

Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- It is expected that US crude oil exports to China could easily double next year as US production and export capacity expands, and as Chinese independent refiners ramp up imports.
- Assuming the debt ceiling is raised and the fiscal stimulus is deployed, we expect a growth acceleration next year which should prompt the Fed under the new leadership of Jerome Powell to continue gradual policy normalization in 2018.
- Agricultural commodities face a supply abundance and record crops which did not bode well for commodity currencies
- We expect a spike in durable goods prices in November and especially December as consumers will opt to avoid the 5% Value Added Tax which will begin in January.
- Accordingly, we believe the market will remain in a wait-and-see mode, with stakeholders awaiting changes to both the National Transformation Plan (NTP) and the Fiscal Balance Program (FBP) that are going to determine the new business landscape.
- Given the currency peg, SAMA announced a rise in the reverse repo rate from 125bps to 150 bps while keeping the repo rate unchanged at 200bps, squeezing the corridor for the central bank which will require attentive assessment going forward.
- According the General Authority of Statistics (GAS), monthly non-oil exports make around 25% of total exports, and as the global economy recovers and demand strengthens, we expect to see non-oil export figures improve even further over the coming years.

View of the Month

The challenging macroeconomic backdrop is feeding pipeline risks as Non-Performing Loans (NPL) have been rising recently. NPLs reached SAR19.1 billion, 1.3% of gross loans by 3Q2017, an annual rise of 15.3% that is mostly concentrated in the construction and manufacturing sectors. We do expect NPLs to continue rising due to the transition costs affiliated with economic reforms.

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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)

Oil Market

OPEC Commits to Production Cuts

In its November 30th meeting and as widely expected, OPEC and its major non-OPEC partners, including Russia, agreed to extend the production cut of 1.8mb/d until December 2018. The compliance with the agreement in 2017 has been remarkable, averaging above 80% level. Accordingly, oil prices have improved since beginning of the year, largely due to the OPEC's and Non-OPEC production cut and also due to higher-than-expected global demand on the back of strong global economic growth. Moreover, the oil production cuts along with global demand growth have more than compensated for the accelerated return of shale oil, which contributed to the increases in US supply. The improvement in global supply-demand conditions, coupled with heightened geopolitical tensions, have boosted oil prices by around 20% higher than 2016's levels to average USD54.0 in the first 11 months of 2017. Though there is scope for further upside in 1Q'18, the market is rather bearish on prices at current levels due to expected shale growth and some concerns about the Chinese economy. Taking into account these developments, and improved global economic outlook, it is expected for Brent prices to be consolidating around USD60.0 a barrel in Q4' 17, but projected to average USD55.0 a barrel in 2018.

Chart 1: Oil Price Developments, YTD

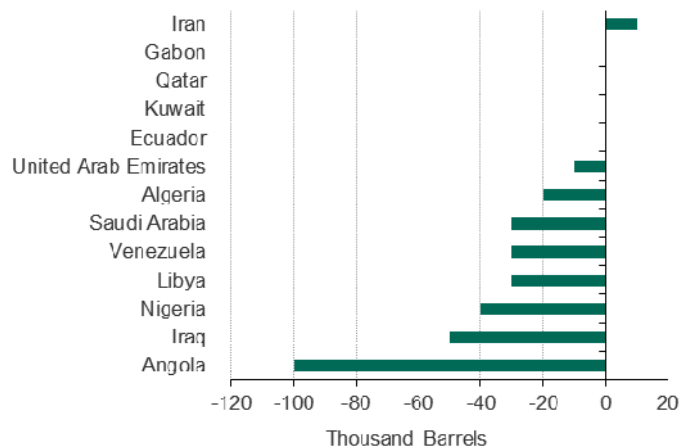


Source: Thomson Reuters

On the supply side, OPEC production is expected to remain flat, while global supply is expected to rise by 1.6mb/d as US output is expected to increase by around 1mb/d, driven by Permian and Oklahoma shale formations. The oil market next year will depend on OPEC and Non-OPEC partners ability to keep a high compliance rate once again in 2018 in order to fundamentally tighten global oil supply. Presuming adherence to a com-

parable rate of compliance as of 2017, global oil market is expected to be balanced in 2018 and oil inventories should decline to their five year average by Q3'18. US producers have already reaped the benefits of OPEC's decision to cut production, and they will continue to do so with the extension of the OPEC and Non-OPEC deal until the end of next year. According to EIA's Petroleum Supply Monthly report, US crude oil production increased by 0.29mb/d m-o-m to 9.48mb/d in September, just 0.145mb/d below its peak level of 2015, and expected to surpass this level before year-end. The horizontal rig count is likely to grow again following the recent three-month rally in oil prices. Moreover, US shale oil producers are hedging their future production at current prices, which are above their breakeven prices.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, IEA projects global demand growth to moderate to 1.3mb/d in 2018 from 1.5mb/d in 2017 in line with marginally slower global GDP growth, and as higher prices weaken demand. In the US, petroleum demand declined for the second consecutive month in September by 0.180mb/d y-o-y, which is likely due to lingering effects of Hurricane Harvey. US oil imports fell 0.49mb/d y-o-y in September, as imports from Saudi Arabia fell to 0.67m/d, the lowest level since the 1980s. On the other hand, petroleum exports increased by 0.82mb/d y-o-y in September, driven by a sharp uptick in crude oil exports. Accordingly, crude oil exports reached a record 1.47mb/d in September, and this figure is likely to increase in October. It is expected that US crude oil exports to China could easily double next year as US production and export capacity expands, and as Chinese independent refiners ramp up imports.

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Foreign Exchange

Markets Shrug off Another Fed Hike

Forex investors are still not favoring USD holdings despite solid economic data and the latest Fed hike this month. To this point, the greenback had spent most of its year on the defensive but the moderation which started in September is indicative of some fundamental support. In October, US unemployment posted 4.1%, the lowest in 17 years. Moreover, non-farm payroll added 261,000 jobs, marking the highest monthly jobs creation since August 2016. Weak inflation at 1.4% (as of October) remains an area of concern at the Fed but the adequate pace of growth which recorded 3% in 3Q2017 is increasing confidence that it will rise to the targeted 2% over the medium term. Assuming the debt ceiling is raised and the fiscal stimulus is deployed, we expect a growth acceleration next year which should prompt the Fed under the new leadership of Jerome Powell to continue gradual policy normalization in 2018. The trade-weighted USD closed at 93 by the end of November, down by 9% YTD. The greenback reversed an up-trend that took place since mid-September and is likely to end the year around current levels.

Chart 3: Trade-Weighted Dollar and the Euro

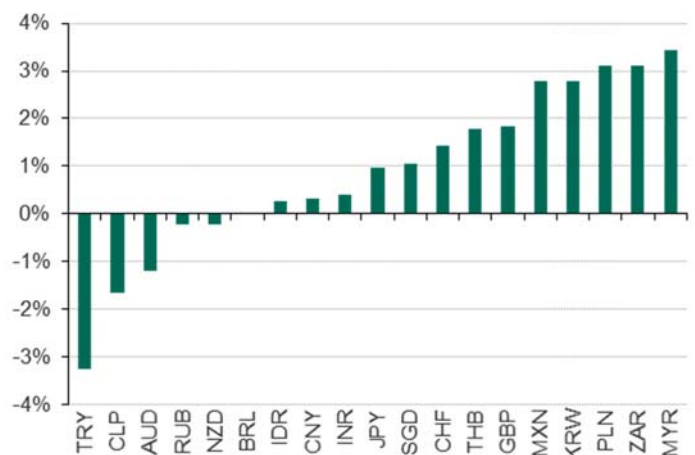


Source: Thomson Reuters

After moderating for two consecutive months, the EUR regained strength in November standing at USD1.19 by the end of the month. Political developments in the US and geopolitics in the Middle East and North Korea are garnering more attention than the relatively calmer investment environment in the Eurozone. In Germany, the ZEW investment sentiment gauge is riding at the highest levels since 2011, standing at 18.7 by November. Flash 3Q2017 GDP growth in Germany recorded 2.3% Y/Y, indicating a notable improvement from 2Q2017 and ensuring that growth is in line with expectations. Italy is

also showing a gradual improvement in economic performance, reaching 1.7% Y/Y in 3Q2017 which solidifies macroeconomic prospects on the Eurozone. Growth in the Eurozone reflected the rapidly improving economic activity, posting 2.5% Y/Y in 3Q2017 which will likely bring this year's growth close to the IMF's latest projection of 2.1% Y/Y. The EUR ended the month of November closing at USD1.2, surging by 13.2% since the beginning of the year. We expect the ECB to taper its monetary policy late next year if economic conditions continue to show improvement.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The Chinese yuan has been volatile as China might widen its trading band, continuing its massive economic reform. President Xi Jinping's second term guarantees another five years of undisrupted leadership which is positive for the renminbi. Existing challenges include total debt rising up to 260% of GDP, an alarming rate for fiscal sustainability which prompted Moody's to reduce China's rating to A1 from Aa3. By the end of November, the CNY appreciated by 5% YTD to 6.6 for the dollar, moderating from September's peak of CNY6.7. As for the JPY, the third largest traded currency closed at 112.6 by the end of November, upturning by 3.9% YTD. The Bank of Japan is still below its 2% inflation target despite its ultra-loose monetary policy. However, governor Kuroda hinted that rates might reverse back to the positive territory if economic indicators deem it necessary, exiting its quantitative and qualitative easing.

Commodities

Commodities Moderate on Mixed Outlook

The year 2017 saw a continued divergence between industrial and agricultural commodities as industrial metals were strongly supported by a mix of improving economic conditions in developed economies and environmentally driven reduction in China's smelting capacity. The agreements made between OPEC and non-OPEC suppliers firmed up oil prices which rose 17.7% YTD by the end of November to USD64.3/bbl. Meanwhile, agricultural commodities face a supply abundance and record crops which did not bode well for commodity currencies. A weaker USD, however, with markets shrugging off interest rate hikes in the US pressured gold prices up in the second half of 2017. The unwinding of the commodity super-cycle is still on-going, and headwinds to investment include geopolitics in North Korea and the Middle East, US fiscal reforms, terms of trade shocks, accumulation of private debt, and policy uncertainty in major economies. By the end of November, the Thomson Reuters CRB index ticked down by 1.7% YTD.

Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Despite average metal prices being at relatively low levels compared to last year, credit stimulus in China combined with supply and environmental constraints sent prices higher. The closure of older, inefficient smelters in China had a profound impact on prices as China account for over 50% of global industrial metals' consumption. Moreover, China's transition to a consumption/service-led growth coupled with an industrial reform and environmental concern will likely create more investor demand, pressuring prices upward. Copper prices rose 22.2% YTD, closing at USD6,762/ton on falling inventories and expectations of higher demand. Despite supply growth in new countries in the coming years, strong demand from China and more

closures and supply disruptions will underpin the red metal. The growing industrial use of aluminum had proven its versatility as it surged 21% YTD by November standing at USD2'048/ton. Strong global demand, rising production cost and bauxite export bans have carried aluminum prices upwards. However, downward risks include Indonesia's decision to roll back on its bauxite export ban, in addition to new Chinese low-cost smelting capacity becoming operational.

Chart 6: Base Metals



Source: Thomson Reuters

Rising USD and real interest rates have not impacted gold prices as narrowing interest rate differentials between the US and Europe did not warrant arbitrage. The spot price of a troy ounce of gold closed 10.7% YTD by the end of November, reaching USD1,275.2, indicating a moderation from August and September's levels but higher than 1H2017 levels. Physical gold demand was generally weak last year, and in particular; India and China. The Indian government is curbing illicit cash stock by removing cash note denominations of 500 and 1000 rupiahs out of circulation in order to shift savings into financial assets and away from physical assets, notably gold and real estate. In China, demand for gold declined as consumer preference shifted towards leisure activities and other goods in response to higher income. According to the Goldman Sachs agriculture index, soft commodities inched down 2.4% YTD by the end of November. Upward price pressure was conceived in the first half of the year due to an El-Nino induced scare that pushed the index as high as 9% since beginning of the year. However, higher than expected crop yield coupled with weaker global demand and a relatively stronger USD rendered soft commodities faltering. According to the Chicago Board of Trade, Wheat prices erased gained made this year returning back to 409.3 cents/bushel, whereas corn prices declined by 2.9% YTD, standing at 341.7 cents/bushel.

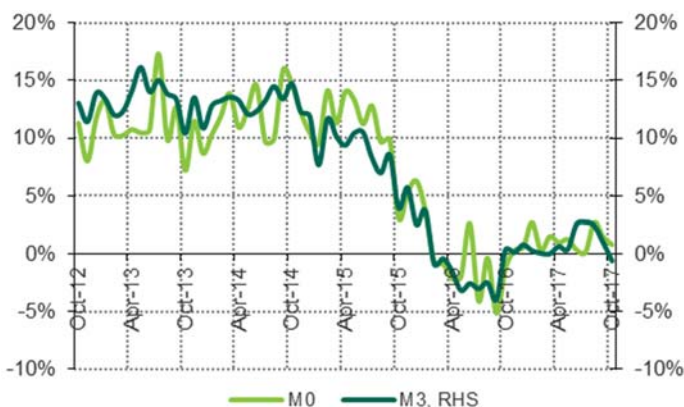
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Money & Inflation

Expected Retail Spike as VAT Looms

The Kingdom is planning to build its non-oil revenues to provide a sustainable inflow for the economy. Saudi Vision 2030 aims to decouple the economy from reliance on oil through diversifying, developing, and creating industries that have been previously unutilized. Non-oil revenues reached SAR131 billion at the start of the current oil crisis, since then, non-oil revenues are expected to increase to around SAR200 billion, a rise of over 50% over three years. However, during the same period, oil revenues dropped from SAR913 billion to an expected SAR477, a collapse of 47.7% equating to SAR436 billion. Accordingly, the oil narrative remains pivotal for the Saudi economy which has been impacting business and consumer markets. The government's prudent monetary policy through its dual mandate of reducing spending and increasing debt issuances, both domestic and international, have reduced the implications on the monetary system. During October, the narrowest measure of money supply (M0) has marginally gained by 0.8% on an annual basis to reach SAR301.2 billion. Deposits with SAMA registered a gain of 6.3% Y/Y as public financial institutions more than doubled their deposits by rising 128% annually to SAR6.3 billion. On the other hand, currency outside banks and cash in vault recorded an annual decline by 1.1% and 5.7%, respectively.

Chart 7: Growth in Monetary Aggregates

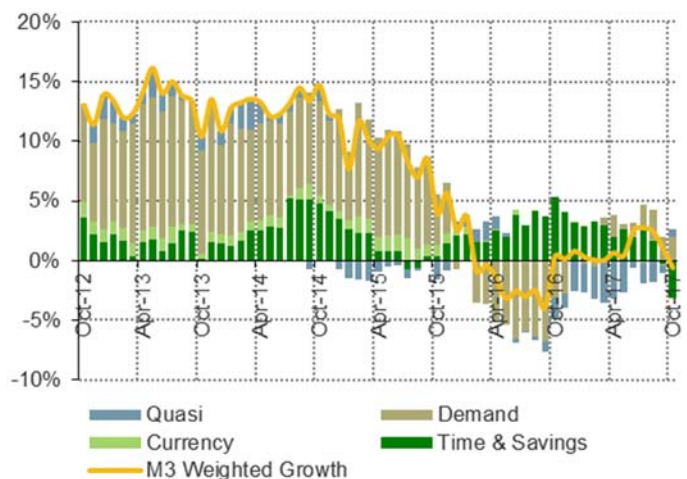


Sources: SAMA

As for the money supply (M3), the broadest measure registered a decline of 0.6% Y/Y during the month of October, the first contraction since September 2016. This was attributed to the drop in time and savings deposits by 11.3% annually to settle at SAR441.9 billion by the end of October. Meanwhile, demand deposits, the largest component of M3, gained 3.7% on an annual

basis and other quasi-monetary deposits expanded by 7.8% Y/Y. The government initiated the sovereign bond issuance program two years ago to plug the fiscal deficit, in doing so, it also created a benchmark yield curve and a new investment vehicle for domestic banks. The banking system's excess reserve ratio has been on a downward trend, settling at 32.9% in October. On the other hand, government bond holdings in the banking system reached SAR244.9 billion. Furthermore, banks' net foreign assets have registered an increase by 19.5% on an annual basis, majorly due to a decline in foreign liabilities that outpaced the decline in foreign assets. We expect local banks to maintain a cautious approach as subsidy reductions and further economic reforms are implemented in 2018.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

The inflation rate remained in the negative territory during the month of October, registering a contraction of 0.2% on an annual basis. The food and beverages sub-index, which represents the largest share in the basket of goods, registered a decline by 1.2% albeit the smallest drop since August 2016, supported by an excise tax on soft drinks. In addition, we believe that the economic slowdown coupled with the expatriates' dependents levy have resulted in the departure of foreigners as the latest labor market report reveals a drop of 175,893 in expat employees during the first half of 2017, prompting rental prices to decline for the third consecutive month at 0.2% Y/Y during October. We expect a spike in durable goods prices in November and especially December as consumers will opt to avoid the 5% Value Added Tax which will begin in January. Accordingly, there will be an expected rise in 2018 inflation to around 5% as cost-push inflation from energy subsidy reductions will permeate across the consumer basket.

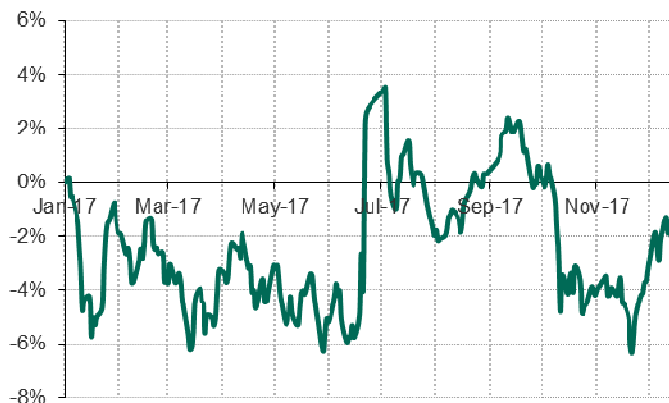
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Capital Markets

Tadawul Lacks Momentum

The upside momentum for global equities shows no signs of abating, with the benchmark indices for the world, G7 and emerging markets respectively registering year to date gains of around 19%, 17% and 28%, according to the MSCI World indices. On the emerging markets front, Turkey and Hong Kong continue to lead, rising respectively by around 35% and 29% while S&P500 is sailing towards its ninth quarterly advance. In contrast, the MSCI GCC and Tadawul maintained their negative stance, with the former falling by around 7% and the latter declining by 2% as 14 out of its 20 subsectors remain in the negative territory.

Chart 9: Tadawul All-Share Index

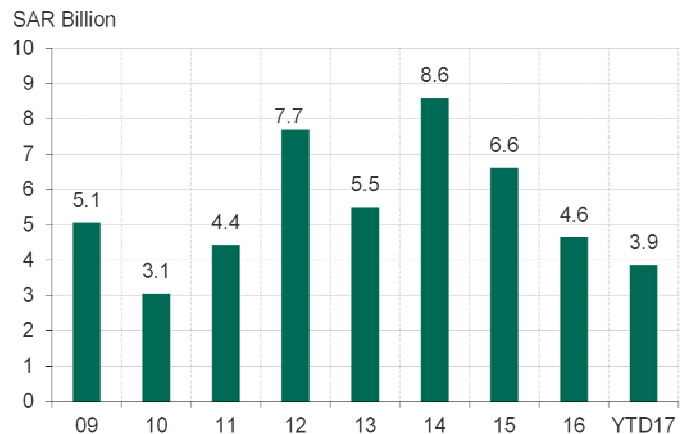


Source: Tadawul

During November, the market rose marginally by 1% to close at 7,003.97, which follows a 4.8% decrease in October. This lackluster performance materialized despite elevated oil prices, with WTI and Brent rising by 5.6% and 4.1%. Regarding the sectoral performance, heavy weights such as materials and energy remained in the red registering year-to-date declines of around 2% and 20%, respectively, while banks remained in the positive territory at 4%. The weakest sector was pharma recording a decline of around 29% since the beginning of the year, followed by the consumer services sector, which fell by 25%. Investors' appetite, represented by the average daily trading volumes, rose during November to SAR3.4 billion from SAR2.9 billion a month earlier, yet significantly below SAR4.6 billion posted in 2016. The majority of trading continues to be attributed to Saudi individuals, representing around 77%. Individuals, GCC investors and QFIs were net sellers while Saudi institutional investors were net buyers. Critically, individuals continued to exit the market, with their net sales increas-

ing from SAR3.2 billion in September to a significant SAR10.1 billion last month, underscoring their risk averseness. Saudi institutional investors, however, have maintained their buying stance that reached SAR12.6 billion of net investment in November. As for foreigners, whether QFIs or swap investors, they sold shares worth around SAR1.6 billion, with QFIs registering the third consecutive month of net sales.

Chart 10: Average Daily Traded Value



Source: Tadawul

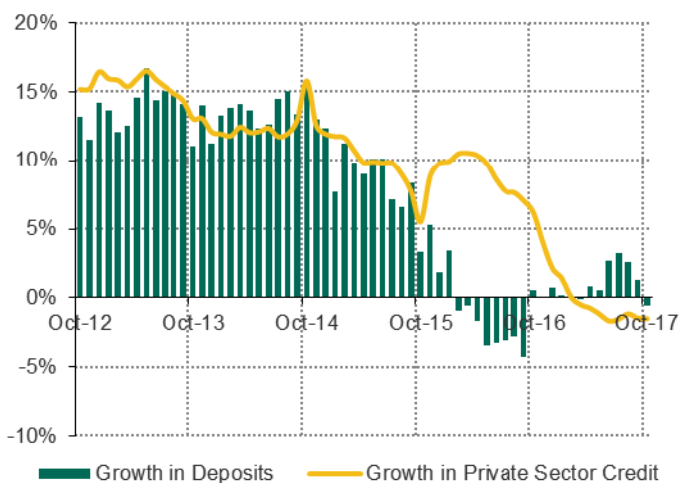
On the fundamental side, profitability had edged higher in the third quarter rising by around 19% Y/Y and 28% Q/Q to SAR33 billion, the highest quarterly earnings since 2Q2014. The boost was largely attributed to the petrochemical sector that benefited from higher prices and spreads, registering SAR8 billion, which is an annual gain of 25%. In addition to the base effect derived from petrochemical companies, the banking sector's net income grew by 14% to register SAR11 billion driven by growth in net special commission income margins that currently stands at 3.2% compared to last year's 3%. As expected, this favorable corporate profitability as well as the significant reduction in Saudi budget deficit by the end of 3Q2017 did not succeed in improving the appetite in the secondary market, with market participants shrugging them off similar to previous announcements. Accordingly, we believe the market will remain in a wait-and-see mode, with stakeholders awaiting changes to both the National Transformation Plan (NTP) and the Fiscal Balance Program (FBP) that are going to determine the new business landscape.

Loans Market

Squeezing the Corridor

Declining oil prices triggered sovereign rating downgrades from all three rating agencies for Saudi Arabia. A relatively large fiscal deficit, rising debt, and a worsening oil outlook promoted Moody's, Fitch, and S&P to revise the Kingdom's rating downwardly to A1, A+, and A-, respectively, albeit maintaining the investment grade position. Last month, Fitch and S&P have affirmed the current rating with a stable outlook as structural reforms have supported fiscal and external balances. The financial system is reflecting that stability as liquidity risks have been muted this year. The depositary base in the Saudi financial system continues to be majorly composed of non-interest bearing liabilities. Demand deposits represented 62.2% of total deposits during the month of October, registering a gain of 3.7% on an annual basis. Businesses and individuals have marginally increased their holdings by 0.3% Y, while the government's holdings maintained its double-digit growth to reach a record SAR103.3 billion. We expect the government is maintaining the most liquid form in order to easily manage the fiscal deficit. Meanwhile, time and savings deposits contracted sharply by 11.3% to settle at SAR441.9 billion. Government entities as well as businesses and individuals have reduced their interest-bearing deposits by 11.6% and 11.0%, respectively, on an annual basis. Additionally, other quasi-monetary deposits reached SAR163.9 billion, a gain of 7.8% on an annual basis.

Chart 11: Private Sector Financing

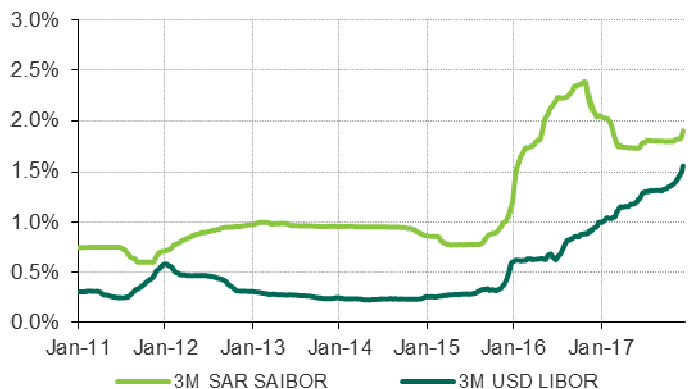


Sources: SAMA and NCB Estimates

Despite a rising interest rate environment, the banks appear to have become price-setters as we expect a shift in the composition between businesses and individuals with

regards to time and savings deposits. Moreover, the need to compete for deposits has somewhat mitigated amidst the declining credit market. The banking system's total credit registered the eighth consecutive annual decline at 1.8% by the end of October, settling at SAR1.41 trillion. By maturity, long term credit rose by 3.2% annually to SAR444.5 billion, representing 31.5% of total credit. Meanwhile, short term and medium term credit declined respectively by 4.5% and 2.3%, reflecting the subdued businesses environment.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

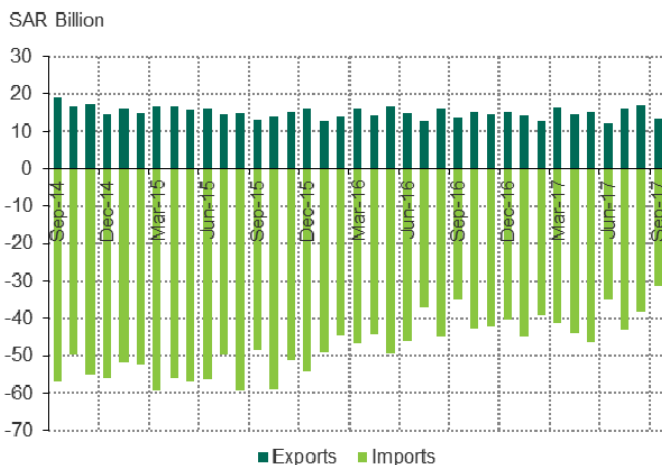
Private sector credit contracted by 1.5% Y/Y during October, settling as SAR1.36 trillion. Fresh lending has only reached SAR10.8 billion thus far, the lowest level since 2009. Additionally, consumer demand has been waning this year as retail loans, excluding real estate loans, registered a decline of 1.3% Y/Y by the end of the third quarter. We believe competition in the retail segment will intensify while the expected privatization plans for 2018 to support the corporate segment. As for claims on the public sector, a growth of 18.2% Y/Y raised the total to SAR307.8 billion by the end of October. As treasury bills held by banks declined by 52.4% Y/Y to settle at SAR15.9 billion, allowing banks to shift their assets to government bonds which gained 39.4% annually to reach SAR244.9 billion, a record high. The US Federal Reserve raised the benchmark interest rate by 25bps in the last meeting for Fed Chairperson Janet Yellen. Given the currency peg, SAMA announced a rise in the reverse repo rate from 125bps to 150 bps while keeping the repo rate unchanged at 200bps, squeezing the corridor for the central bank which will require attentive assessment going forward. Given that US inflation remains stubbornly below the Fed's target, we expect more hikes, albeit gradual, in 2018 as the world's largest economy continues to expand, which will be underpinned by Trump's tax cut reforms.

External Trade

Non-oil Exports Remain Positive

The Kingdom's massive social and economic reform is changing the dynamics in favor of less oil dependence. Diversification efforts have increasingly put more emphasis on growth of non-oil trade. Encouragingly, non-oil exports have been growing rapidly in recent years which is a much needed direction amid faltering and volatile oil prices. According the General Authority of Statistics (GAS), monthly non-oil exports make around 25% of total exports, and as the global economy recovers and demand strengthens, we expect to see non-oil export figures improve even further over the coming years. By the end of August 2017, the Kingdom's non-oil trade recorded a 5.8% increase over the 12-month period. On the other hand, lower government expenditure on infrastructure projects and fiscal consolidation efforts reduced the import bill which tumbled by 15.5% Y/Y. We expect that base effect will help reflecting a more positive outlook next year, highlighting the government's efforts in boosting non-oil trade.

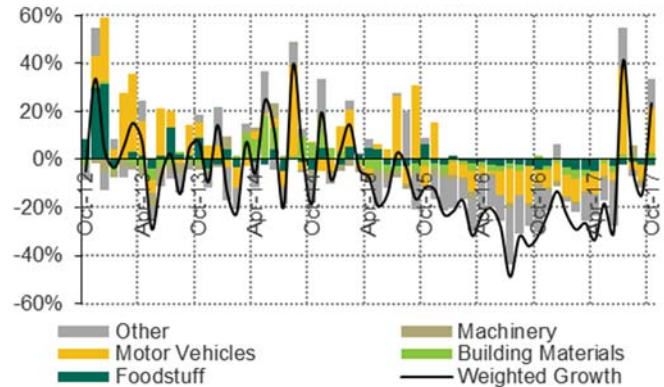
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB Estimates

Non-oil exports largely consist of chemicals and plastics, accounting for around 65.9% in value terms. According to GAS, plastics contributed SAR6.3 billion in the month of August, surging by 21.5% Y/Y. Chemical products on the other hand recorded SAR 4.9 billion, declining by 2% Y/Y. Base metals accounted for a further 8.6% of total exports, or SAR1.5 billion, upturning by 17.8 Y/Y. By destination, China accounts for most of the non-oil export contribution by value at SAR2.5 billion (14.6% of the monthly total.) In comparison to last year, non-oil exports to China surged 37.3%. The UAE came in second at

SAR2.2 billion, contributing 13% of exports. By annual comparison, exports to the UAE inched down by 1%. Exports to Singapore during the month totaled SAR 1 billion, rising by 25.8% Y/Y.



Sources: SAMA and NCB Estimates

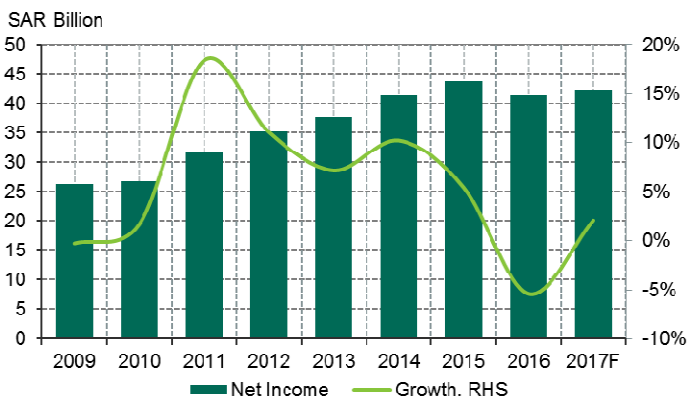
On the import side, we see double-digit declines across all main categories which is in line with the Kingdom's fiscal consolidation efforts. Imports of machinery and electrical equipment account for 24.8% of the import bill which at SAR9.5 billion had tumbled by 11.6% Y/Y. Imports of transport equipment reached SAR6.4 billion during August falling in annualized percentage change by 12.9%. Imports of chemical products are the third largest item in the import bill, accounting for 9.8%. Their total for the month recorded SAR3.7 billion, falling by 12.9% Y/Y. By import origins, China accounted for as much as 15.9% of the import bill at SAR6 billion. Compared to last year, Chinese imports to the Kingdom declined by 13% Y/Y. Imports from the US make up about 14.4% of the import bill at SAR5.5 billion. By annual comparison, however, imports from the US slid 12.4%. The UAE was the third largest trade partner by import value. The Kingdom's imports from the UAE make up 6.9% at SAR 2.6 billion, declining by 6% Y/Y.

Special Focus:

Privatization to Support Banks in 2018

Throughout the first nine months of 2017, the 12 locally incorporated banks recorded a combined net profit of SAR34.4 billion, a gain of 3.3% over the same period last year. Saudi's fiscal consolidation efforts reduced the flow of government capital expenditures over the past couple of years, which pressured the business environment. Consequently, bottom-line net income from the corporate segment has been on a downward trend, declining 21.3% Y/Y in 2016 and a further 3.7% Y/Y during 9M2017 albeit contributing the largest share of total net income at 35.7% by September. However, banks have been increasing their income from the consumer segment with operating income gaining 5.6% annually while operating expenses were contained by registering a gain of 1.2%, which resulted in net income rising 11.6% to SAR11.4 billion. Furthermore, the treasury segment registered a drop of 22.6% annually in operating expenses, which could be attributed to the contraction in liabilities by 13.5% Y/Y, contributing to a growth of 12.7% on an annual basis in net income by the end of September. The latter segment will benefit from the improved interest rate environment and we expect the normalization cycle in the US to reflect positively on future margins domestically. In addition, digital transformation, greater efficiency, and the privatization initiatives will maintain a positive outlook for the banking sector.

Chart 15: Local Banks' Profits

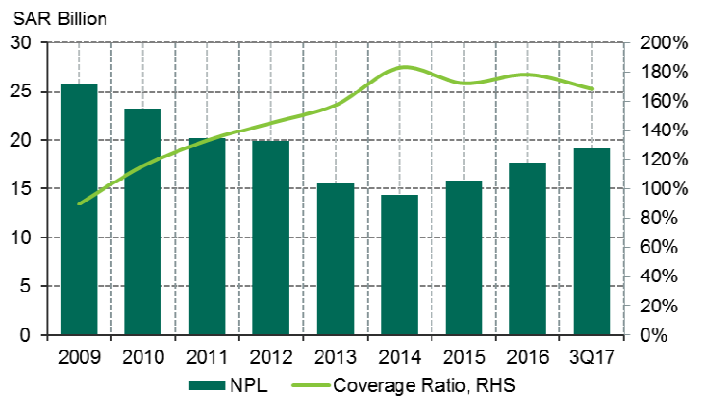


Sources: Annual Financial Statements and NCB

As for the balance sheets, the banking system's total assets marginally grew by 0.4% annually to SAR2.22 trillion, equating to 87.2% of nominal GDP. The structure remains relatively the same as the largest four banks, NCB, Al Rajhi, SAMBA, and Riyadh held 55.5% of total assets. The 1.8% Y/Y decline in the loans portfolio, the largest category in assets which represents of 63.4%, was undermined

by an expansion in investments at 7.2% Y/Y by the end of September. The most liquid form of assets, cash and balances with SAMA, declined by 22.4% since the beginning of the year as the Saudi interbank market strains have eased given the government's reduced pace of local issuances due to accessing international markets to finance the fiscal deficit. Additionally, the reduced flow of oil revenues impacted the depositary base which registered a contraction by 1.5% through the first nine months of 2017 to settle at SAR1.65 trillion. Deposits by type reveal that savings deposits added SAR6.9 billion since December, rising by 26.4% YTD, while demand deposits remained flat and time deposits declined by 5.0%. Consequently, total liabilities edged lower by 0.5% through the same period to settle at SAR1.87 trillion.

Chart 16: Local Production, Million Tonnes



Sources: Annual Financial Statements and NCB

The challenging macroeconomic backdrop is feeding pipeline risks as Non-Performing Loans (NPL) have been rising recently. NPLs reached SAR19.1 billion, 1.3% of gross loans by 3Q2017, an annual rise of 15.3% that is mostly concentrated in the construction and manufacturing sectors. We do expect NPLs to continue rising due to the transition costs affiliated with economic reforms. Accordingly, a provisioning cycle has been triggered to preempt possible defaults, with varying degrees across different sectors. By the end of the third quarter of 2017, provisions for possible credit losses have increased by 22.6% on an annual basis, bringing the accumulated stock for provisions to SAR32.3 billion. Looking forward, however, the Ministry of Finance launched a program to disperse claims within 60 days that will support businesses with their cash flow management. Additionally, the prudent management and supervisory practices that have been applied by banks and SAMA contributed in maintaining a robust NPL coverage ratio of 168.6% by 3Q2017 as well as registering a collective 17.4% for tier-1 capital adequacy ratio.

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