Saudi Economic Perspectives

2014 - 2015

Growth Moderation on the Horizon

NCB الأهلي

Contents

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Growth Moderation on the Horizon

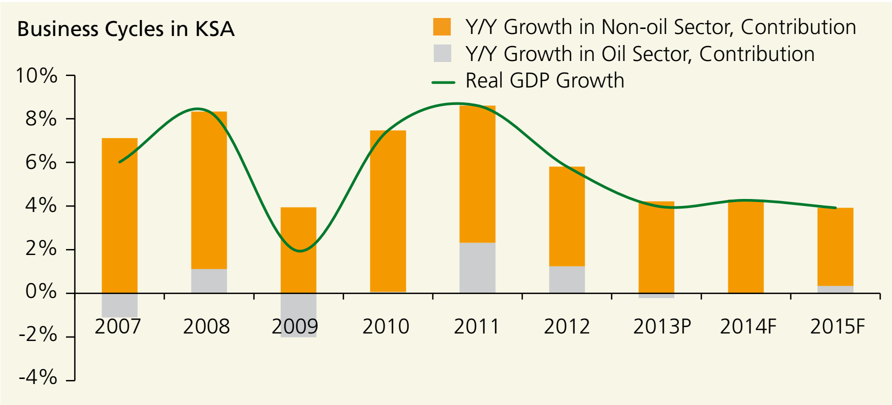
- The world economy will continue to experience a multi-stage growth, given the divergent economic outlooks for the advanced and emerging countries, an inflection from the heydays of the crisis when the emerging economies were the locomotive for growth. The deviation on interest rates between the emerging economies and their developed counterparts is expected to widen, in contrast to 2008 and 2009 whereby accommodative policies were adopted across the board. The International Monetary Fund (IMF) projects higher global growth in 2014 and 2015 at 3.6% and 3.9%,respectively, yet below the 5.1% registered in 2010.

- Last year marked the slowest economic growth rate since 2009, and we do believe that the Kingdom will face a moderate business cycle during 2014 and 2015, growing around 4%. In 2013, growth in real GDP decelerated to 4%, mainly against the backdrop of the negative contribution from the oil sector, stemming from a lower production level. We project real GDP growth of 4.3% for 2014 driven by non-oil sector growth that will post 5.4%, with oil maintaining its negative contribution.

- Libya's unstable production since 2011 in addition to the EU sanctions on Iran's crude exports that commenced in July 2012 enabled the Kingdom as a swing producer to reach a 30-year high daily production, but this situation is reversing on the back of non-OPEC supply and an expected rise in production from the two aforementioned countries, albeit slowly. Thus, we do believe that the Kingdom in giving way to these countries will be producing below the 10 MMBD mark during the next three years. According to our estimates, Arabian light prices will remain range-bound, protected at a floor of USD90/bbl in 2014, with Saudi crude oil production expected to slightly fall by an average of 40 thousand b/d, reaching 9.6 MMBD, which will result in lower current account and fiscal account surpluses and a marginal increase in net foreign assets.

- The monetary situation remains in a virtuous cycle with broader economic activities, supported by SAMA's policies that enhanced the operating environment for banks. The favorable economic backdrop has obviously helped SAMA in recent years, with no recourse to unconventional monetary tools. A sustainable level of credit, elevated excess reserves and a range-bound inflation will justify a wait and see strategy by SAMA in the medium-term. SAMA is expected to maintain the repo and reverse repo rates at 2% and 0.25%, respectively, since the Fed isn't expected to raise its target funds rate until 2016.

- The global economy is no longer on the edge of the abyss, with sovereign credit risks receding tremendously, as evident from the low yields on peripheral Europe's debt, the ability of Greece and Ireland to return to the bond markets and a bipartisan budget deal that relatively ended three years of impasse and fiscal instability in the United States. Yet structural imbalances across peripheral Europe and US fiscal sustainability will continue to hang as a cloud of uncertainty over the world economy in the medium to long-run. During 2014, downside risks pertaining to China's growth story will be pivotal, especially that the second-largest economy via trade and financial linkages might weigh negatively on the global economy. Additionally, the Crimean standoff remains a key concern. Although a possible full scale war between Russia and the Ukraine is highly unlikely, the inflammatory rhetoric will disrupt energy markets occasionally. The unfolding situation in Iraq is also a cause of concern on regional stability and might relatively increase the risk premium built into oil prices.



Sources: SAMA and NCB

2014 and 2015 Projections

Our macroeconomic projections are based on an average crude oil price (Arabian Light) of USD102/bbl and an average daily crude oil production level of 9.6 MMBD (out of which 77% is exported) in 2014. The decrease in oil revenues will weigh negatively on the fiscal and current account surpluses that will fall in percentage terms to 2.9% and 15.7% out of GDP, respectively. Real GDP growth is expected to rise by 4.3%, due mainly to an expected growth in non-oil sector by 5.4%, driven by the private sector that will offset the negative contribution of oil. The key beneficiaries in 2014 will remain to be the construction and manufacturing sectors, growing at 6% and 5%, respectively. Our projections for the two sectors are supported by buoyant activity in the projects' market and strong business confidence. Looking ahead, even though the Kingdom might have decoupled from the rest of the world during the financial crisis whether it be on the macroeconomic or the banking front, the next five years might prove to be a challenging time for policy making. Range-bound crude oil prices and reduced production might materialize, with the increased possibility of oversupply from OPEC and non-OPEC, which will weigh negatively on oil revenues and will reverse the hefty twin surpluses of recent years. Against this backdrop, the government might have to prudently manage its rising expenditure and/or deploy the substantial net foreign assets and the unutilized debt capacity that can act as countercyclical buffers that smooth out the business cycle if it surprised to the downside, an unlikely scenario, given the resilience of the Saudi banking and corporate sectors. Yet, we are more inclined to favor the former course of action that contains the growth in expenditure since it will mitigate any medium to long-term concerns pertaining to fiscal sustainability.

Key Macroeconomic Indicators

	2010	2011	2012	2013P	2014F	2015F	Latest	Date
Real Sector								
Weighted Average KSA Crude Spot Price, Arab Light, USD/BBL	77.6	108.1	110.2	106.4	102.0	100.0	105.6	5M14
Average Daily Crude Oil Production, MMBD	8.2	9.3	9.8	9.6	9.6	9.7	9.7	5M14
GDP at Current Market Prices, SAR billion	1,975.5	2,510.7	2,752.3	2,806.7	2,877.08	2,902.8	-	-
GDP at Current Market Prices, USD billion	526.8	670.4	734.9	749.4	768.2	775.1	-	-
Real GDP Growth Rate	7.4%	8.6%	5.8%	4.0%	4.3%	3.9%	-	-
Oil Sector GDP Growth Rate	0.3%	11.0%	5.7%	-1.0%	-0.2%	1.7%	-	-
Non-oil Sector GDP Growth Rate	9.6%	8.0%	5.8%	5.4%	5.4%	4.5%	-	-
Population, million	27.6	28.4	29.2	30.0	30.7	31.4	-	-
Population Growth Rate	3.4%	2.9%	2.9%	2.7%	2.5%	2.0%	-	-
GDP /Capita, USD	19,112.7	23,625.3	25,172.6	24,986.4	25,533.7	25,264.5	-	-
CPI Inflation, Y/Y % Change, Average	3.8%	3.7%	2.9%	3.5%	3.0%	3.2%	2.7%	May-14
External Sector								
Merchandise Trade Balance, USD billion	153.7	244.7	246.6	222.7	206.1	197.7	-	-
Oil Exports, USD billion	215.2	317.6	341.6	324.9	303.1	294.6	-	-
Non-oil Exports, USD billion	35.9	47.1	51.0	54.1	57.7	60.3	-	-
Merchandise Imports, USD billion	(96.7)	(119.0)	(140.7)	(152.0)	(154.7)	(157.2)	-	-
Invisibles Trade Balance, USD billion	(87.0)	(86.2)	(81.8)	(90.1)	(82.6)	(83.6)	-	-
Net Factor Income, USD billion	7.0	9.7	11.0	10.8	11.4	13	-	-
Net Unilateral Transfers, USD billion	(27.9)	(29.4)	(30.4)	(35.9)	(38.7)	(40)	-	-
Current Account Balance, USD billion	66.8	158.5	164.8	132.6	123.5	114.1	-	-
Current Account Balance/GDP	12.7%	23.6%	22.4%	17.7%	15.7%	14.4%	-	-
Net Foreign Assets with SAMA, USD billion	441.0	535.9	648.5	717.7	753.6	791.3	729.6	Apr-14
Fiscal Sector (Central Government)								
Budgeted Expenditure, SAR billion	540.0	580.0	690.0	820.0	855.0	914.9	-	-
Actual Revenues, SAR billion	741.6	1117.8	1247.4	1156.4	1089.7	1066.0	-	-
Actual Expenditure, SAR billion	653.9	826.7	873.3	976.0	1005.3	1035.5	-	-
Expenditure Overrun, %	21.1%	42.5%	26.6%	19.0%	17.6%	13.2%	-	-
Total Revenues/GDP	37.5%	44.5%	45.3%	41.2%	37.1%	35.9%	-	-
Total Expenditure/GDP	33.1%	32.9%	31.7%	34.8%	34.2%	34.9%	-	-
Overall Budget Balance, SAR billion	87.7	291.1	374.1	180.3	84.4	30.6	-	-
Budget Balance/GDP	4.4%	11.6%	13.6%	6.4%	2.9%	1.0%	-	-
Break-Even Oil Price	64.1	75.3	73.9	82.6	87.1	90.1	-	-
Financial Sector								
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75	Apr-14
Growth in Broad Money (M3)	5.0%	13.3%	13.9%	10.9%	11.7%	9.5%	13.3%	Apr-14
Growth in Credit to the Private Sector	4.8%	11.0%	16.4%	12.1%	11.4%	11.0%	12.0%	Apr-14
Average 3M SAR Deposit Rate	0.7%	0.7%	0.9%	1.0%	0.9%	1.2%	1.0%	4M14
Average 3M USD Deposit Rate	0.3%	0.3%	0.4%	0.3%	0.3%	0.5%	0.3%	4M14
Spread, in Basis Points, SAIBOR-LIBOR	39.8	40.9	55.2	68.7	60.0	70.0	69.4	4M14

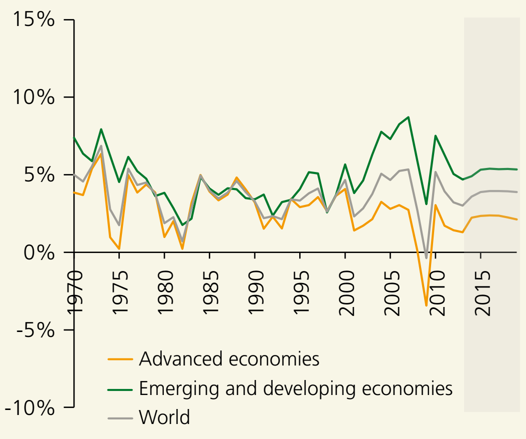
Sources: Reuters, SAMA and NCB

A. Global Economic Developments

Global economic growth inched lower to 3% in 2013, with advanced and emerging economies failing to act as catalysts for recovery. However, the International Monetary Fund (IMF) projects higher global growth in 2014 at 3.6%, supported by economic growth in the advanced economies, notably the US, Germany and the UK. In contrast, the emerging economies will maintain a lackluster 4.9%, which is far below the 7.4% recorded in 2010, with the international organization citing capital outflows and inflationary pressures as downside risks for this year. In our opinion, the recent rate hikes by the Central Bank of Turkey, the Reserve Bank of India and the Central Bank of Brazil is a trend that will continue in 2014 and well into 2015, thus, the divergence on interest rates between the emerging economies and their developed counterparts is expected to widen, in contrast to 2008 and 2009 whereby accommodative policies were adopted across the board. The massive liquidity that had been injected by the developed world's central banks and overheated emerging markets since 2008, in the process concealing their ailments, is no longer in place with the tapering exercise in full swing. Thus, We expect pressures on those emerging markets that suffer from structural deficiencies. Most notable, Indonesia, India, South Africa, Brazil and Turkey are going to face capital outflows, weaker currencies and higher interest rates on their public debt. Monetary policy will be in a balancing act between encouraging economic growth, supporting currencies and containing inflation, objectives at odds and necessitate different policy mixes. Ostensibly, the world economy will continue to experience a multi-stage growth, given the divergent economic outlooks for the advanced and emerging countries, an inflection from the heydays of the crisis when the developing economies were the locomotive for growth.

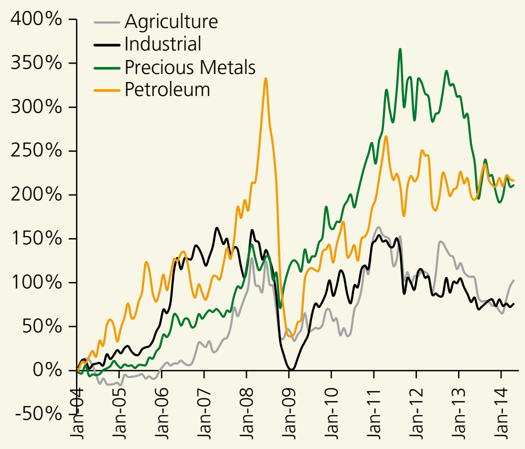
Commodity analysts are predicting that the "super cycle" of gains that saw prices more than double in the past decade has ended, with emerging market growth weakening and China's economic growth moderating. In 2013, Commodities had registered the third annual drop in a row, with the S&P Goldman Sachs Commodity Index of 24 commodities and Reuters/Jefferies CRB Index of 19 commodities losing around 2.2% and 0.94%, respectively. The dismal fortunes for these major commodity indices were fundamentally driven not only by demand concerns, but also by the improved supply outlook for some commodities as well as supply overhangs for others. On the agriculture front, corn was the biggest loser, plunging by around 40%, as US supply edged higher by a staggering 30% to a record 355.3 million metric tons, according to the US Department of Agriculture. However, there is a relative rebound in agriculture commodities this year, with the S&P Goldman Sachs Agriculture Index gaining a double-digit 16.4% by the end of the first quarter. The fact that China is the largest global consumer of base metals weighed on copper and aluminum in 2013 that registered declines of 7.2% and 13.2%, respectively. And, it seems that 2014 does not look any better, with copper and aluminum falling by 9.4% and 2.3% year-to-date. The allure of precious metals faded as data became increasingly positive from the US and

1. Global GDP Growth
(Annual % change)



Sources: IMF

2. Selected Commodity Price Indices
(S&P Goldman Sachs Spot Indices; January 2004 = 100)



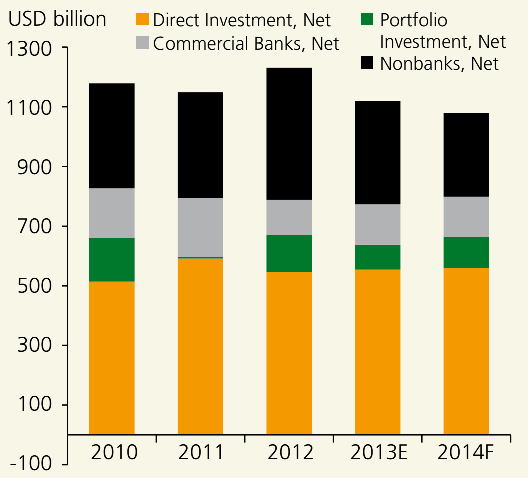
Sources: Thomson Reuters

Europe, with investors embracing equities and elevating global stock prices by the highest in four years. Gold ended last year around USD1,200 /Oz mark, a 28% annual decline, the first annual drop since 2000, as investors withdrew USD38.6 billion from gold funds. On the investment front, risk aversion was apparent from the reduced inflows to commodity-related exchange-traded products that fell by a record USD88 billion to USD332 billion in 2013. Looking forward into 2014, commodities might recover part of the losses incurred last year due to base effects, but it is highly unlikely that we will witness any substantial and/or sustainable gains.

2013 has been a vibrant year for equities that surpassed bonds and commodities in terms of returns. The equities' benchmark MSCI All Country World Index of 44 countries recorded a 20.3% Y/Y upturn, another double-digit gain after registering 13.4% in 2012, largely supported by G7 equity markets, which edged higher by 25.7% as the heavyweights, Japan, US, Germany and UK rose by 56.7%, 29.6%, 25.5% and 14.4%, respectively. In contrast, emerging market equities acted as a drag for the second year running, registering a 5% decline, with countries like Brazil, Chile, Turkey and China losing between 7-16% of their market capitalization. Additionally, the bond market suffered across the board, with the exception of a rally in peripheral Europe that saw Greek bonds record a 43% gain in 2013 and speculative-grade corporate bonds that rose by 7.6%. Yet, bonds globally had lost 0.31%, the first loss since 1999, according to Bank of America Merrill Lynch Bond Indices, as the US and German treasuries slumped by 3.4% and 2.1%, respectively in 2013, with funds flowing more into equities. Emerging-market dollar denominated debt securities did not fare any better, losing a significant 5.3%.

In 1Q2014, volatility was the name of the game, with equities reversing the upside trend early in January, and regaining the positive territory once again by the end of March. The worst January since 2009 that saw emerging market stocks extending last year's downside momentum by an additional 6.5% was mostly recovered in March, with the MSCI EM Index currently registering just 0.2% loss for the year. Nevertheless, as mentioned earlier, the weak economic growth and persistent deficits had made investors more skeptical and selective. The Chinese story is not helping either, with manufacturing at the second-largest economy sliding to an eight-month low in February, signaling that the government's efforts to curb credit might have started to cool headline growth. In our opinion, higher risk aversion will remain a real threat for emerging market equities well into 2014. According to the IIF, emerging economies' portfolio investments' net inflows is expected to rise compared to last year, but it will remain below USD124 billion posted in 2012 during the next two years.

3. Emerging Market Economies: Capital Inflows



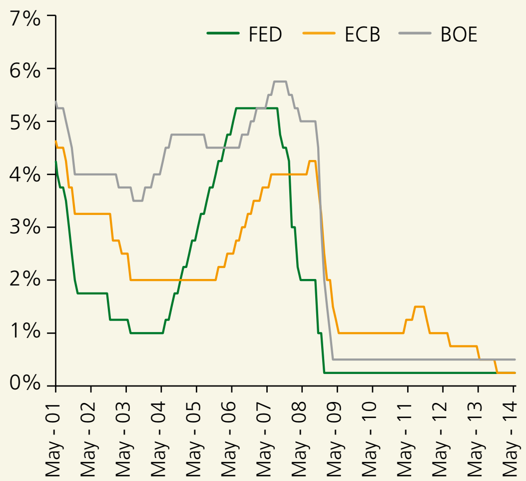
Sources: IIF

4. Global Equity Markets
(January 2008 = 100)

Sources: Thomson Reuters

Monetary policy divergence between emerging and developed economies is gaining traction, with an increased likelihood of an "interest rate war" among the emerging markets. In 4Q2008 and 2009, policy rates took an abrupt shift to the downside, being cut at a fast pace, with most central bankers opting to support growth and avert the hanging cloud of recession. Latin American countries like Chile and Brazil slashed their benchmarks by 7.75% and 5%, respectively, while advanced countries, notably the Eurozone and the UK slashed their respective rates by 1.5% to unprecedentedly low levels. The reduced interest rate differentials that were dictated by economic weaknesses and structural deficiencies at the height of the crisis is in stark contrast with the divergence seen of late, as the emerging world try to support currencies and contain the fallout from excessive capital outflows. The decision by the monetary policy committee of the Central Bank of Turkey, at its emergency meeting on 28th January, to substantially increase all of its policy rates, underscores the susceptibility of emerging markets, especially those with persistent current and fiscal accounts deficits. The elevated interest rates in Turkey, now one of the highest among emerging economies, might help Turkey to reverse the sizeable capital outflows and capture a share of the suppressed inflows to emerging markets. Nevertheless, there might be an interest rate war between emerging markets, with the likes of Brazil and India following the same path, which they are doing in a gradual rather than a shock therapy manner.

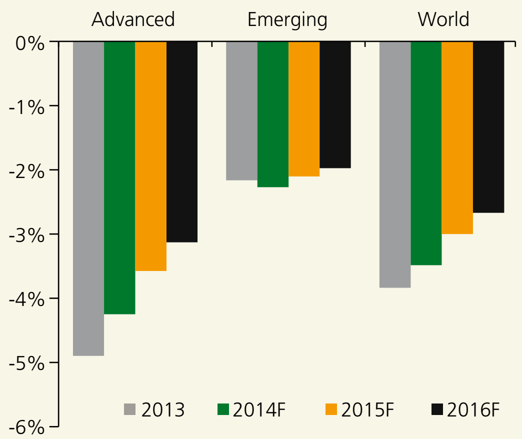
5. Central Bank Policy Rates



Sources: Thomson Reuters

6. Fiscal Deficits

(in % of GDP)



Sources: IMF

As for advanced economies, the US tapering exercise is in full swing, with the FOMC in its last five meetings opting to cut USD50 billion from its quantitative easing program, which currently stands at USD35 billion. Apparently, the positive data stream from the US concerning housing and employment have supported this trend going forward. Unemployment rate had fallen to 6.3% recently while housing prices continued to rise in the double-digits around 13%, resulting in positive wealth effects that will underpin consumption. However, the Fed seems to have its doubts on the pace of growth as the Federal Open Market Committee believes accommodative policy is much needed and will continue for some time. Accordingly, the Fed altered to a qualitative rather than a quantitative approach, dropping the 6.5% unemployment threshold for mulling an interest rate increase. Interestingly, the European Central Bank became the first major central bank to cut its deposit rate into negative territory at -0.1%, which was coupled by reducing its main refinancing rate from a historic low 0.25% to an even lower 0.15%. This increased accommodation by the ECB was driven by deflationary risks that had seen the eurozone inflation benchmark well below half the 2% target rate. Additionally, it is highly likely that the Bank of Japan will increase its monetary stimulus in the next couple of quarters to support the economy from an expected drag from the hike in value added tax. In our opinion, quantitative easing continue to be an unprecedented experiment and as such the normalization process might take longer than expected and be fraught with uncertainties.

Even though fiscal consolidation remains a priority for most countries, China and Japan might opt for fiscal stimuli in 2014. The disappointing economic indicators from China are increasingly pointing towards a possible deviation from the 7.5% growth target set by the State Council in March. As a result, the government has announced in April a mini-stimulus that includes railway spending, expansion of credit to small-scale enterprises and extension of credit for purchasing cheap homes. Even though, such measures cannot be compared to the 4 trillion Yuan package during the financial crisis, we do believe that the Chinese authorities will step up their efforts to support economic growth to avert social unrest. In our opinion, the communist party document, which have been issued in November 12th and entailed plans to increase the role of consumption and market forces at the expense of exports and state-led investment, is a long-term strategy that will not change the government's fixation with short-term growth. Additionally, on the Japanese front, the increase in value added tax from 5% to 8% and its expected drag on the economy might force the government to compile another fiscal stimulus package this year. In fact, the Japanese finance ministry has announced plans to spend 40% of the outlays for the fiscal year starting April in 2Q2014 to mitigate the weakness in household consumption. However, in contrast to China, Japan's finances are in dire shape given the persistent trade and budget deficits, which will limit the scope and magnitude of additional fiscal spending.

Box 1: Oil… Range-Bound Movement in 2014

Crude oil prices ended last year in the red after four consecutive annual increases, with the two benchmarks Brent and the Arabian light falling by 2.6% and 3.5%, respectively. The first annual decline, since the double-digit plunge witnessed in 2009, was largely driven by demand downside risks that emanated from weakening Chinese economic data and the possible drags on emerging markets, given the trade linkages with the world's second-largest economy. Nevertheless, the downside trajectory would have been significant if not for the supply disruptions and concerns, notably, the slump in Libya's oil supplies since July and instability in South Sudan. On the inventory front, the markets look well supplied when crude oil stocks in the OECD is assessed especially with the forward demand cover at a comfortable 55.3 days at the end of last year, albeit lower than the five-year average of 58 days.

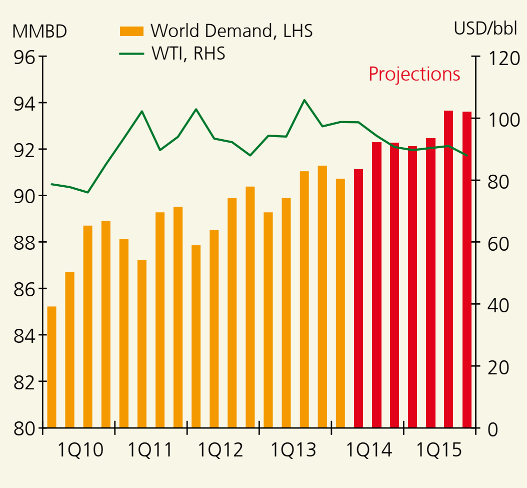
On the supply front in 2014, it seems the geopolitical uncertainty in the Middle East, the Ukrainian/Russian standoff over Crimea and supply disruptions from some OPEC members will continue for some time, thus, sustaining this tight market balance and risk premium during the near term. This will relatively balance the rising output from non-OPEC producers that accounts for 60% of global production, mainly from the US, Canada and Brazil. We believe that the oversupply theme, pertaining to OPEC, that have been propagated by the end of last year, amid speculation that Iran and Libya will be able to restore supplies restrained respectively by sanctions and political unrest, will not materialize this year, given that major Libyan export ports continue to be disrupted by infighting between militant groups. Additionally, even though Iranian crude production have been increasing of late after an interim accord that eased restrictions came into effect in January, the talks with Western counterparts in July regarding Tehran's nuclear program might be complicated, as always. Against this backdrop, OPEC's production will be critical in supporting prices in an environment of rising non-OPEC supply and if the unlikely became likely, a surge in Iranian and Libyan crude exports. The fact that OPEC's oil production was below the 30 MMBD quota, agreed in December 2011, for five out of the last seven months since September 2013, reflects adamancy to maintain a semblance of normalcy in the oil markets. Yet, the issue of accommodating the return of Iran, Libya and Iraq will continue to pose medium-term challenges on OPEC, especially for Saudi Arabia that benefited from ramping up its production, given its swing producer status.

The oil demand outlook has relatively improved on the back of higher demand and a stronger global economy, with the world's GDP expected to grow by 3.6% in 2014, higher than the 3% registered last year. Non-OECD countries, led by China, will account for almost all of the expected consumption growth during the next two years. Accordingly, the IEA had increased its worldwide crude consumption forecast, projecting an incremental growth of 1.4 MMBD in 2014, a 1.5% annual growth rate. The EIA and OPEC, after similar upward revisions, are anticipating increases by around 1.2 MMBD and 1.1 MMBD, respectively, in 2014. Even though global economic activity has improved lately, downside risks pertaining to China's growth story prevail. In generating 40-50% of total incremental oil demand in recent years, China will remain pivotal in influencing oil market fundamentals, thus, a lower headline growth rate for the second-largest oil consumer will exert pressure on oil prices. However, the Chinese State Council and the PBOC look more inclined towards targeted stimulus and monetary easing, which might reduce concerns for the remainder of 2014. However, on a medium-term note, the drive towards rebalancing the economy, reducing environmental degradation and encouraging market forces, will negatively impact Chinese incremental oil demand, until the needed transition ends.

To conclude, We do believe that oil markets are expected to remain in a range-bound movement during the year, especially that oil lacks strong directional momentum for Brent prices to remain above the USD110/barrel mark, as increased supplies from non-OPEC producers are expected to offset downside risks pertaining to China's economic growth. Yet, as mentioned earlier, OPEC will be instrumental in mitigating supply concerns by balancing out the market. Hence, we see Arabian light prices protected at a floor of USD90/bbl and on average to settle at USD102/bbl in 2014.

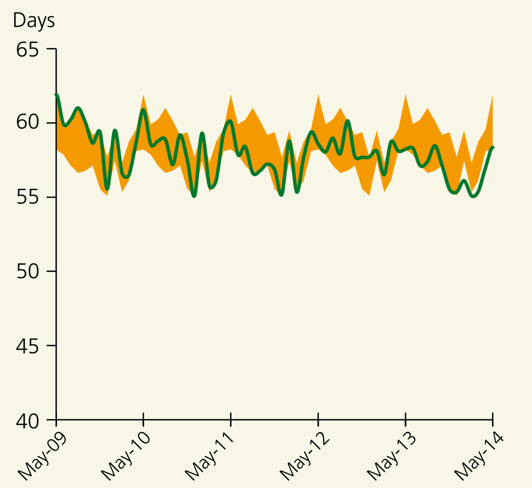
The unfolding situation in Iraq would pose an upside risk to our forecast, with the central government losing its grip on the second-largest city, Mosul. This heightened geopolitical uncertainty might mean a relatively higher risk premium to be built into oil prices going forward. It is our own opinion, however, that the markets have been largely factoring in geopolitical risks in prices especially that the region has not experienced a semblance of normalcy in a long time. Currently, the impact on Iraq's crude oil exports is limited especially that the conflict is contained in the western and northern parts of the country and far from the south, which house three-quarters of Iraq's crude output. The three biggest oilfields, namely Rumaila, Majnoon and West Qurna-2, as well as the export terminal of Basra lie in the south, and as such a significant drop in output and exports is highly unlikely for the short-term at least.

Real GDP Growth, Contribution



Sources: EIA

OECD Forward Demand Cover



Sources: EIA

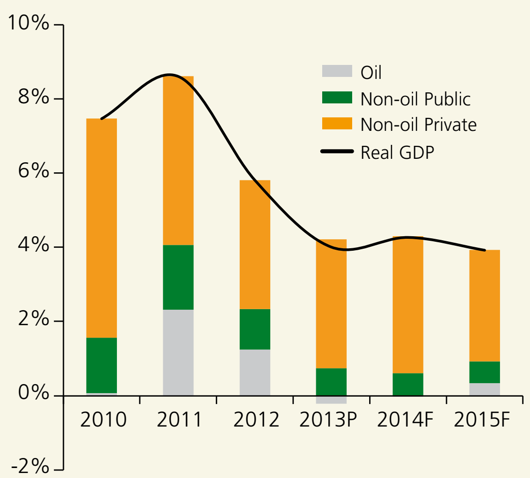
B. Saudi Economic Developments and Outlook

I. Real Sector

Last year marked the slowest economic growth rate since 2009, and we do believe that the Kingdom will face a moderate business cycle during 2014 and 2015, growing around 4%. In 2013, growth in aggregate output, real GDP, decelerated to 4%, mainly against the backdrop of the negative contribution from the oil sector, stemming from a lower production level. Saudi oil output fell by around 1.6% in 2013, averaging 9.64 MMBD, which weighed negatively on the oil sector GDP that declined by 1%, the largest contraction since 2009. Nevertheless, the contraction in the oil sector was more than offset by non-oil GDP growth that grew by around 5.4%. Importantly, the non-oil private sector increased by 5.97% Y/Y, driven by construction, trade, and manufacturing. The economic growth outlook for 2014 will continue to be driven by non-oil growth, with oil maintaining its negative contribution. We project real GDP growth of 4.3% for 2014 due mainly to the non-oil sector maintaining last year's pace of 5.4%, driven by the private sector, mainly manufacturing and construction. Our assumption centers on a tight market balance in oil markets that limits the upside potential for crude prices and results in a marginal decline in Saudi oil production during the forecast period.

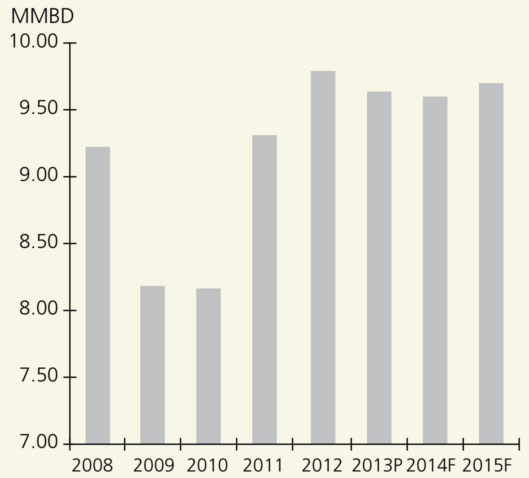
Contribution of the oil sector to economic growth will remain negative. Libya's unstable production since 2011 in addition to the EU sanctions on Iran's crude exports that commenced in July 2012 enabled the Kingdom as a swing producer to reach a 30-year high daily production, but this situation is reversing on the back of non-OPEC supply and an expected rise in production from the two aforementioned countries during the next couple of years. Accordingly, compliance among OPEC members has been rising since July 2013, with the Kingdom cutting its production levels from around 10.05 MMBD in August and September 2013 to as low as 9.60 MMBD in March. Thus, we do believe that the Kingdom in giving way to these countries will be producing below the 10 MMBD mark during the next three years. According to our estimates, Saudi crude oil production is expected to fall by an average of only 40 thousand b/d, reaching 9.6 MMBD, which will weigh negatively on real oil GDP that will contract by 0.2% in 2014. Furthermore, in nominal terms, with the weighted average Arab light prices falling from USD106.4/bbl in 2013 to estimated USD102/bbl in 2014, oil revenues are expected to plunge by 6.8% to around SAR965 billion, below the SAR1 trillion mark that has been registered over the last three years. Our baseline scenario for the medium-term that projects range-bound movement in oil prices and slower growth in Saudi crude production will necessitate fiscal prudence going forward.

7. Real GDP Growth, Contribution



Sources: SAMA and NCB

8. Saudi Crude Oil Production



Sources: OPEC and NCB

The non-oil sector will be the driving force for economic growth in 2014, remaining above the 5% threshold for the third year in a row. Real non-oil GDP in 2013 grew by around 5.4%, largely driven by the stellar performance of the non-oil private sector. The private sector maintained its significant contribution to real GDP at 58.9%, growing by 5.97%, which illustrates the vibrant role that private enterprises are assuming in the Saudi economy. The main drivers of private sector growth were the construction, retail, and the manufacturing sectors, which posted 8.8%, 6.6% and 5.3% annual growth, respectively. This vibrancy of the private sector emanated from the enhanced business confidence and the improved financing environment. Evidently, the growth in commerce and manufacturing benefited from the pickup in credit, receiving SAR28.7 billion and SAR13.6 billion, respectively, in incremental loans and advances from banks in 2013, which represents an annual increase of 14% and 10.7%. The boost to business confidence underpinned the value of awarded construction contracts that registered an all-time high. One of the promising growth drivers for corporate Saudi is non-oil exports that reached a historical USD54.1 billion last year and that, in our view, will gain momentum, along with domestic demand, given the vertical and horizontal diversification plans that will enhance the absorptive capacity of the economy. The aforementioned business cycle will likely moderate on the back of relatively less favorable oil dynamics, a 13% reduction in the budget allocation for capital expenditure and the tighter implementation of labor regulations.

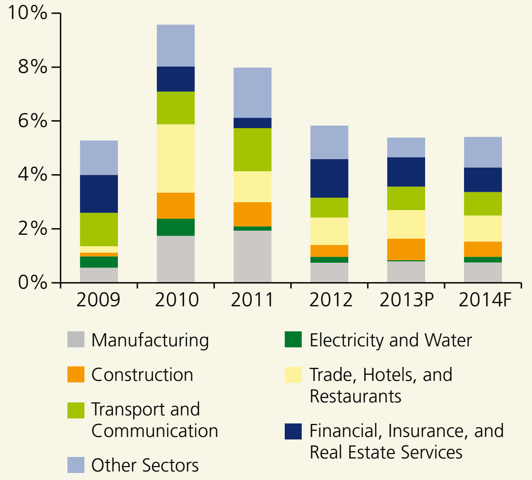
A closer look at the slower pace of increase in government expenditure and budget overrun during the last three years will result in a relatively lower direct and indirect stimuli. Since the Royal decrees announced in 2011, the annual growth in government expenditure had fallen from a staggering 26.4% to 11.8% coupled by a similar reduction in the budget overrun from 42.5% to 19%, in 2011 and 2013, respectively. The rising concerns on fiscal policy sustainability, especially on higher production outside OPEC and range-bound oil prices will likely make the government more prudent and conservative, even though substantial net foreign assets and lower debt levels can sustain expansionary policies. We expect non-oil sector growth to remain elevated, albeit lower than the 10-year average, recording 5.4% in 2014, with the non-oil private sector registering 6.2% as most sectors continue to reap the benefits of the myriad of projects still coming on-stream from the 2008-2013 capital expenditure boom.

The key beneficiaries in 2014 will remain to be the construction and manufacturing sectors, growing at 6% and 5%, respectively. Our projections for the two sectors are supported by buoyant activity in the projects' market and strong business confidence. During 2013, the value of awarded construction contracts remained above the SAR200 billion threshold for the third year in a row, registering a record SAR293.4 billion. The awarded contracts in the real estate and manufacturing sectors respectively reached SAR40 billion and SAR22.3 billion in 2013, the second and third largest shares across all sectors, surpassed only by the transportation and power sectors. Ostensibly, the role of the government is critical, whereby it signed approximately 2,441 capital expenditure related contracts with the private sector valued at an estimated SAR161.5 billion, 12% Y/Y increase, according to the Ministry of Finance.

As we pointed out, the moderation theme is highly likely during this year and next, which had been underscored by NCB's Business Optimism Index (BOI) that dipped from 54 points in 4Q2013 to 50 points in 2Q2014 due to a pullback in expectations on all parameters that include volume of sales, new orders and selling prices. Most of the non-hydrocarbon sectors are expected to moderate, with the construction and manufacturing sectors registering index values below the composite index for the non-hydrocarbon sector in 2Q 2014, standing at 49 points for each. However, manufacturing firms displayed a steady outlook, with 67% of the firms expecting an improvement in demand for their products. According to the BOI, respondents have cited government labor regulations and the availability of labor as challenges impacting business operations. We do believe that these challenges will remain short-term bottlenecks for companies seeking low-skilled expatriate workers, especially after the recent decisions by the Interior Ministry to toughen punishment on illegals, which compliments endeavors by the Labor Ministry to regulate the labor market.

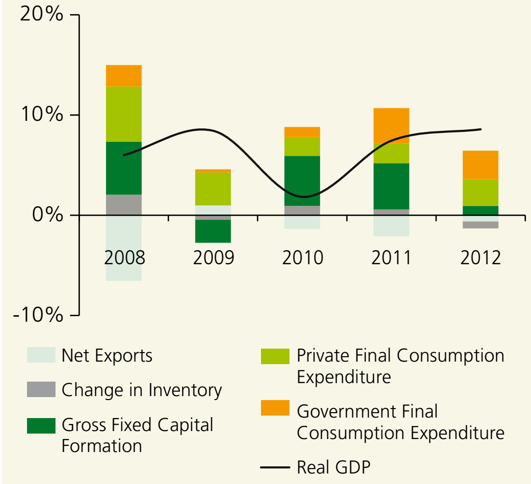
FDI inflows are expected to moderate going forward. Structural reforms continue unabatedly, improving the Kingdom's business environment and its attractiveness for foreign capital inflows. The World Bank's Doing Business 2014 report ranked the Kingdom 26th out of 189 countries for ease of doing business. The 2013/14 Global Competitiveness Report prepared by the World Economic Forum also ranked Saudi Arabia at 20 out of 148 countries, ahead of China, Turkey, Brazil and India. According to the World Investment Report 2013, issued by the United Nations Conference on Trade and Development (UNCTAD), the Kingdom was the second-largest FDI recipient in West Asia, with receipts totaling USD12.2 billion in 2012, surpassed only by Turkey that posted USD12.4 billion and followed by a fellow GCC member, the UAE, that came in third with USD9.6 billion. However, the inflows fell by 25.3% compared to USD16.3 billion in 2011, and We believe that FDI will moderate in the next couple of years mimicking an expected relative slowdown in the Saudi business cycle and as the projects' market plateau. Accordingly, the share of FDI in gross fixed capital formation (GFCF) will continue to hover around 10%, below figures registered for the previous three years, yet significantly higher than the 1.5% average rate posted during the period 1995-2004.

9. Non-oil GDP Growth, Contribution



Sources: SAMA and NCB

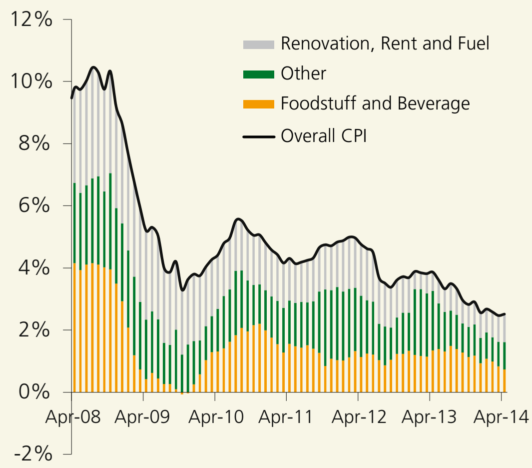
10. Real GDP Growth by Expenditure, Contribution



Sources: SAMA and NCB

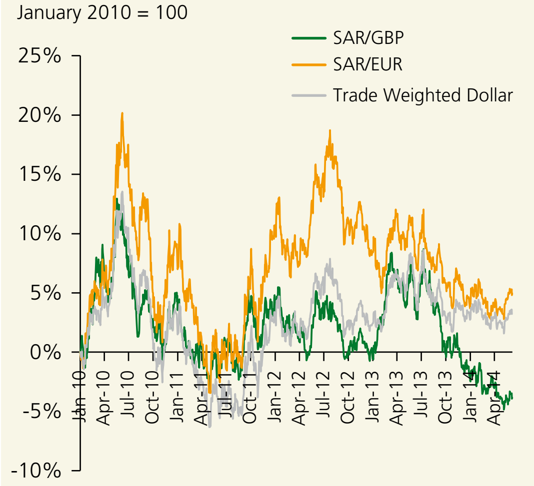
Inflation is likely to hover around 3% this year, with the recent sharp increase in commodity prices moderating by the 2H2014 and offset by lower imported inflation. In 2013, prices edged higher, averaging 3.5% due to higher food prices. The liquid state of the economy was supportive of higher consumption expenditure, which drove up local food prices that averaged 5.7% Y/Y, higher than 4.5% Y/Y registered in 2012. On the rental component, prices maintained a slightly higher pace than 2012, albeit low compared to the 2007-2011 period by averaging 3.5% in 2013. Accelerating the implementation of the mortgage law will positively impact the local real estate market by providing financing to home seekers. Looking ahead, the cost of building materials is not exerting upward pressure on prices, with the average prices for timber, cables, iron and cement falling year-to-date by 1.7%, 1.2%, 0.9% and 0.6%, respectively, by the end of February 2014. It is important to note that the robust growth in private credit in general and consumer loans in particular will constitute an upside risk to our forecast for headline inflation. With unemployment at the lowest level since 2009, 11.5% by the end of 4Q2013, an expected increase in disposable income will boost private consumption expenditure, which posted a 7.2% increase last quarter. However, the dollar-positive effect due to tapering will underpin the headline inflation rate, which will remain in a range-bound movement around 3% this year.

11. Drivers of Inflation



Sources: SAMA

12. Imported Inflation
January 2010 = 100



Sources: SAMA

II. Fiscal and External Balances

The next five years might prove to be a challenging time for policy making, with range-bound crude oil prices and contained production weighing negatively on oil revenues and, thus, reversing the hefty fiscal and current account surpluses of recent years. Even though the government's 2014 budget does not provide oil price and production level assumptions, we believe that both revenues and expenditures are understated. The Ministry of Finance estimates revenues and expenditures at SAR855 billion for each, projecting a break-even. Based on announced revenues, the government seems to have assumed the average oil price at USD73/bbl for this year. With our forecast of USD102/bbl for the average Arabian light spot prices and 9.6 MMBD for average oil production, we project a budget surplus of SAR84 billion, or 2.9% of estimated GDP in 2014. The decline in the surplus will be largely due to a fall in actual revenues, expected at SAR1090 billion, with oil revenues registering SAR965 billion, which is 6.8% below actual level in 2013. Additionally, on the expenditure side, the government will most likely exceed budgeted expenditures, albeit at a mere 3%, to breach the SAR1 trillion mark, as has been historically the case, however, this figure will be the lowest budget overrun since 1998. According to our forecast, actual capital expenditures will likely end up above the budgeted figure of SAR248 billion to reach SAR251 billion in 2014. Against this backdrop of projected higher expenditures and lower revenues, the break-even oil price required to balance the budget will rise from USD83/bbl last year to USD87/bbl in 2014.

The current account balance will fall to the lowest level since 2010 in absolute terms, registering USD124 billion. Based on our oil price and production assumptions, We expect oil export revenues to decline by 6.7% to USD303 billion. Nevertheless, non-oil exports are expected to partially offset the contraction in oil revenues, growing by 6.8% to USD58 billion due to an expected improvement in the global and GCC economic outlook. There is a downside risk to our projection that can arise from further deterioration in China's economic growth, especially that the second-largest economy had been suffering from slow economic growth and contraction in manufacturing of late, which might impact its 14% share of the Kingdom's non-oil exports. On aggregate, total exports are forecasted to record USD361 billion in 2014 compared with USD376 billion in the previous year. As for imports, they are expected to grow 1.8% to USD155 billion, which is a record value. This marginal increase will largely be due to moderating domestic demand, as evident from the year to date decline in the value of the settled and newly opened Letters of Credit (LCs) that plunged by 8.3% Y/Y for each, with foodstuff and motor vehicles aiding the fall. Accordingly, we expect the current account surplus to fall to USD124 billion this year, 15.7% relative to GDP, smaller than the USD133 billion in 2013. The still robust external position will reflect favorably on net foreign assets this year. In 2013, these assets grew by 10.7% to reach USD717.7 billion by the end of December, and We expect they will build up, albeit at a slower pace, to USD754 billion in 2014, covering more than 58 months of imports, with the largest share in USD denominated liquid assets.

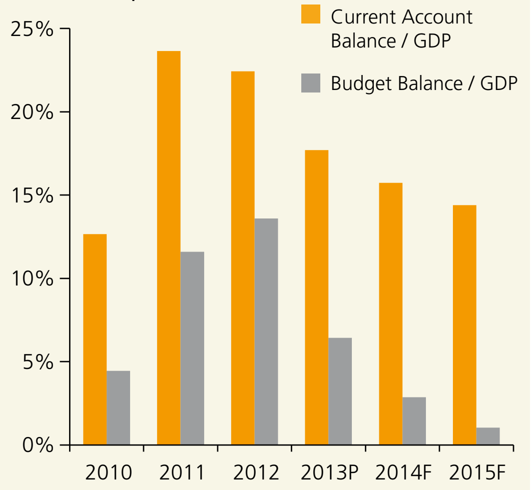
13. Government Revenue and Expenditure Balance

SAR billion	2012	2013	2014 Budget	2014 Forecast
Total Revenue	**1,247**	**1,156**	**855**	**1,090**
Oil	1,145	1,035	735	965
Non-Oil	103	121	120	125
Total Expenditure	873	976	**855**	**1,005**
Current	612	664	607	754
Capital	262	312	248	251
Deficit/Surplus	**374**	**180**	**0**	**84**

Sources: SAMA and NCB

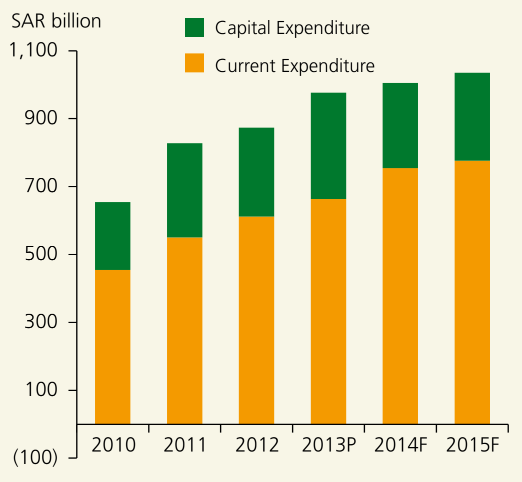
The government continues to allocate funds to specialized credit institutions to support balanced development. Based on the MOF announcement, around SAR85.3 billion in 2014 will be disbursed by specialized credit institutions to finance industrial projects and to support social development, thus, complementing private credit growth that recorded 12.4%Y/Y in March 2014. A case in point is the SAMAPCO project for ethylene dichloride and caustic soda, whereby Public Investment Fund (PIF) is extending a loan worth SAR0.7 billion. The Saudi Industrial Development Fund (SIDF) has also recently approved 19 loans valued at SAR2.8 billion for 15 new industrial projects and the expansion of 4 projects. On aggregate, the outstanding loans of government specialized credit institutions have reached a record SAR268.6 billion, expanding by 7.7% to add around SAR19.3 billion during the first three quarters of last year. On the SME front, the Saudi Credit and Saving Bank has financed 1,495 of such establishments, granting more than SAR376 million under the "Masarat" program. Additional measures of finance for SMEs continue to gain ground, with the Loan Guarantee Program "Kafala" facilitating credit worth around SAR2.3 billion in 2013 to 1173 establishments, representing 28.7% of the aggregate beneficiaries since the inception of the program in January 2006.

14. Twin Surpluses



Sources: SAMA and NCB

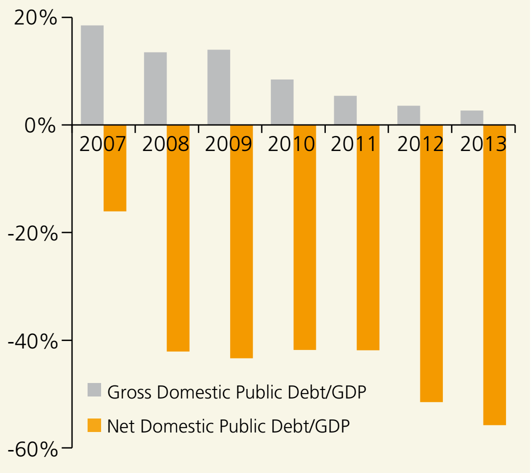
15. Government Expenditure



Sources: SAMA and NCB

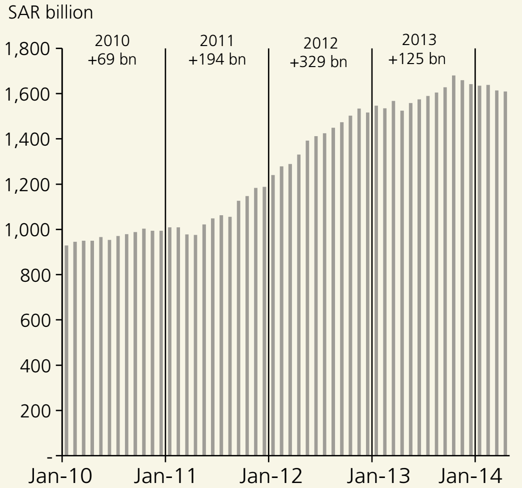
The Kingdom's stable macroeconomic backdrop and the move towards streamlining regulations continue to be widely and positively recognized by renowned institutions. Accordingly, Standard and Poor's had affirmed the Kingdom's sovereign rating at AA- with a positive outlook in 2013 and Fitch upgraded it in March 2014 to AA with a stable outlook. The decisions by the rating agencies were prompted by strong government finances, which have largely withstood oil price volatility and the global economic crisis. This enhanced ability to contain shocks and smooth business cycles will continue to support Saudi Arabia's positive economic outlook, going forward. Public domestic debt was reduced further from SAR98.85 billion to SAR75.1 billion in 2013, amounting to 2.7% relative to GDP. We believe that government debt will remain below SAR100 billion threshold for this year and next.

16. Domestic Public Debt



Sources: SAMA and NCB

17. Government Deposits at SAMA

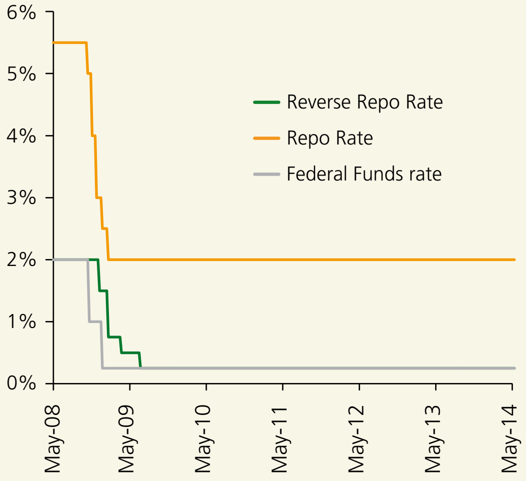


Sources: SAMA

III. Monetary Developments

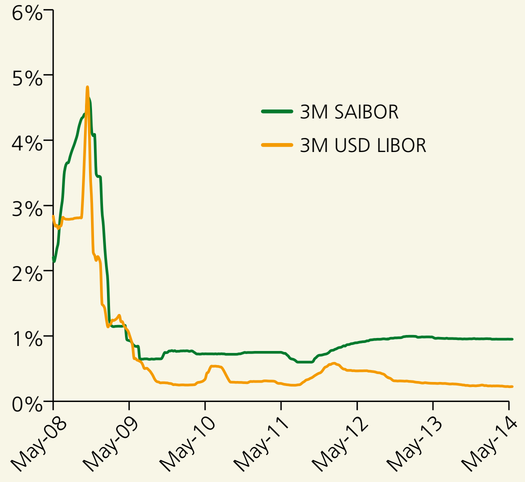
Saudi Arabia's monetary system continues to be awash with liquidity as elevated oil prices and production resulted in higher revenues that underpinned broader economic activities. On the regulatory front, SAMA's proactive stance contained liquidity risks, ensured compliance with Basel III requirements ahead of schedule and assessed the soundness of local banks via stress tests that reflected lower systemic risks. Additionally, SAMA was keen to ensure price stability for businesses and consumers to benefit from the buoyant economy. Open market operations that mop up excess liquidity have been accelerating and by the end of 2013 SAMA has issued SAR179.1 billion worth of T-bills. The conservative policy approach was accentuated by the buildup of net foreign assets, which was supported by the influx of oil revenues. SAMA's net foreign assets under management incrementally increased by SAR238.8 billion, 9.8%, during last year, reaching SAR2.7 trillion by the end of 1Q14. It is widely expected that the majority of foreign assets are invested in USD-denominated fixed-income securities, which provide a stable return albeit lower than other riskier alternatives. The lock-step nature of Saudi monetary policy with the US is an important factor that will support our view of no change to the domestic benchmarks, with SAMA keeping the repo at 2% and the reverse repo at 0.25%.

18. SAMA and US Federal Reserve Policy Rates



Sources: Thomson Reuters and SAMA

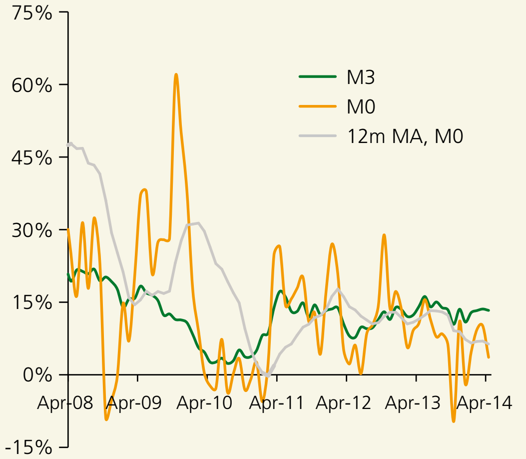
19. Interbank Market Rates



Sources: Thomson Reuters

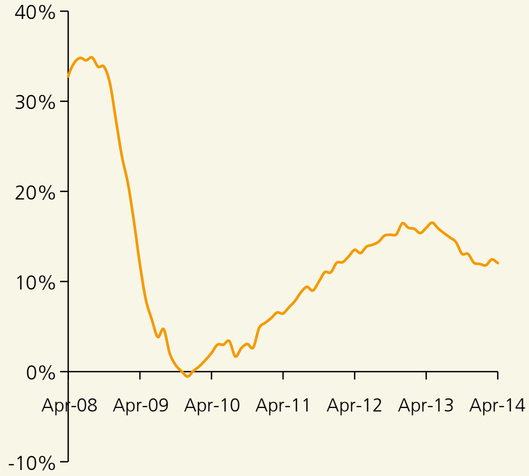
The sustainable pace of monetary aggregates reduces the risk of overheating the economy. During 2013, the monetary base (M0) recorded its first annual contraction since 2008. The narrowest monetary measure settled at SAR343.5 billion by the end of December, slightly lower than 2012's SAR350.6 billion. The decline is not representative of a negative situation as the largest component of M0, deposits with SAMA, decreased given local banks' preference to utilize their excess reserves for granting credit. Accordingly, the credit market witnessed another healthy year by expanding at 12.1% Y/Y. Additionally, money supply (M3) maintained its double-digit growth, recording 10.9% on an annual basis. The local financial system remains liquid with excess reserves settling at 54.2% last year. Saudi banks held SAR1.4 trillion worth of total deposits by the end of last year that represent more than 70% of their total liabilities and continue to provide a stable funding base. The capacity utilization, represented by the loans-to-deposits ratio, dropped to 79.9% by the end of last year after peaking in August at 83.1%. Interestingly, local banks continued to accumulate net foreign assets that grew by 9.6% to reach SAR149.3 billion in 1Q2014 after a marginal 2.1% increase during 2013. As for the interbank market, We expect the SAIBOR to remain around the 100bps level in the short-term due to the healthy cash levels of most Saudi banks.

20. Growth in Money Supply



Sources: SAMA

21. Growth in Private Sector Credit



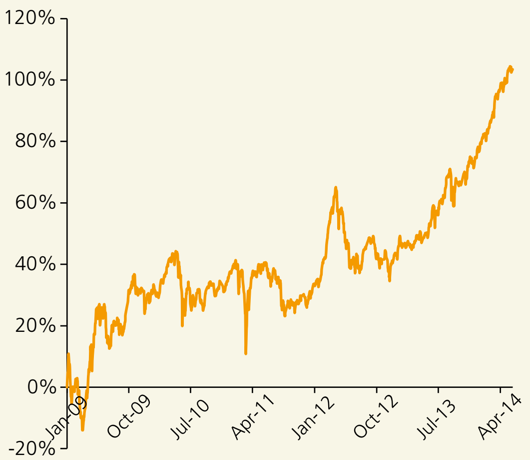
Sources: SAMA

IV. Financial Sector

The Saudi banking system capitalized on reforms implemented during the financial crisis and posted record profits in 2013. The vibrancy of the private sector underpinned economic activities, which, in turn, provided opportunities for banks to expand their balance sheets, a scenario that is likely to materialize this year as well. Even though low interest rates kept net interest margins contained, the 12 locally incorporated banks by the end of last year recorded a staggering SAR37.6 billion, an annual growth of 7.1%, supported by volume-growth in credit. Saudi banks increased their average credit maturities by focusing on long-term loans that recorded a growth of 16.1% Y/Y, reaching a total of SAR305.2 billion. Additionally, non-performing loans and provisions significantly declined by 21.7% and 15.1%, respectively, as banks improved their asset quality. The Saudi financial system has always complied with international standards and SAMA has already started guiding banks towards embracing Basel III standards, propping up capital buffers with capital adequacy levels standing at 17.8% well above requirements and as the banking industry increased its share capital recently by 27.5%. Moving forward, the banking system is secured by ample liquidity levels and capital buffers, indicative of a much healthier industry going forward.

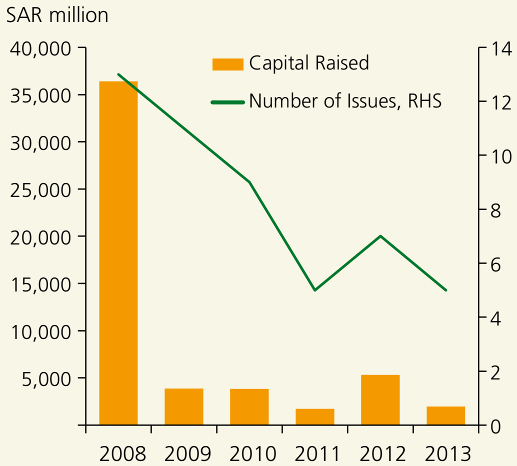
As 2013 was bullish for equities on a global scale, Tadawul managed to reach levels unseen since 2008 by climbing 25.5%. Following a stuttering start in the first quarter of last year, the local equity index gained momentum on the back of attractive valuations as corporate profitability soared. The market net income exceeded the SAR100 billion level by rising 6.6% Y/Y, which attracted investors into riskier assets. The global bull market also supported prices higher, with relatively lower systemic risks facing the world economy. The stronger local demand pushed the price-to-earnings ratio by the end of last year to 15.52 from 12.75 multiple in 2012. Earlier this year, the DOW and NASDAQ have reached record highs and their momentum positively spilled over on Tadawul, which gained 11.0% during 1Q14. The rise in business activity that translated to rising profits increased the level of trading in 1Q14 to an average of SAR7.3 billion, a double-digit increase compared to last year. However, the market is still structurally burdened with over 90% individual traders that doesn't provide the stability needed to withstand shocks. On the primary market front, the market's depth was expanded by five initial public offerings (IPOs) during 2013, with a total worth of around SAR2.0 billion and an average oversubscription of 7.5 multiple, higher than previous year's 5.1 multiple. Looking ahead, the primary market is expected to flourish this year and reach a record high. However, it is not expected that Tadawul will overshoot the 10,000 threshold by much, at least for this year.

22. Saudi Equity Market Index
(January 2009 = 100)



Sources: Tadawul

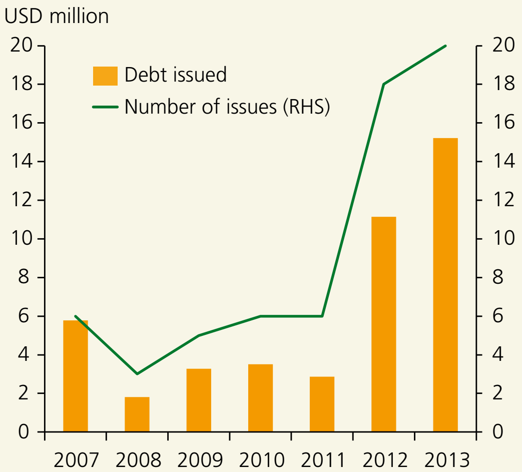
23. Saudi IPO Issuance



Sources: Tadawul

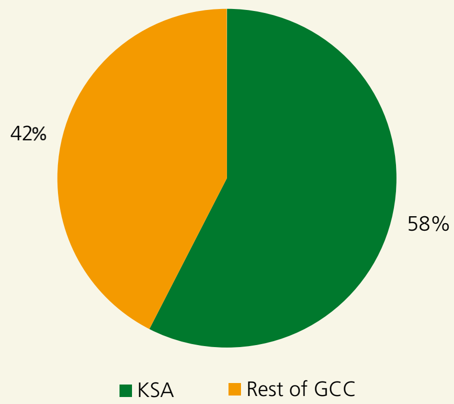
Following a record setting year, the Sukuk market is becoming a viable alternative financing vehicle for local businesses. Global Sukuk issuances dropped during 2013 to USD118.2 billion, falling 15.1% mainly due to Malaysia's weaker performance. The Asian market continues to hold the top spot for Islamic financing with a total number of 637 issues last year worth USD80.9 billion. Saudi Arabia firmly came in second with a record setting USD15.2 billion worth of Sukuk, up 36.4% Y/Y, through 20 issues. The Sukuk issuances of GACA's Guaranteed Senior Sukuk II (USD4 billion) and Aramco's Sadara Sukuk (USD2 billion) were the largest during 2013 on a global-scale, cementing Saudi status in this rapidly growing market. Furthermore, SEC issued a two-tranche Islamic bond with a tenor of 10 years and a first ever 30 years Sukuk, each with a value of SAR3.75 billion. Evidently, the extended maturity will provide a pricing benchmark for longer-tenor Sukuk and energize an alternative venue for financing infrastructure projects. The majority of issuances were denominated in Saudi Riyals with varying return rates from a flat 1.5% for Islamic Development Bank's issuance to a fluctuating 6 months SAIBOR plus 155bps for Saudi Hollandi's Tier 2 Sukuk. In addition, a number of banks opted for the Shariah compliant alternative to boost their tier 2 capital, such as Saudi British Bank, National Commercial Bank, and the upcoming Banque Saudi Fransi issuance (SAR2 billion).

24. Saudi Sukuk Issuance



Sources: Zawya

25. Saudi Share of GCC Sukuk Issuance, 2013



Sources: Zawya

IV. Risks

Systemic macro and banking sector risks are at an all time low. Sizable fiscal surpluses have boosted the ability of the government to smoothen cyclical vagaries and withstand negative terms of trade shocks. The current standing of the Kingdom that includes one of the lowest net debt levels on a global scale, 2.7% out of GDP, and the world's third-highest net foreign assets that amounts to USD717.7 billion contrasts with an economy that was mired in debt at 103.5% to GDP and held meager net foreign assets of USD37.9 billion by the end of the 1990s. Ostensibly, the Saudi government had learned from the unfavorable business cycle that remained in place from the end of the 1980s throughout the 1990s, becoming more prudent in managing finances and investing assets. Additionally, in comparison to other countries, the Saudi banking system had a comfortable loan to deposit (L/D) ratio of 78.9% by the end of April 2014, a level that reflects excess capacity to lend and a lower systemic risk. Meanwhile, the capital adequacy ratio at 17.8% is another signal of an ample cushion to match the embedded risk in assets, especially after taking into consideration the lower capacity utilization compared to regional and international counterparts, with the UAE, Kuwait and Russia near 90%, 92% and 124% L/D ratios, respectively. The improvement in asset quality since mid-2011 is another plus for the domestic banking system, illustrating the prudent management and supervisory practices that have been applied by banks and SAMA. Figure 26 below depicts key macro and banking sector vulnerability indicators of Saudi Arabia between 2009 until 2013.

26. Key Systemic Macro and Banking Sector Risk Indicators

	2008	2009	2010	2011	2012	2013
1. Macro Risks						
Overall Budget Balance/GDP	29.8%	-5.4%	4.4%	11.6%	13.6%	6.4%
Gross Domestic Public Debt/GDP	13.5%	14.0%	8.5%	5.4%	3.6%	2.7%
Net Domestic Public Debt/GDP	-42.1%	-43.4%	-41.8%	-41.9%	-51.5%	-55.8%
Net Banking Sector Claims on the Government (SAR bn)	-846.0	-768.9	-810.5	-1009.2	-1334.6	-1411.8
Overall Current Account Balance/GDP	25.4%	4.9%	12.7%	23.6%	22.4%	17.7%
Net Factor Income/Merchandise Imports	9.1%	10.0%	7.3%	8.1%	7.8%	7.1%
Net Foreign Assets/Imports of Goods and Services	249.4%	251.5%	254.3%	272.0%	302.9%	313.9%
Net Foreign Assets/M2	207.1%	179.9%	178.8%	188.2%	200.5%	199.8%
Merchandise Import Coverage (1YR ahead imports, in months)	52.3	56.4	54.8	54.0	55.3	56.7
2. Banking Sector Systemic Risks (11 Locally Incorporated Banks)						
Loan-to-Deposit Ratio	83.5%	74.4%	73.9%	74.2%	75.9%	77.4%
Minimum Risk Assets/Total Assets	28.4%	35.4%	34.9%	33.8%	32.7%	31.4%
Cash and Balances with SAMA/Total Assets	7.3%	11.7%	11.1%	11.7%	12.5%	10.6%
Tier 1 Capital Adequacy Ratio	13.4%	16.1%	16.6%	16.1%	15.8%	16.4%
Non Performing Loan (NPL) Ratio	1.4%	3.4%	2.9%	2.3%	1.9%	1.3%
NPL Coverage Ratio	152.4%	89.8%	115.7%	133.2%	145.3%	157.4%

Sources: Financial statements of commercial banks, SAMA and NCB

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