Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- Although the recent downswing in oil prices below the USD90's level has not prompted any reaction from the Kingdom yet, we believe Kingdom's view of a fair oil price remains USD100. Should the market balances actually warrant a reduction in production, it is expected that Saudi Arabia will reduce output aggressively.

- Over the short term, we expect to see a global downturn marked by overall currency devaluations as world economies sustain the blows from the Euro zone being offset by positive indicators rising from increasing quantitative easing expectations.

- Food prices have posted a gain of 4.8% Y/Y and are expected to remain elevated as businesses build up their stocks in preparation for the Holy month of Ramadan.

- Systematic risks pressured stock prices downwards as the global economy struggles with the European debt crisis. The only two sectors to record a gain over the month were transport, gaining 5.0%, and hotel and tourism growing by 2.1%.

- Fresh lending by Saudi banks was focused towards the consumer and credit cards category as witnessed in 2011 which are expected to carry forward into 2012 given the ample opportunities in the retail segment.

- The high increase in petrochemical exports of 21.4% in value terms compared to the 3% increase in tonnage is in line with elevated oil prices stemming from the geopolitical developments especially, the US-Iranian standoff.

View of the Month

'Mortgage Law's impact on Housing Sector'

The mortgage law is one solution out of a few that will help address the housing market challenge. Recent developments including the housing related royal decrees and the partnerships between banks and the Real Estate Development Fund will provide much needed support.

Macroeconomic Indicators

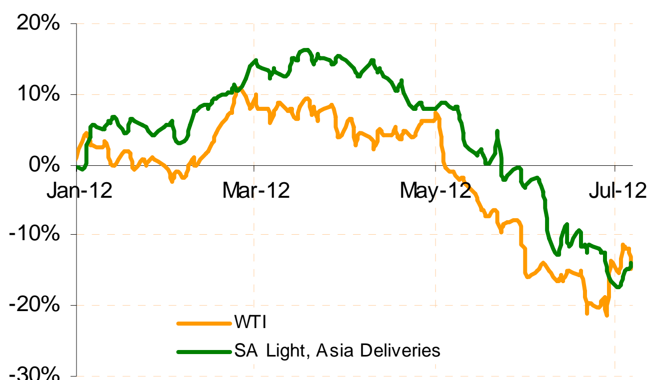
	2007	2008	2009	2010	2011P	2012F	2013F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	68.3	94.9	59.2	77.6	108.1	105.0	100.0
Average Daily Crude Oil Production, MMBD	8.8	9.2	8.2	8.2	9.3	9.4	9.7
GDP at Current Market Prices, SAR billion	1,442.6	1,786.1	1,412.6	1,679.1	2,163.1	2,217.9	2,272.3
GDP at Current Market Prices, USD billion	385.2	476.9	377.2	447.8	577.6	592.2	606.8
Real GDP Growth Rate	2.0%	4.2%	0.1%	4.6%	6.8%	3.9%	4.4%
Oil Sector GDP Growth Rate	(3.6%)	4.2%	(7.8%)	2.4%	4.3%	1.8%	3.2%
Non-oil Sector GDP Growth Rate	4.7%	4.3%	3.5%	5.5%	7.8%	4.7%	4.9%
Population, million	24.9	25.8	26.7	27.6	28.4	29.2	30.1
Population Growth Rate	3.4%	3.4%	3.4%	3.4%	3.0%	3.0%	3.0%
GDP /Capita, USD	15,444.2	18,495.4	14,147.9	16,244.8	20,344.8	20,252.6	20,144.9
CPI Inflation, Y/Y % Change, Average	4.1%	9.9%	5.1%	5.3%	5.0%	4.8%	4.5%
External Sector							
Merchandise Trade Balance, USD billion	150.6	212.0	105.2	153.7	244.7	254.6	249.7
Oil Exports, USD billion	205.3	281.0	163.1	215.2	317.6	335.9	330.1
Non-oil Exports, USD billion	27.8	32.3	29.1	35.8	46.9	45.8	53.7
Merchandise Imports, USD billion	(81.5)	(100.6)	(86.4)	(96.7)	(119.1)	(127.1)	(134.1)
Net Unilateral Transfers, USD billion	(17.0)	(23.0)	(27.7)	(27.9)	(29.4)	(32.1)	(35.1)
Current Account Balance, USD billion	93.3	132.3	21.0	66.8	158.5	151.7	144.0
Current Account Balance/GDP	24.2%	27.7%	5.6%	14.9%	27.4%	25.6%	23.7%
Net Foreign Assets with SAMA, USD billion	301.3	438.5	405.9	441.0	535.9	636.7	702.7
Fiscal Sector (Central Government)							
Budgeted Expenditure, SAR billion	380.0	410.0	475.0	540.0	580.0	690.0	759.0
Actual Revenues, SAR billion	642.8	1101.0	509.8	741.6	1110.0	1092.5	1076.2
Actual Expenditure, SAR billion	466.2	520.1	596.4	653.9	804.0	771.8	818.2
Expenditure Overrun, %	22.7%	26.8%	25.6%	21.1%	38.6%	11.9%	7.8%
Total Revenues/GDP	44.6%	61.6%	36.1%	44.2%	51.3%	49.3%	47.4%
Total Expenditure/GDP	32.3%	29.1%	42.2%	38.9%	37.2%	34.8%	36.0%
Overall Budget Balance, SAR billion	176.6	580.9	(86.6)	87.7	306.0	320.7	258.1
Budget Balance/GDP	12.2%	32.5%	(6.1%)	5.2%	14.1%	14.5%	11.4%
Break-Even Oil Price	40.5	40.2	60.8	64.1	70.4	65.4	67.6
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)	19.6%	17.6%	10.7%	5.0%	13.3%	11.2%	14.1%
Growth in Credit to the Private Sector	20.6%	27.9%	-0.6%	4.8%	11.0%	13.3%	13.7%
Average 3M SAR Deposit Rate	4.9%	3.3%	0.9%	0.7%	0.7%	0.8%	1.0%
Average 3M USD Deposit Rate	5.2%	3.0%	0.7%	0.4%	0.3%	0.5%	0.8%
Spread, in Basis Points, SAIBOR-LIBOR	(31.9)	29.7	17.5	38.0	39.5	30.0	25.0

Oil Market

Geopolitical Pressures

Crude oil markets had a volatile week, with prices first surging higher on June 29th upon optimism the European debt crisis may be contained after leaders agreed to ease repayment rules for emergency loans to Spanish banks and relax conditions on help for Italy, but then quickly declined on July 2nd on new data that Euro-area unemployment reached the highest level on record. Meanwhile, demand has been under downward pressure, owed to weaker economic growth in advanced economies, crude oil inventories above historical average, particularly, in the US, and soft landing in major emerging economies, especially, China. Moreover, despite recent optimism, worries on Europe's ability to solve its ongoing financial crisis will remain an enduring concern. The US EIA noted that US commercial crude oil inventories reached 387.2 million barrels, which is above the upper limit of the average range for this time of year. While China's crude oil imports rose by 14.4% in May to a 5.99 mb/d, it is expected that its imports for June's have inched down, as China's PMI fell from 50.4 points in May to at 50.2 in June.

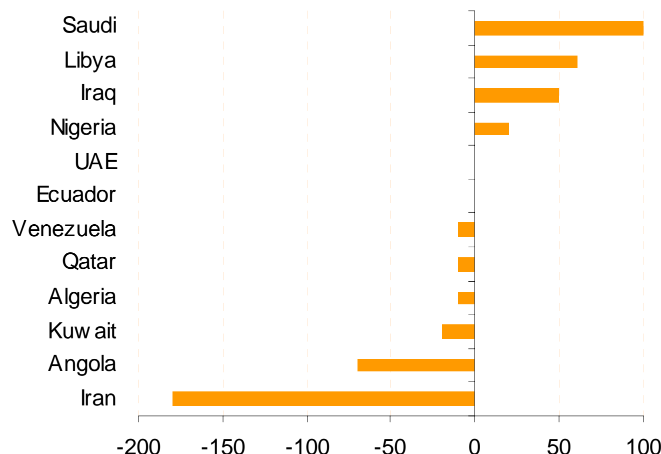
Chart 1: Oil Price Developments, YTD



Source: Thompson Reuters

On the supply side, Iranian crude exports have been hit by US sanctions and threaten to cut them even further following the recent EU's sanctions, which were just implemented on 1 July. In addition, the ban on provision of protection and indemnity for ships carrying Iranian crude by insurance and reinsurance European companies, already going into effect, will hit most of the major Iranian crude importing countries. While European imports have adjusted, the insurance ban is likely to affect crude flows into India and South Korea in particular, thereby narrowing the surplus on the supply side. Iran's production was already down at 3.32 mb/d in May from 3.65 mb/d at the end of last year, as much of this has gone into storage. Oil exports have fallen sharply, and even prior to 1 July, they are estimated to have declined by 20-30% from their normal levels of 2.2 mb/d. Accordingly, we expect prices to eventually build a base for a recovery, but sustained price upside is still some time away. Meanwhile, further pressure could be brought to bear on Iran because an increase in OPEC's oil exports for July is likely to keep a lid on crude prices.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

Although Saudi production hovers around 10 mb/d, it has not increased significantly much over the past 10 months. Moreover, while Saudi Arabia appears to have taken a dovish stance at the latest OPEC meeting by aiming for a soft landing of prices at about USD100 per barrel, it is likely that the pace of the latest freefall in prices to below USD90 for Brent crude might have stirred an element of nervousness in OPEC members, including Saudi Arabia. Although the recent downswing in prices below the USD90's level has not prompted any overt reaction from the Kingdom yet, we believe the Kingdom's view of a fair and defensible oil price remains USD100. Should the market balances actually warrant a reduction in production, it is expected that Saudi Arabia will be among the first to reduce output aggressively.

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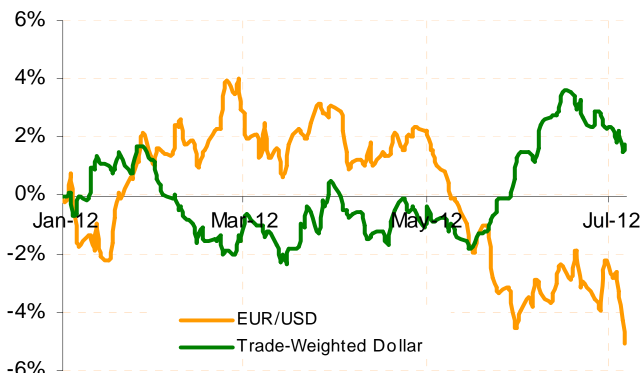
Foreign Exchange

Dollar to Demonstrate Strength

Financial markets remain volatile as the Euro crisis continues to ripple across global markets. Although the future of the Euro zone greatly rests in the hands of Greek reforms as it sits in the forefront of the European economic crisis, the ECB's supervisory plans provide a rope of hope to keep the Euro from slipping further behind. The Euro plummeted against the USD to offset previous gains of 2.4% during June following the bold announcement of continued ECB support via the new permanent bailout fund, the European Stability Mechanism (ESM), as well as a new fiscal pact to enshrine the union's existence. On part, the slowing US factory data which is the lowest since 2009 coupled with a severe decrease in consumer sentiment by 7.7%, in addition to a slowing quarterly GDP growth of 1.9%, gave the single currency a momentum bringing it back closer to this year's peak of USD1.2614. However, this gain is not expected to be sustained due to ECB's interest rate cutting of 25bps and Euro bond redemption sale which will reduce the attractiveness of any interest-bearing security. Although it is also expected to boost risk sentiment and reduce the risk premium for the currency, cutting interest rates is more likely to harm the Euro than save it. In addition the rising expectations of QE3 would also give the USD the upper hand. As such, the Euro touched a three-year low last week and settled at 1.2291.

Chart 3: Trade-Weighted Dollar and the Euro

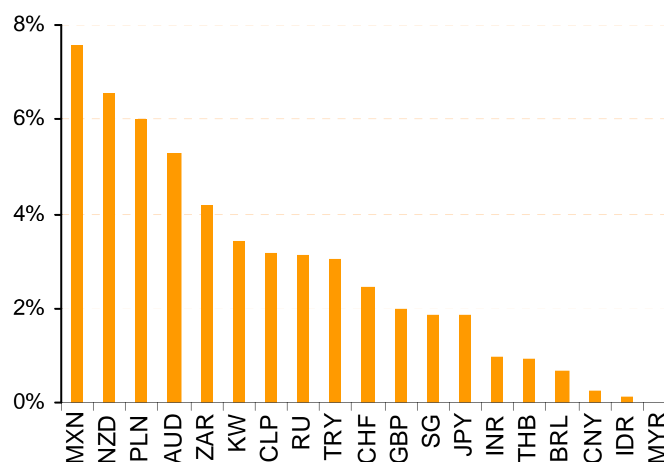


Source: Thompson Reuters

The Euro's strength remains heavily stringent upon the upcoming reform policies of the bloc and whether the US economy is taking a downward trend or just hitting a soft patch. On the latter's regard, the trade weighted USD suffered a loss of 1.7% which came in favor of the safe haven, the Japanese Yen, gaining 1.9% on the back of the Euro and US uncertainties.

In Mexico, the peso showed a huge retreat of 7% over fears of a global meltdown. One of the supporting factors, which gave these fears merits is a slowdown in the US, which crippled demand for Mexican exports, mainly fruits and vegetables. The inflationary pressures that resulted from the weakened currency give little room for maneuver by Banco de Mexico, the central bank of Mexico, especially that interest rates are currently at 4.3%, the highest since 2010. In contrast, while the slowing US growth leaves its drag on Mexico, Brazil which only lost 0.6% of its currency's value is aggressively campaigning to cut interest rates in order to jump-start the economy for the remainder of this year.

Chart 4: Monthly Foreign Exchange Rate Changes



Note: KW denotes North Korea's Won, Source: Thompson Reuters

Although China is losing demand from its key markets, the Chinese Yuan, against all odds, appreciated by 0.2% against the USD regardless of the current quantitative easing. This is due to posting a positive GDP growth of 8.1%. Over the short term, we expect to see a global downturn marked by overall currency devaluations as world economies sustain the blows from the Euro zone being offset by positive indicators rising from increasing quantitative easing expectations.

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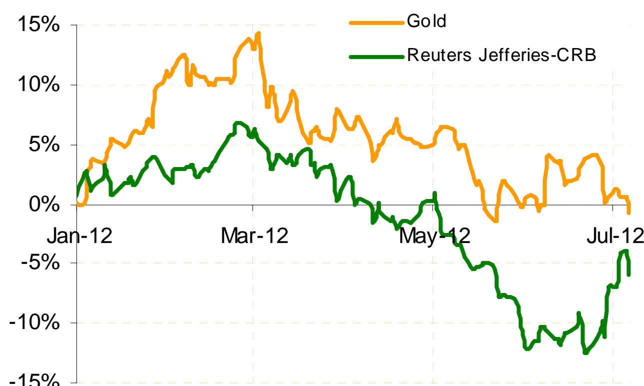
Commodities

Salvaging an Abysmal Second Quarter

Commodities mounted a significant comeback at the end of the second quarter but were unsuccessful in climbing out of negative territory. Commodity markets posted their biggest rally on the last day of trading in June as oil prices surged by 9% on the back of a long-awaited debt deal in Europe that was aimed to cut soaring borrowing costs in Spain and Italy. The rally saved commodities from posting their worst quarterly loss since the onset of the financial crises in 2008. Despite sharp gains, both international benchmark Brent and U.S. oil futures posted their biggest quarterly declines since the Q4 of 2008. Brent crude oil futures rose more than USD6 a barrel to near USD98 while U.S. crude jumped by more than USD7 to settle below USD85 a barrel, marking the fourth largest daily gains in dollar terms since the contracts were launched. Crude prices were further supported by a strike in Norway that cut production of oil and natural gas liquids by 230,000 to 250,000 barrels a day, or up to 13% of the capacity of the world's 8th largest crude exporter.

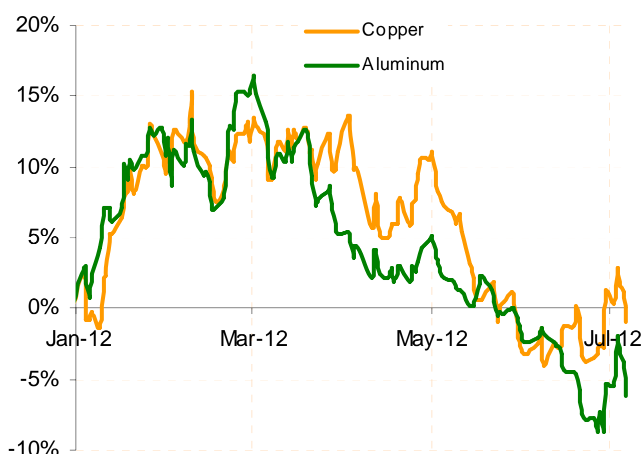
Chart 5: Reuters Jefferies vs. Gold



Source: Thompson Reuters

Gold also rebounded with a slight gain of 2.3% during June. It was the first monthly gain in five months, as the European deal alleviated the bullion's investment appeal. US gold futures for August delivery settled up USD53.80 at USD1,604.20 an ounce, with trading volume in line with its 30-day average for the first time in nearly a week, according to data by Reuters. However, gold posted a 4% drop for Q2, its biggest quarterly fall since Q3 of 2008. After an impressive 11 year run, which pushed gold prices to a record USD1,920.30 an ounce last September, it is now up just 1.2% on the year. The gain of the USD over the week pressured gold prices, which have dropped below the USD1,600 level again. Another gainer was copper, where it surged up 4% on the last trading day of June, its biggest one day gain since November. Again, even after the sharp gains, copper still ended Q2 down around 8% in New York and 9% in London, its sharpest quarterly decline since the middle of last year. Three month copper on the London Metal Exchange closed at USD7,690 a ton, more than 4% up from USD7,385 at the close on Thursday, 28th of June. In China, physical copper buyers have been restocking on a ration basis, capitalizing on cheaper prices after Shanghai copper lost over 6,800 Yuan from the year's high of more than 62,000 Yuan in February and a smaller LME-over-ShFE copper spread.

Chart 6: Base Metals



Source: Thompson Reuters

Other base metals surged, with zinc and aluminum establishing their biggest one day gains on Friday 29 June since November and breaking 20 and 14 day moving average resistances, respectively. Aluminum reached above USD1,900 per ton. As for agricultural commodities, corn, soybeans and wheat prices also powered to new highs, extending this month's unexpected rally on fears that hot, dry weather was decimating crops in the US Midwest.

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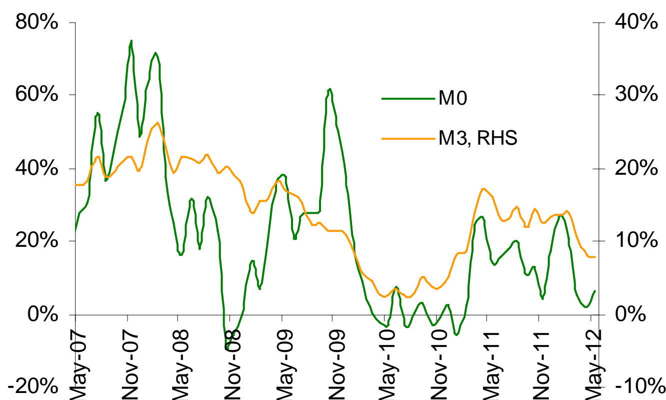
Money & Inflation
SAMA's Wait-and-See Approach

In the face of a globally adverse environment, Saudi's monetary policy has been a supporting factor to the overall growth of the economy. Although the monetary base (M0) reached an all-time record in January 2012, the pace of growth has slowed over the past three months to single digit figures. During May, M0 increased at annual rate of 6.1% while decreasing by 6.5% on a monthly basis. The contraction is due to a withdrawal of over SAR20 billion in deposits with SAMA. Further analyzing SAMA's monthly bulletin reveals an upsurge of SAR9.5 billion in local banks' total foreign assets mainly driven by due from branches abroad. Additionally, the recent local pick up in lending is expected to continue, thus utilizing large dormant cash levels.

The aforementioned contributed to the fourth consecutive monthly slowdown in money supply (M3) which grew by 7.7% Y/Y during May. Interestingly, time and saving deposits have recorded back to back annual declines from November 2009 for 25 months due to globally suppressed interest rate environment, but have rebounded and managed to record their sixth monthly gain at 1.9% in May. Moreover, demand deposits made record gains albeit at a slower pace and represent a share of 54.1% of M3, a record share. We expect the levels of demand deposits to continue outpacing time and saving deposits until European leaders structurally resolve their regional debt crisis and the global economy regains confidence to raise interest rates, which are bound to be a medium-term target.

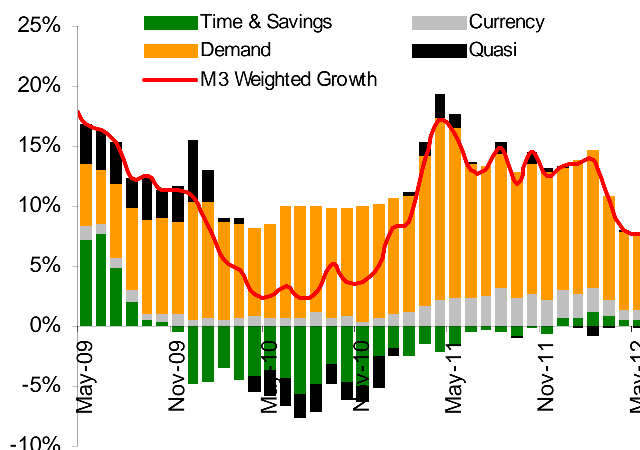
Chart 7: Growth in Monetary Aggregates



Source: SAMA, NCB Estimates

As for inflation, prices have cooled to an annual rate of 5.1% during May following a peak of 5.5% during February this year. As a worrying concern for consumers and the government alike, real estate and rental prices have been slightly fueled by the summer holidays. The category of renovation, rent, fuel & water posted a rise of 9.2% for May, matching April's rate. Prices are expected to ease once the academic year begins. Additionally, food prices have posted a gain of 4.8% Y/Y and are expected to remain elevated as businesses build up their stocks in preparation for the Holy month of Ramadan. Furthermore, the Standard & Poor's/Goldman Sachs Agriculture Index gained 11% during June, indicating higher imported inflation for the coming months as Saudi imports a large amount of food and beverages. Furthermore, the trade weighted dollar has lost 1.7% last month (see Foreign Exchange section), intensifying pressures on imported inflation.

Chart 8: Money Supply, Contribution



Source: SAMA, NCB Estimates

As for the current policy rate, officials are expected to keep the benchmark interest rate at 2% as its policy is paralleled to the US's. We believe prices will hover around the 5% level for the remainder of the year as the government maintains an expansionary fiscal policy. SAMA has not announced any measures of attempting to further subdue the inflation rate, adopting a wait and see approach, yet, SAMA is keeping an eye that lending has started to regain momentum.

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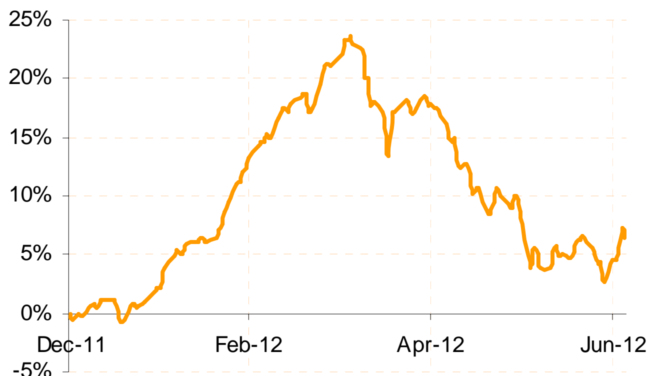
Capital Markets

Liquidity Supports Tadawul

The stock market, Tadawul, moderated from a sharp slowdown that was triggered in early April which dragged the index down by 12% by the end of May from its peak. During June, Tadawul remained volatile and was range bound confined by support and resistance levels over the month, the index only declined by 3.8% last month. Systematic risks pressured prices downwards as the global economy struggles with the European debt crisis. The only two sectors to record a gain over the month were transport, gaining by 5.0%, and hotel and tourism growing by 2.1%. The heavy weight sectors, Petrochemicals, Banking, and Cement lost 2.2%, 4.4%, and 1.8%, respectively last month. Among the worst performers were the real estate sector and the building and construction sector, dropping 9.3% and 6.6%, respectively during June. However, the recent approval of the mortgage law will certainly lift stock prices in the latter sectors and are expected to record substantial gains this month.

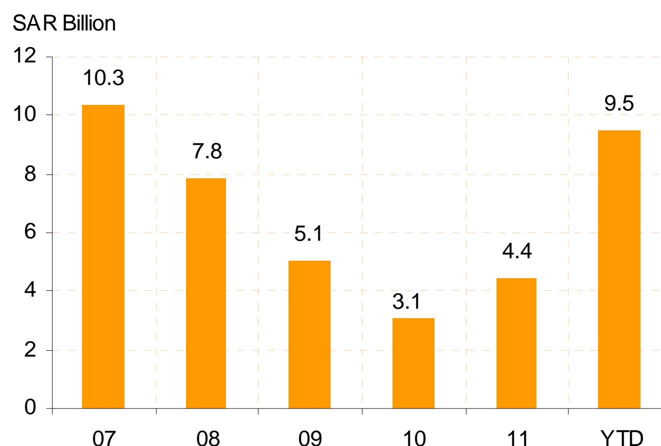
Chart 9: Tadawul All-Share Index



Source: Tadawul

The level of activity in the stock market has picked on a large scale by reaching levels unseen since 2008. Daily traded volume by the end of the first half of 2012 averaged at SAR9.6 billion in comparison to SAR4.6 billion for the same period a year ago. For the month of June, daily traded volume averaged at SAR6.2 billion, a significant 83.9% increase Y/Y, however, it recorded a 16.9% decrease over May's average. Although the attractiveness of stock prices have certainly been subdued, they remain relatively cheap in regards to the corporate earnings expected this year. We expect the year's average to settle within the SAR8-9 billion range as investors regain confidence and opt for the riskier assets. The majority of trades remain to be dominated by Saudi individuals with a lack of key market makers. Due to the fact of stringent regulations upon non-Saudi investment in the local market, their trade share for June compromised less than 2.5%, limiting the potential growth for the market. International investors are keen to enter the Saudi market given the state of the economy and the level of political stability in comparison to other Arab nations.

Chart 10: Average Daily Traded Value



Source: Tadawul

As for the primary market, Saudi Arabia has surpassed GCC markets in Initial Public Offerings (IPO) for the first half of 2012. In June, Saudi Airlines Catering offered 24.6 million shares at a price of 54 to raise a total of SAR1.3 billion. The offering adds to the tally of 2012 IPOs YTD to reach SAR3.8 billion raised for new entrants. The Saudi market is regaining its status as a leading market in the region with respect to growth and depth. The rise in IPOs indicates the growing business environment and the potential development ahead of the Capital Market Authority (CMA) to offer a diverse selection of investment opportunities such as options and swaps. Additionally, the Sukuk and Bonds market still lingers in the early stages of its lifetime. Activity was non-existent during May and June. However, CMA has announced the approval of SABIC and SEC requests to buy-back their SABIC Sukuk 2 and SEC Sukuk 1, a whole 15 years ahead of their maturity.

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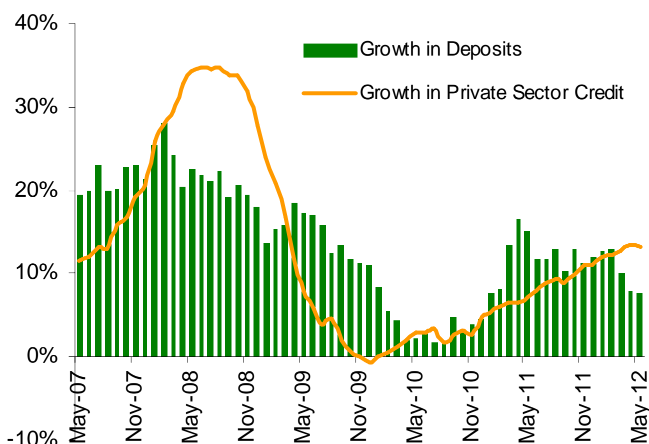
Loans Market

Sustainable Credit Levels

Towards the end of 2011, local banks regained their confidence and lending started to pick up, with the momentum carrying throughout 2012 thus far. Banks have the ability to expand their loans portfolios given the ample liquidity provided by the vast inflows of deposits over the past few years. However, the pace has slowed given the investment opportunities in the robust economy and the sudden surge in the local stock market. Total deposits grew at 7.6% by the end of May, the slowest pace since December 2010. Demand deposits, holding a share of over 60% of total deposits, reached SAR684.9 billion. Meanwhile foreign currency deposits edged higher by 6.3% on an annual basis, driven by deposits of government affiliated entities.

Chart 11: Private Sector Financing



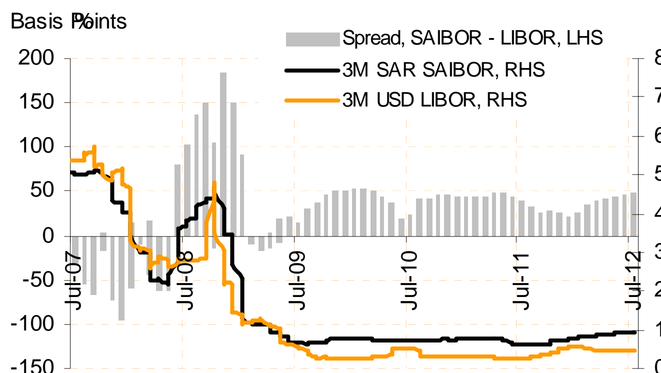
Source: SAMA, NCB Estimates

On the financing front, total claims of the banking system, excluding T-bills and government bonds, posted a fifth consecutive increase in growth to reach 14.7% Y/Y in May at SAR921.5 billion. Unlike previous years, so far this year the loans portfolio accelerated at a faster pace than the flows of deposits into banks. Furthermore, credit to the private sector gained 13.1% on an annual basis, indicative of the strong private business growth, which will reflect on the economy. Fresh lending was focused towards the consumer and credit cards category as witnessed in 2011, which are expected to carry forward into 2012 given the ample opportunities in the retail segment. The newly approved mortgage law will allow banks to penetrate a huge demand in housing market (see Special Focus). Saudi families have been struggling to own their houses and the law will bridge the financing gap, providing more affordable loans to borrowers while ensuring protection for lenders. Meanwhile, aggregate claims on the public sector dropped by 12.3% Y/Y due to a sharp contraction in T-bill levels. During May 2011, T-bills recorded its highest level at SAR176.9 billion due to efforts by SAMA to mop up excess liquidity in the market. This year, T-bills posted SAR129.4 billion, dropping almost 27%, this led to the noticeable drop in credit to the public sector.

Local banks continue to struggle with maturity mismatches as a large portion of their credit resides in short -term financing. The share of short term bank credit is still relatively high as it currently stands at 58.5%, albeit lower than the record high level of 65.1% during March 2009. Long-term maturity credit holds a share of 24.1%, while medium-term credit presents the remaining share. Given the vast amounts of large projects, banks are constrained by asset/liability mismatch and are unable to expand their balance sheets with long-term assets. Accessing the capital market, locally or internationally, with issuances of long-term debt will lure investors in opting to supply the banks with the needed long-term liability in Saudi Riyals or USD to remedy the constraining funding base.

The interbank market remains subdued owing to the extremely low policy rate taken by SAMA. However, Saudi interbank overnight rate (SAIBOR) has been rising since late September 2011 from 60bps to 93bps by the end of June 2012. Interestingly, interbank liabilities have gained a substantial 78.2% Y/Y, the highest level since November 2009. The increase could be clarified by the rise of lending activity, which probably enticed the need for greater cash level management during the period. We do not foresee a sharp rise in SAIBOR in the short-term

Chart 12: Liquidity and Risk Detector



Source: Thompson Reuters

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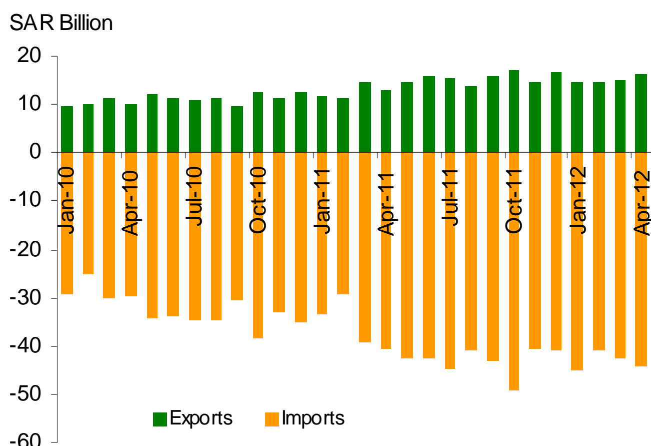
External Trade

LCs Point Towards More Opportunities

Saudi non-oil exports have increased in 1Q by 11.4% compared with the same quarter last year to reach a total of SAR44.1 bn, the highest figure since 2009. The biggest contributors to the rising trend are petrochemicals and plastics exports which recorded a Y/Y growth of 24.1% and 13.1%, respectively. The high increase in petrochemical products in value terms compared to the 3% increase in tonnage is in line with elevated oil prices stemming from the geopolitical developments especially, the US-Iranian standoff. The largest export market by weight remains the UAE and China, which both increased moderately by 12.8% and 11.6%, respectively. However, Qatar marked the highest surge in demand for Saudi exports rising from SAR1.5 billion to SAR2.3 billion, a lift of 48%, which reassures an increasing reciprocal dependency on intra GCC trade amidst the current global political and economic turbulence.

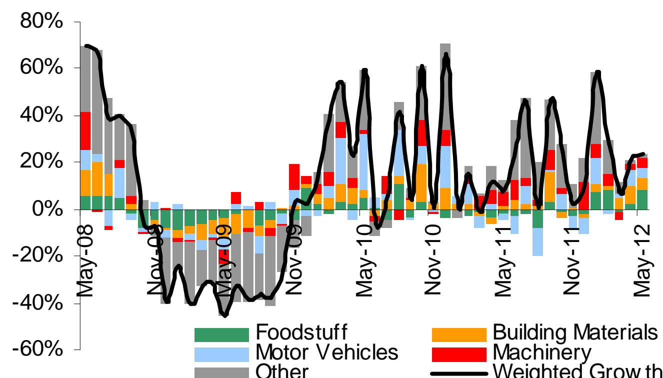
Chart 13: Saudi Non-Oil Trade Balance



Source: CDSI, NCB Estimates

As for Imports, 1Q12 showed an 18% upturn compared to 1Q11 as foodstuffs and base metals dominated imports, rising by 49% and 37% by weight, and by 20% and 33% in value terms, respectively. Major import markets such as China and Germany have both shown a 34% increase in value; however, Chinese imports have only increased by half the weight of the German counterparts. Locally, settled LCs have recorded a sharp increase of 19.5% Y/Y, rising to SAR106.0 billion since the beginning of the year in comparison to SAR88.7 billion for the same period last year. Looking forward, newly opened Letters of Credit (LCs) accumulated SAR89.4 billion since the beginning of this year, a 25.8% increase over the same period of last year. Also, annual growth has increased by 23.7% in May, up 10.7% over previous month's. Meanwhile, total newly opened LCs are expected to continue to rise for the remainder of 2012 following May's SAR18.9 billion, a growth of 8.1% M/M indicating that the economy is performing well and is set to reach a record high.

Chart 14: Attribution Analysis of Letters of Credit Opened



Source: SAMA, NCB Estimates

The biggest contributor to the newly opened LC's increase was the 1331.9% M/M rise in the category of fruits and vegetables followed by a 131.5% monthly increase in food and grains, which reflects the annual stocking up in preparation for Ramadan. Alternatively, livestock and meat marked the biggest retreat of 28.6%, followed by a contraction of 26.8% in sugar, tea and coffee. Imports of motor vehicles increased by 36% M/M, reaching SAR3.2 billion, as automobile wholesalers continue to stock on new models, while LCs for building materials have fallen by 7.6% due to an increase in local production.

Private sector exports show a 16.9% Y/Y increase in Q1 by importing countries. This is facilitated by a 944.2% Y/Y increase in LCs from Latin America, followed by a 398.4% increase in other non-western European countries. In addition, the strong intra-trade between the GCC countries indicates stronger trade ties as they recorded a staggering growth of 46.9% Y/Y in value terms. On the other hand, geopolitical tensions in other Arab countries and the Euro zone's sovereign debt crisis have warded off LCs by declining 36.6% and 48.6%, respectively.

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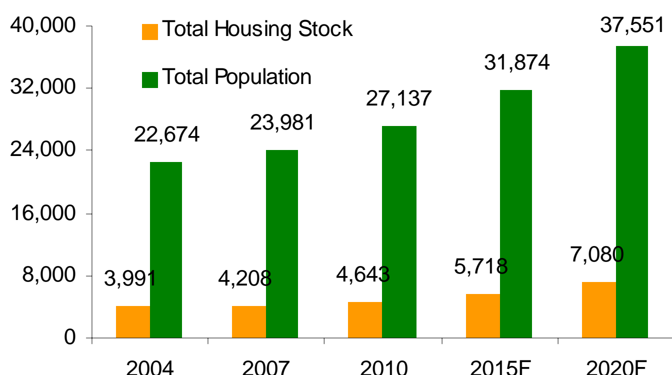
Special Focus:
Mortgage Law's impact on Housing Sector

The recent approval of the long awaited mortgage law by the Council of Ministers this past week has been a welcomed development by all players in the housing sector. The housing sector's growth and diversification of financing alternatives is largely dependant on a robust law where legal committee rulings are enforced. The lack of a mortgage law in the Kingdom has hindered the potential growth in the housing sector leading many financial institutions and developers to maintain low risk portfolios. While we expect the momentum to gradually shift towards the implementation of higher risky offerings by banks and developers, the immediate short-term behavior is to maintain cautious optimism by taking a wait and see approach.

The Shoura Council's approval of the mortgage law and subsequent passing to the cabinet last year signaled the inevitable ratification by the Council of Ministers. The passing of the mortgage law is expected to help convince individuals and entities to enter the housing market, whom would otherwise hold off in the absence of a law. However, the law clearly addresses solutions to the pent-up demand for housing by the middle to high income segment, but does not address the inherent supply shortage of affordable housing. Additionally, until precedence has been set, the enforcement and full applicability of the law will be unknown.

Chart 15: Housing Market Size vs. Total Population

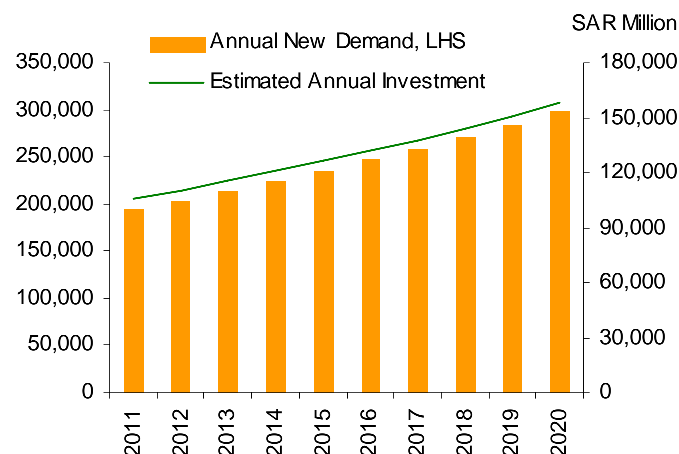


Source: NCB Estimates

The housing sector will begin to witness a measured development of an active secondary market, whereby mortgage lenders will be able to sell the assets on their balance sheets and utilize their capital more efficiently. Additionally, mortgage securitization will allow originators of the loans to diversify their risk by enabling them to secure immediate liquidity for assets. An increase in loan tenors, with the expectations of higher returns, would make the assets more attractive to the secondary market, especially for institutional investors such as GOSI and investment banks.

The mortgage law is one solution out of a few that will help address the housing market challenge. Recent developments including the housing related royal decrees and the partnerships between banks and the Real Estate Development Fund will provide much needed support. The allocation of SAR250 billion to build 500,000 housing units, which was announced last year, will largely benefit the low income segment. The average value of SAR500,000 per home falls within the range of what is affordable to the lower income population. Additionally, the speed at which these homes are expected to be erected underscore the urgency the King has set forth to ensure these affordable homes will be completed within the short to medium-term.

Chart 16: Housing Demand vs. Investment Needed



Source: NCB Estimates

The REDF's increase in loan size from SAR300,000 to SAR500,000 along with the supplementary bank lending will primarily cater to the middle income segment. This will allow Saudi families to either build or purchase an existing dwelling unit such as a villa at a cost that exceeds SAR500,000. As the mortgage industry matures and competition heightens, the middle income segment will stand to benefit the most from competitive mortgage rates and lower risk criteria set forth by lending institutions.

Although all income segments will be positively impacted from the enactment of a mortgage law, those within the affluent segment will have greater freedom to either finance the construction of their own houses or to invest in the housing sector. Current lending by banks use various forms of financing but prefer the Ijara scheme due to the lack of a mortgage law. The mortgage law would allow for greater use of Islamic financing schemes within mortgage lending such as Murabaha, which would allow the buyer to retain ownership of an asset.

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