QNB

The Kingdom of Saudi Arabia Economic Insight

2013

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Editorial closing, September 10, 2013

Executive Summary

A. Recent Macroeconomic Developments (2012)

- **Real GDP expanded strongly** (6.8%) in 2012 on the back of both oil- and non-oil growth. Oil production reached an all time high of 9.8m b/d, which financed higher government spending and non-oil economic activity. The non-oil private sector slowed slightly (7.5%) on softer domestic demand. Inflation moderated to 2.9%, despite higher housing costs.
- The **current account surplus remained high** (22.7% of GDP) in 2012 as rising oil prices and exports were accompanied by stronger import demand; international reserves reached an all-time-high (34.1 months of import cover).
- The overall **fiscal balance registered a large surplus** (13.7% of GDP) due to high oil revenue, while government spending remained broadly in check compared with 2011.
- At end-2012, the **banking sector was well capitalized**, liquid and profitable, with credit growth to the private sector remaining robust (16.4%).

B. Macroeconomic Outlook (2013-14)

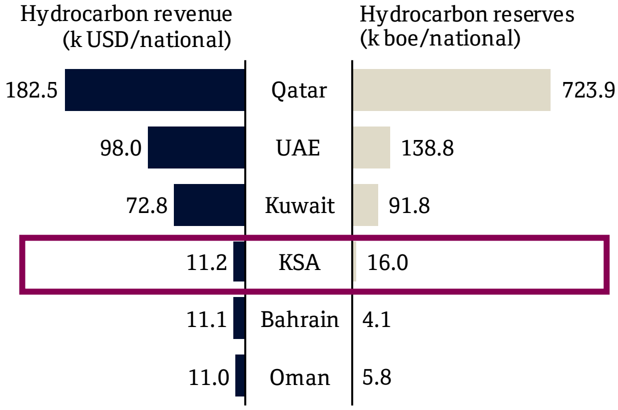
- We forecast a **slight slowdown in real GDP growth** to 4.0% in 2013 as oil output declines due to weakening global demand. The non-oil sector is expected to grow strongly (5.9%), reflecting government-led infrastructure and mining projects. Real GDP growth is projected to pick up to 4.4% in 2014 with a slight recovery in the oil sector and continued strong non-oil activity. Inflation will remain moderate over the medium term.
- The **current account surplus is expected to narrow** in 2013 (18.1% of GDP) and 2014 (15.2% of GDP), as lower oil prices and production and higher imports reduce the overall trade balance.
- The **fiscal surplus is projected to be lower** in 2013 (7.1% of GDP) and 2014 (5.2% of GDP), reflecting lower oil revenue and higher government infrastructure spending.
- The **outlook for the banking sector remains positive** as loan growth is likely to pick up with brighter profitability prospects as interest rates trend up.
- The **key challenge for the KSA economy going forward is the absorption of the growing Saudi population entering the labor market**. Attracting the national workforce to private sector jobs will remain critical to reverse the growing pool of the unemployed.

Background

The Kingdom of Saudi Arabia (KSA) is the world's largest oil producer and has the largest global oil reserves

KSA is the world's largest oil producer, accounting for 12.9% of global oil production and oil production reaching an all time high of 9.8m b/d in 2012.[1] It also has the largest oil reserves in the world, estimated at 266bn barrels as of end-2012. At current production rates, these reserves are expected to last at least 63 years. However, given its large population (29.2m in 2012), hydrocarbon revenues and reserves per national are relatively low at USD11k and 16k barrels of oil equivalent (boe), compared with other Gulf Cooperation Council (GCC) countries.

GCC Oil and Gas Wealth (2012)



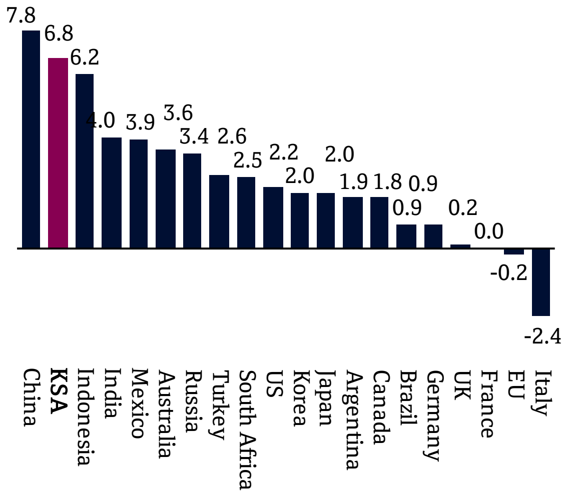
Sources: British Petroleum (BP) and QNB Group estimates

The Kingdom is among the top performing economies in the G-20

KSA had the second best economic growth performance amongst the G-20 in 2012 (6.8%). This confirmed the strong performance over the last five years, with the third highest G20 real GDP growth rate in 2008-12 (averaging 6.1%), just below the growth rates of China and India.[2] Economic growth has led to social prosperity and wealth: GDP per capita at purchasing power parity (PPP), at USD31k in 2012, was significantly above the Middle East and North Africa (MENA) average (USD11k) and close to the average for advanced economies (USD41k).

G-20 Real GDP Growth (2012)

(% change)



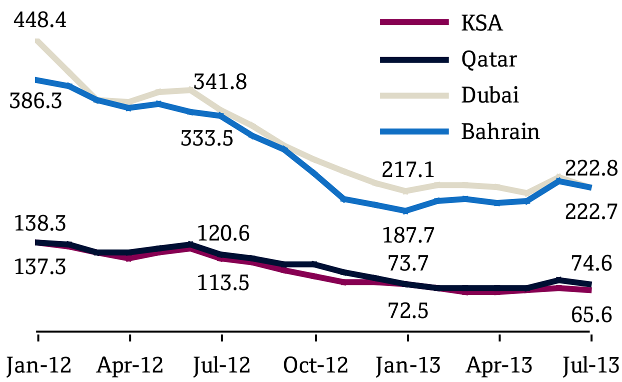
Sources: International Monetary Fund (IMF) and QNB Group estimates

KSA has the lowest CDS spreads in the region based on its strong economic performance

KSA had the lowest risk spreads in the region. Its USD Credit Default Swap (CDS) spreads have dropped from an average of 137.3 basis points (bps) in January 2012 to 72.5bps in January 2013 and touched a low of 65.6bps in July 2013, based on its strong economic performance and very low debt. KSA also has high investment grade long-term foreign currency credit ratings from Moody's, Standard and Poor's (S&P) and Fitch, at Aa3, AA- and AA- respectively. In May 2013, S&P upgraded KSA's outlook to positive, reflecting its strong economic growth prospects.

CDS Spreads (Jan 2012 – Jul 2013)

(basis points above US Treasuries for a 5yr USD bond)



Sources: Bloomberg and QNB Group analysis

[1] KSA's Ministry of Petroleum and Mineral Resources.

[2] This is the compounded annual growth rate (CAGR), which is a geometric mean. In general, unless otherwise specified, all multi-year growth rates mentioned in this report will be CAGRs, rather than arithmetic means.

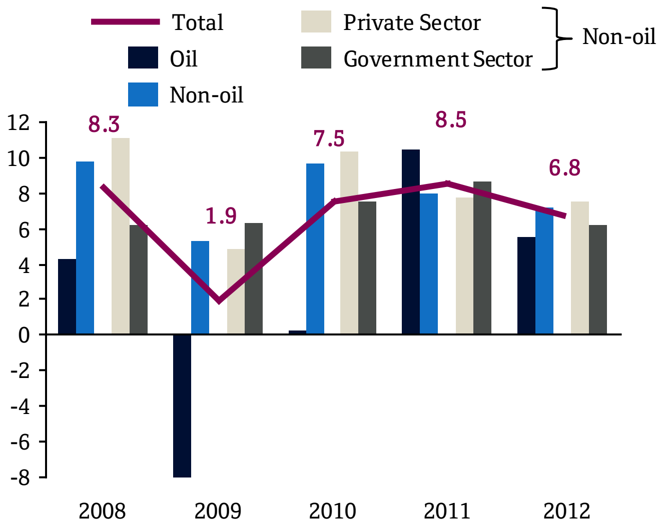
Recent Developments (2012)

The non-oil private sector drove growth in 2012...

Real GDP growth continued to be robust in 2012 (6.8%), supported by higher oil production and a dynamic non-oil economy. The oil sector witnessed a growth of 5.5% in 2012 on higher crude oil production. The non-oil private sector was the strongest contributor to growth, expanding 7.5% in 2012. On the demand side, the private sector picked up in 2012. Adding to a strong private consumption growth (6.6%), was government consumption (9.7%) and increased investment (6.1%). Private consumption has been underpinned by the strong population growth, which has averaged 3.1% over the last decade. The Saudi population which consumes proportionally more than expatriates, has been growing by 2.4% a year. Inflation remained moderate at an average annual rate of 2.9% in 2012.

Real GDP Growth with Major Components (2008-12)

(% change)



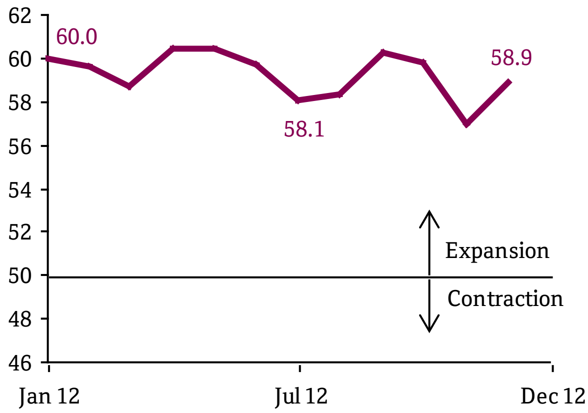
Sources: Central Department of Statistics and Information (CDSI), Ministry of Economy and Planning (MEP) and QNB Group analysis

...with a strong performance in manufacturing...

Manufacturing continued to witness strong growth in 2012 (7.6%), after a rapid expansion in 2011 (13.7%). Further evidence of increased economic activity can be seen through the Purchasing Managers' Index (PMI). The PMI reading for KSA remained above the 50 mark in 2012, indicating a strong expansion. Manufacturing output increased as new orders rose firmly, driven by an uptick in new business and workforce numbers.

Manufacturing PMI (Jan 2012 – Dec 2012)

(index change - above 50 indicates expansion)



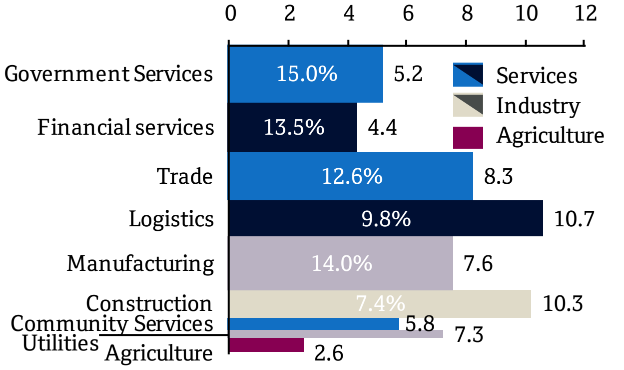
Sources: HSBC, Markit and QNB Group analysis

...and key contributions also from logistics and construction

The transport, storage and communications (logistics) sector was the fastest growing sector in 2012. The rapid growth has been supported by large projects in transportation and logistics infrastructure. Construction has been the second fastest growing sector in 2012 as strong public spending on various projects has progressed swiftly. Healthcare has been one of the government priorities, with around 130 hospitals being under construction and a further 17 announced in the 2012 budget. The plans announced by King Abdullah in 2011 to build 500,000 affordable housing units is also underway.

Sector Contributions to Non-Oil Real Growth (2012)

(length of bars is % change, area of bars is share in non-oil real GDP growth)



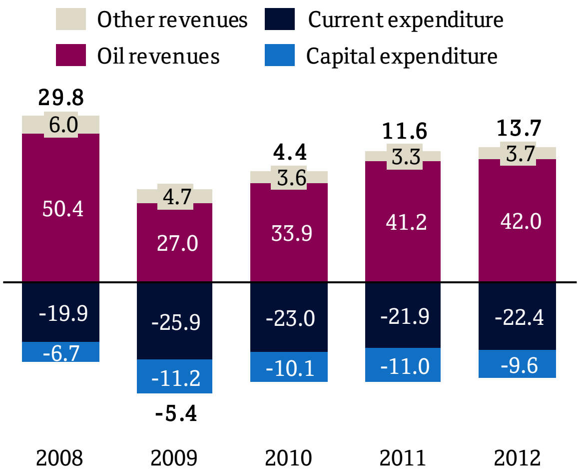
Sources: CDSI, MEP and QNB Group analysis

Higher oil revenues produced another large fiscal surplus

Higher oil prices and production outweighed increased spending, leading to another large fiscal surplus in 2012 (13.7% of GDP). Total government revenues rose significantly (45.7% of GDP) boosted by strong oil revenues. Total expenditures fell somewhat as a share of GDP (32.0% of GDP) in 2012, but still overshot the budget ceilings by a large amount. Current expenditures rose in 2012, mainly due to the introduction of unemployment benefits in late 2011 and a generalized increase in wages and salaries. On the other hand, capital expenditure declined as various capital investment projects initiated in the aftermath of the global financial crisis of 2008-09 came to an end.

Fiscal Balance (2008-12)

(% of GDP, overall balance in bold)



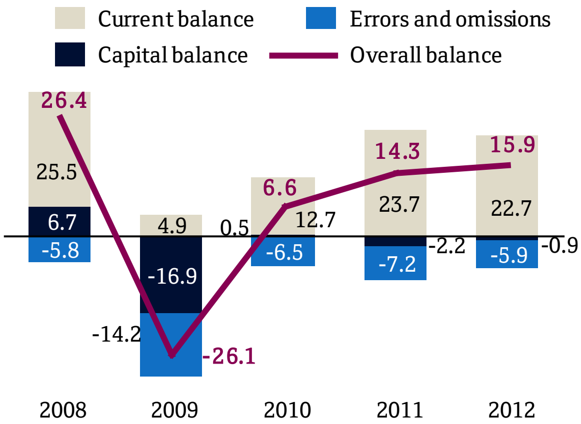
Sources: Ministry of Finance and QNB Group analysis

The large current account surplus continued to be driven by higher oil prices and output

The current account balance registered another large surplus in 2012 (22.7% of GDP). Higher oil prices and production pushed overall exports up 6.5%. However, imports surged by an equivalent amount, leaving the overall trade surplus flat. Foreign workers' remittances reached an all time high in 2012 (3.9% of GDP). The capital and financial account was in near balance. As a result, the overall balance of payments surplus boosted the Saudi Arabian Monetary Authority's (SAMA) international reserves to USD664.0bn at end-2012, equivalent to 34.9 months of import cover.

Balance of Payments (2008-12)

(% of GDP)



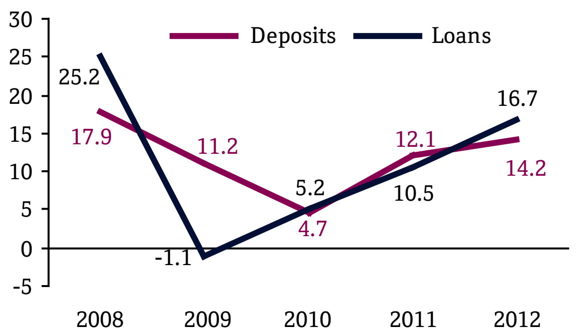
Sources: SAMA and QNB Group analysis

The banking sector was well capitalized at end-2012, with strong credit growth and declining NPLs

The banking sector showed a strong capital adequacy ratio of 18.7% at end-2012. Total assets of the banking sector expanded rapidly, driven by both an increase in reserves and lending. Credit growth witnessed a strong rebound in 2011-12, as the banking sector recovered from the aftermath of the global financial crisis. An increase in public spending has reinvigorated private consumption, leading to a robust growth in private sector credit and high levels of liquidity in the banking sector. Even as the loan book expanded, the ratio of non-performing loans (NPLs) declined to 1.9%. Overall bank profitability has also gained strong traction in recent years.

Bank Loan and Deposit Growth (2008-2012)

(% change)



Sources: SAMA and QNB Group analysis

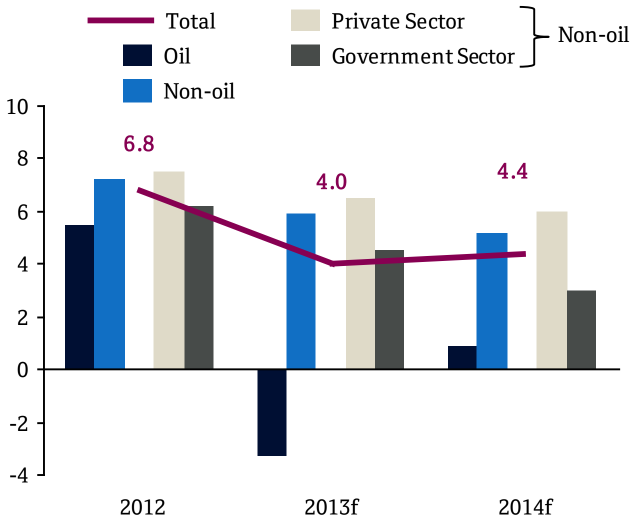
Macroeconomic Outlook (2013-14)

The non-oil private sector is expected to drive growth in 2013-14

Overall growth is forecast to moderate to 4.0% in 2013 as oil production declines. The non-oil private sector is expected to continue to grow at a robust pace (6.5%) on the back of continued large public sector infrastructure investment and population growth. Recently released data from the CDSI for the second quarter of 2013, shows a real GDP growth of 2.7% year-on-year compared with 2.1% in the first quarter. The slowdown in growth during the first two quarters was mainly due to the decline in oil output. However, non-oil growth picked up to 4.5% during the second quarter of 2013 on higher demand for government services. The oil sector is expected to stabilize and accelerate in the second half of 2013, which coupled along with government spending will support overall growth in 2013. A small recovery in oil production will raise real GDP growth to 4.4% in 2014. Downside risks to this scenario come from lower international oil prices and/or slower-than-expected global economic activity.

Real GDP Growth by Sector and Demand (2013-14)

(% change, major components)



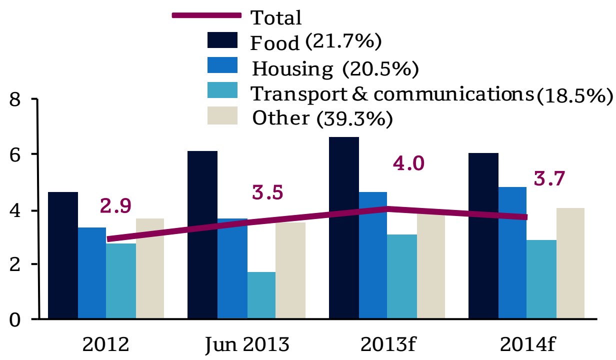
Sources: IMF and QNB Group forecasts

Food and housing is projected to push inflation up

The consumer price index (CPI) rose 3.5% year-on-year in June 2013, with food and housing pushing up the headline index. Population growth is likely to push food prices and housing demand higher, keeping upward pressure on overall inflation in 2013-14. On the other hand, public sector infrastructure investments are likely to ease inflation in the transport and communication sectors. As a result, we forecast inflation to peak at 4.0% in 2013 and then moderate to 3.7% in 2014.

Inflation (2012-14)

(% change, sector weights in consumer price index shown)



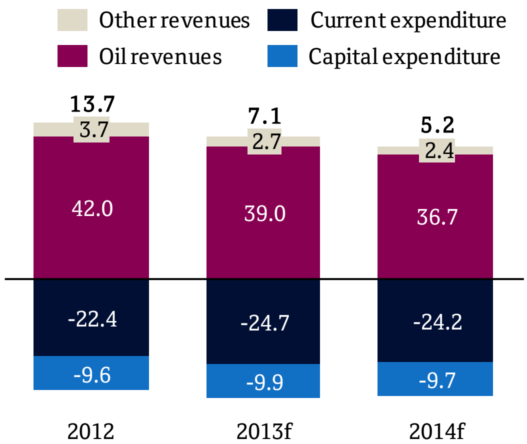
Sources: CDSI, MEP, IMF and QNB Group forecasts

The fiscal surplus is expected to fall in the coming two years

The government has built up comfortable fiscal buffers over the past two years. Against this background, we forecast oil prices to drop on the back of weakening global oil demand and a reduction in oil production in 2013. As a result, oil revenues are expected to decline to 39.0% of GDP in 2013 and 36.7% of GDP in 2014. Continued growth in government spending will contribute to economic growth over the medium term. The Ministry of Finance announced a record budget for 2013, with overall expenditures increasing by 19% over the previous budget year. The bulk of capital expenditures will be allocated towards ports, railroads and water resources projects, education and healthcare. As a result, we project the overall surplus to fall to 7.1% of GDP in 2013 and 5.2% in 2014.

Overall Fiscal Balance (2012-14)

(% of GDP, balance shown at top of columns)



Sources: Ministry of Finance and QNB Group forecasts

Public debt levels continue to remain very low by international standards

Public debt levels fell to 3.6 percent of GDP, which was the third lowest in the world. This represents a drastic reversal compared with the debt-to-GDP ratio in the 1990s being above 100%, when the Kingdom had large fiscal deficits due to low oil prices. We forecast a slow uptick in the debt to GDP ratio in 2014 as the government maintains a minimal level of debt to provide a benchmark yield curve while continuing to add to its large foreign assets.

The current account balance is projected to narrow as oil export receipts decline

A narrowing in the current account surplus is forecast as oil exports decline due to a drop in oil production and prices in 2013-14. Imports will remain strong as the demand for capital goods rise with increased investment spending. As a result, the services balance is expected to increase reflecting higher freight costs. Overall, we project the balance of payments surplus (averaging 9.8% of GDP in 2013-14) to boost international reserves to around USD810bn by end-2014, equivalent to about 40 months of import cover.

Credit expansion is expected to drive growth in banking sector assets

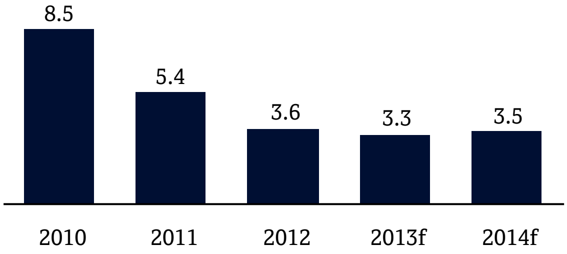
The total domestic banking sector assets increased 11.6% year-on-year as of end-June 2013 to reach USD482 bn. Asset growth was primarily driven by credit expansion (11.2%) as private consumption, industry and trade related demand grew. Deposits rose (10.8%) and were mainly influenced by demand deposits. The outlook for the banking sector looks promising with a robust operating environment, low NPLs, strong capitalization and profitability, low cost funding and ample liquidity. Adding to this will be the government's ambitious spending program that will support and enhance overall banking activities. We therefore forecast bank deposits to grow by 12.7% in 2013 and 13.2% in 2014. In the same vein, we project bank assets to expand by 10.2% in 2013 and 11.5% in 2014.

Creating jobs is a key challenge for the government

Unemployment among nationals was estimated at 12.0% in March 2013, with the unemployment rate among female nationals at 34.8%. The Saudi labor force is expected to increase by an estimated 3.6% over the next decade. Attracting the national workforce to private sector jobs will remain critical to reverse the growing pool of the unemployed.

Public Debt (2010-14)

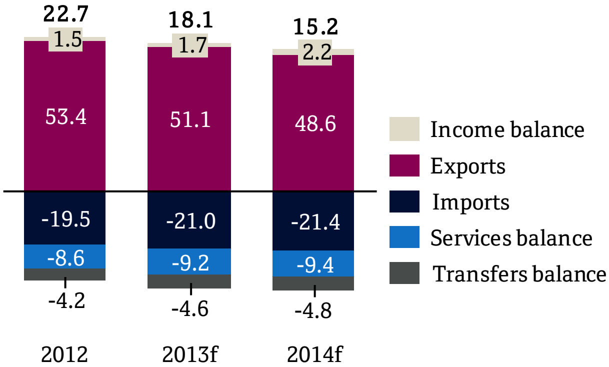
(% of GDP)



Sources: IMF and QNB Group forecasts

Current Account Balance (2012-14)

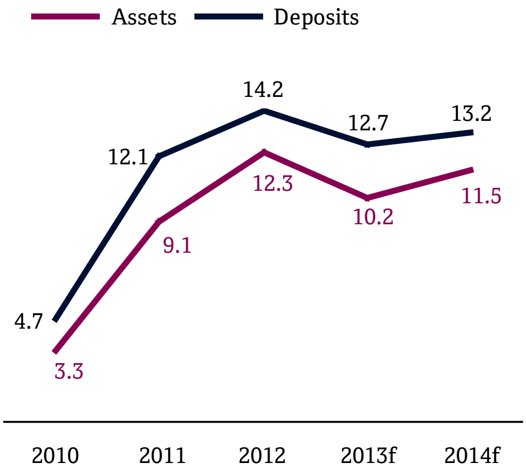
(% of GDP, current account balance shown at top of columns)



Sources: SAMA, IMF and QNB Group forecasts

Bank Assets and Deposit (2010-14)

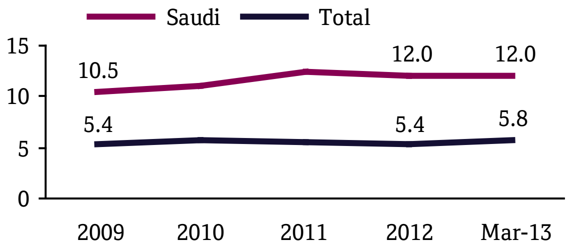
(% change)



Sources: SAMA and QNB Group forecasts

Unemployment (2009-March 13)

(% of total labor force)



Source: CDSI

Key Macroeconomic Indicators

	2008	2009	2010	2011	2012	2013f	2014f
National Accounts and Prices							
Nominal GDP (USD bn)	519.8	429.1	526.8	669.5	727.3	**735.3**	**755.2**
Growth (%)	25.0	-17.4	22.8	27.1	8.6	**1.1**	**2.7**
Oil (% of GDP)	52.7	37.8	41.6	48.4	47.2	**46.3**	**45.8**
Real GDP growth (%)	8.3	1.9	7.5	8.5	6.8	**4.0**	**4.4**
Oil growth (%)	4.3	-8.0	0.3	10.4	5.5	**-3.3**	**0.9**
Non-oil growth (%)	9.8	5.3	9.6	8.0	7.2	**5.9**	**5.2**
Private sector (%)	11.1	4.9	10.3	7.8	7.5	**6.5**	**6.0**
Consumer price inflation (%)	9.9	5.1	3.8	3.7	2.9	**4.0**	**3.7**
Food	14.1	2.0	6.3	5.2	4.4	**6.6**	**6.0**
Housing	17.5	14.2	9.4	7.8	8.1	**4.6**	**4.8**
Budget Balance (% of GDP)	29.8	-5.4	4.4	11.6	13.7	**7.1**	**5.2**
Revenue	56.5	31.7	37.5	44.5	45.7	**41.7**	**39.1**
Expenditure	26.7	37.1	33.1	32.9	32.0	**34.6**	**33.9**
Central government debt	12.1	14.0	8.5	5.4	3.6	**3.3**	**2.8**
External Sector (% of GDP)							
Current account balance	25.5	4.9	12.7	23.7	22.7	**18.1**	**15.2**
Trade balance	40.8	24.5	29.2	36.6	33.9	**30.1**	**27.2**
Exports	60.3	44.8	47.7	54.5	53.4	**51.1**	**48.6**
Imports	-19.5	-20.3	-18.5	-17.9	-19.5	**-21.0**	**-21.4**
Services balance	-12.7	-15.2	-12.5	-9.9	-8.6	**-9.2**	**-9.4**
Income balance	1.8	2.0	1.3	1.4	1.5	**1.7**	**2.2**
Current transfers balance	-4.4	-6.4	-5.3	-4.4	-4.2	**-4.6**	**-4.8**
Capital account balance	6.7	-16.9	0.5	-2.2	-0.9	**-1.0**	**-0.9**
International reserves	85.1	95.6	84.1	80.1	91.3	**101.7**	**107.3**
External debt	15.3	20.1	17.4	17.0	19.2	**20.8**	**22.0**
Monetary Indicators (% Change)							
Broad money supply (M3)	17.6	10.7	5.0	13.3	13.9	**11.4**	**10.1**
Foreign assets	43.8	-3.1	7.3	22.3	19.7	**12.0**	**8.1**
Domestic credit	28.6	-6.1	8.0	7.9	14.2	**16.4**	**14.8**
Private sector credit	27.1	0.0	5.7	10.6	16.4	**14.3**	**13.1**
Banking Indicators (%)							
Bank assets growth	21.1	5.2	3.3	9.1	12.3	**10.2**	**11.5**
Bank deposit growth	17.9	11.2	4.7	12.1	14.2	**12.7**	**13.2**
Capital adequacy ratio (CAR)	16.0	16.5	17.1	19.6	18.7	**-**	**-**
Return on equity (RoE)	20.5	13.7	17.7	14.5	14.5	**-**	**-**
Non-performing loans (NPLs)	1.4	3.3	3.0	2.3	1.9	**-**	**-**
Liquid assets to total assets	22.0	25.3	24.7	22.6	23.7	**-**	**-**
Memorandum Items							
Population (m)	25.8	26.7	27.6	28.4	29.2	**29.6**	**30.3**
Growth (%)	3.4	3.4	3.4	2.9	2.9	**1.4**	**2.4**
Oil production (m bpd)	9.2	8.2	8.2	9.3	9.8	**9.4**	**9.5**
Saudi crude price (USD/barrel)	92.5	62.2	77.6	107.1	109.5	**106.8**	**101.7**
Exchange rate USD:SAR (av)	3.750	3.750	3.750	3.750	3.750	**3.750**	**3.750**

Sources: SAMA, CDSI, MEP, MPMR, Ministry of Finance, IMF and **QNB Group estimates and forecasts;** Data as at September 10, 2013

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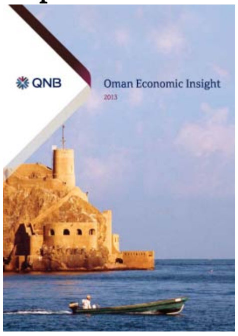
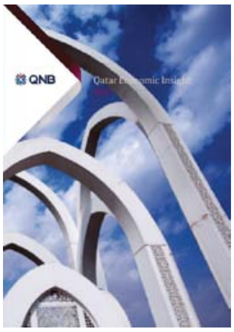
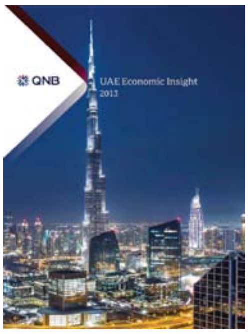


Oman 2013



Qatar, April 2013

Qatar, Sept. 2013



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