering government support are key enablers for the sector, allowing the Kingdom to become the 9th largest polymer producer in the world. Furthermore, exports of base metals was almost unchanged, inching up by 0.4% Y/Y to SAR1.4 billion. Regarding export destinations, the UAE received 15% of the monthly total at SAR2.3 billion. Compared to last year, non-oil exports to the UAE declined by 6.6% on the back of slowing re-exports to China. Moreover, exports to China declined by 10.5% Y/Y, valued at SAR1.7 billion whereas exports to Singapore surged 12.9%Y/Y to SAR0.8 billion.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB Estimates

On the imports side, the bill for machinery and electrical equipment was slashed by 11.5% Y/Y, standing at SAR10.2 billion as construction activity remains muted. Imports of vehicles and transport equipment recorded the largest annualized decline during the month, tumbling by 30.4% to SAR6.1 billion indicating lower demand. Furthermore, imports of base metals declined by a sizeable 11.5% Y/Y on the back of slower construction. The nature of items imported shows that 71.7% of all imports are finished goods, while 24.7% are semi-finished and only 3.7% were raw material. China accounted for 17.3% of the import bill by origin at SAR7.6 billion, upturning by 3.8% Y/Y. The US comes second, accounting for 12.3% at SAR5.4 billion, tumbling by 14.5% Y/Y whereas UAE imports saw an annualized 12.3% surge in value terms, posting SAR2.9 billion.

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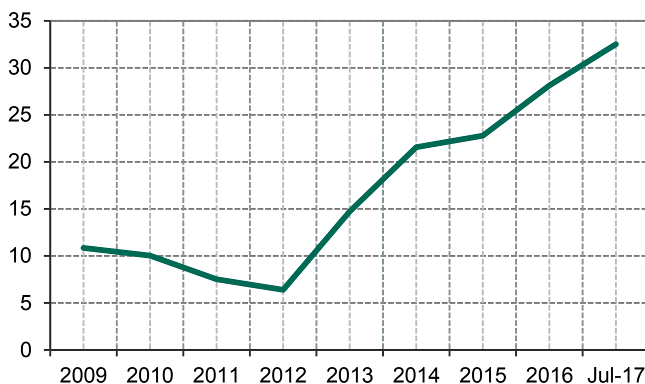
NCB الأهلي

Special Focus:
Cement Market Remains Subdued

Oil prices took an upward trajectory following the war on Saddam Hussein in 2003, breaching the USD50/bbl in 2004. Prices continued to rise, peaking around USD140/bbl during the global financial crisis in 2008. Coupled with the supply disruptions from OPEC producers such as Libya and Iran, oil remained elevated as geopolitical risks supported prices earlier this decade. Saudi benefitted from substantial oil revenues which facilitated record fiscal expansionary policies. Accordingly, mega projects nourished as the government pursued long-term sustainable development that required investments in infrastructure, education, healthcare, and social and economic development projects. Cement plays a pivotal role in the construction, maintenance, repair, and renovation of building structures. The surge in local demand increased prices on the 50kg cement bag, which was later capped at a maximum SAR12/bag for wholesales and SAR14/bag for end users, set by the Ministry of Commerce. Furthermore, the Ministry of Trade banned cement exports in 2008 to accommodate local consumption. However, tumbling oil prices in 2014 had severely impacted the Saudi economy as the influx of revenues weighed on its fiscal policy. Government expenditure has since been reduced and a vast capital expenditure rationalization program will tackle a total of SAR1.4 trillion worth of government projects, many of which have been placed on-hold.

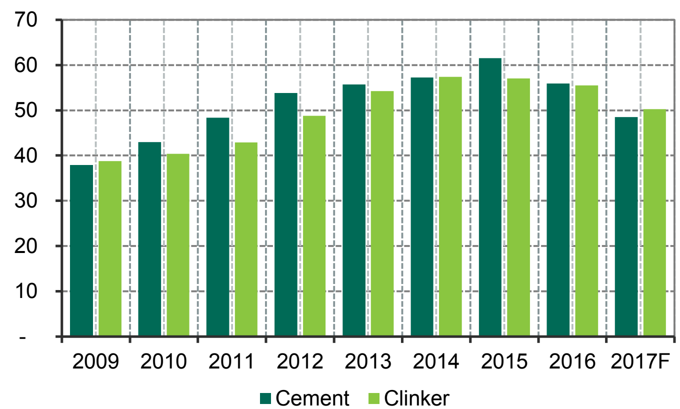
Chart 15: Clinker Inventory Levels, Million Tonnes



Sources: Yamama Cement Statistics

During 2016, construction sector real GDP contracted by 3.3% annually as contract awards were reduced significantly. The momentum continued in the first quarter of 2017 with a decline of 3.2% Y/Y as contractors and construction companies struggled to manage cash flow needs. Domestically, there are 17 cement companies supplying the local market with a production capacity of about 65 million tons. Clinker production reached 55.5 million tons last year, dropping 2.6% on an annual basis. In the first seven months of 2017, clinker production was further reduced by 10.9% over the same period in 2016, settling at 29.3 million tons. Cement production, which is typically clinkers with additives, fell by 9.0% Y/Y in 2016 while registering a drop of 19.4% since the beginning of the year through July. The slowdown in production have been driven by weak domestic demand which fell by 9.8% in 2016 and record high clinker inventory levels reaching 28.1 million tons by the end of last year and continued to rise to 32.5 million tons by July. Further pressures on the industry emanate from rising input costs due to higher energy and fuel prices given the government's fiscal consolidation efforts.

Chart 16: Local Production, Million Tonnes



Sources: Yamama Cement Statistics and NCB Estimates

In order to alleviate the pressures on the local market, the Ministry of Trade approved the removal of the export ban, albeit an export tariff around SAR110/ton was imposed. However, as regional cement prices remain subdued and provide no financial incentive for Saudi companies to diversify regionally, the export tariff was reduced by 50% to provide support. In our opinion, the construction sector will continue to consolidate over the short-term as the government targets economically viable and efficient projects. Nonetheless, our long-term view remains positive as the Saudi demographic will remain supportive. Furthermore, the recently announced Qidyah entertainment city, spanning 334 sq km, and Al Faisaliah city which will cover 2'540 sq km, as well as the Red Sea project with an estimated area of 34'000 sq km will spur the construction industry beyond 2020.

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