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ABSTRACT

The Role of Financial Intermediaries in Saudi Arabia's Development with Particular Reference to the National Commercial Bank

by

Fatima Mohammed Saleh Affara

The purpose of this thesis is to examine the role of financial intermediaries in Saudi Arabia's development with particular reference to the experience of the National Commercial Bank, the oldest bank in the Kingdom and the largest in the Middle East.

The objective of the work was to reveal to what extent financial intermediation was involved in the development process of Saudi Arabia? Were commercial banks a prerequisite for development or was their growth a consequence of it? Was the development financed through Saudi Arabian financial intermediaries or was it funded from elsewhere, namely, revenues from crude oil disbursed through government spending? As a result, was the financial system permitted to deepen its financing or merely widen its activities? Was the Saudi Arabian government's role in development so great that commercial banks experienced crowding out?

These issues were explored by examining the overall position of the commercial banks, and the National Commercial Bank in particular. The case study of the National Commercial Bank's financial statements and financial ratios over a period of two decades revealed its unfolding role within the economy. An investigation was made of the competitive position of the National Commercial Bank vis-a-vis other banks, and the fluctuations in its market share of deposits and loans was assessed. Finally, interviews and surveys revealed the bank's new managerial strategies and its plans for future business development to serve the needs of its clients.

It was found that the liberalisation of the Saudi Arabian financial system had contributed to the Kingdom's economic development, and resulted in changes in institutions such as the National Commercial Bank which meant they could play an increasing role in the funding of industrialisation.

Dedication

This work is dedicated in memory of two very special people. Sheikh Salem Bin Mahfouz, the founder of the National Commercial Bank and the inspiration behind this work, and to my aunt, Ne'ma Affara, who taught me the value of knowledge and education.

ACKNOWLEDGEMENT

I am deeply indebted to my supervisor Dr. Rodney Wilson who has guided me through this research and provided invaluable advice and encouragement which has helped to bring this dissertation to a close.

I also wish to convey my gratitude to Sheikh Mohamed Bin Salem Bin Mahfouz, Chairman and General Manager of the National Commercial Bank, as without his help this thesis would never have come to being. My extended appreciation also goes to the staff of the bank.

To my parents, husband and daughter, Mona, I wish to express my admiration for their understanding enthusiasm and reassurances during my studies.

I am also grateful to my friends Feroza Cooper and Avril Shields for their kindness and support.

Finally, I would like to thank the Department of Economics and Durham University Library staff for their constant assistance.

Durham, December, 1995.

The Role of Financial Intermediaries in Saudi Arabia's Development with Particular Reference to the National Commercial Bank

by

Fatima Mohammed Saleh Affara

Thesis Submitted in Partial Fulfilment of the
Degree of Doctor of Philosophy

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University of Durham
Department of Economics

1995

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ABBREVIATIONS

ANB = Arab National Bank
AOC = Arabian Oil Company
ARAMCO = The Arabian American Oil Company, later American was omitted
ATM = Automated Teller Machine
BAJ = Bank Al-Jazira
BSDA = Banker Security Deposit Accounts
CD = Customer Deposits
CPO = Central Planning Organisation
D.F = Degrees of Freedom
D.W = The Durban Watson Statistics Test
EFTOPS = Electronic Funds Transfer Points of Sales
GCC = Gulf Central Council
GDP = Gross Domestic Product
GSFMO = Grain Silos and Flour Mill Organisation
LR = Lending Ratio
MOAW = Ministry of Agriculture and Water
NADCO = National Agriculture Development Company
NCB = National Commercial Bank
NP = Net Profit
NTS = Netherlands Trading Society
OAPEC = Organisation of Arab Petroleum Exporting Countries
OPEC = Organisation of Petroleum Exporting Countries
PETROMIN = Ministry of Petroleum and Minerals
PIF = Public Investment Fund
RB = Riyadh Bank
RJH = Al-Rajhi Banking Company
ROA = Return on Assets
ROE = Return on Equity
ROEBP = Return on Equity Before Provisions
ROI = Return on Investments
SR = Saudi Riyal
SAAB = Saudi Arabian Agriculture Bank
SABIC = Saudi Arabian Basic Industries Corporation
SADF = Saudi Arabian Development Funds

SAMA = Saudi Arabia Monetary Agency
SAMAREC = Saudi Arabian Marketing and Refining Company
SAMB = Saudi American Bank
SBB = Saudi British Bank
SC = Staff Cost
SC/TA = Staff Cost to Total Assets
SCB = Saudi Cairo Bank
SCECO = Saudi Consolidated Electric Company
SFB = Saudi Faranse Bank
SHB = Saudi Holandi Bank
SIB = Saudi International Bank
SIDF = Saudi Arabian Industrial Development Fund
SOCAL = Standard Oil of California
SRO = Saudi Railway Organisation
SUCB = Saudi United Commercial Bank
SWCC = Saline Water Conversion Corporation
TA = Total Assets
TD = Total Deposits
TL= Total Lending
TOP = Total Operating Profit

Declaration

No part of this material has been submitted for a degree in this or any other university.

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Chapter One

Introduction



The objective of this chapter is to introduce the research conducted by the author into the role of financial intermediaries in Saudi Arabia's development with the National Commercial Bank (NCB) as the case study. The aim of this study is to give further insight into the Saudi financial system, its evolution and participation within the economy. The motivation for the study was the limited amount of research conducted on financial intermediaries in Saudi Arabia and in particular on the NCB, the oldest bank in the Kingdom and the largest in the Middle East.

The research consists of twelve chapters, including the introductory and concluding chapters. All chapters are designed to discover the answers to the objective of the research, which is to determine whether or not financial intermediaries played an active role in the development process of Saudi Arabia, or if they were merely spectators? Were the financial intermediaries a prerequisite for development in Saudi Arabia? Or were they a consequence of development? What was the drive behind the Saudi Arabian development process? Was it financed through banks or other sources, namely income from oil? Were the banks given a chance to participate in the development or were they left out completely?

A survey of financial policies in developing countries was necessary in order to look at the traditional role played by financial intermediaries in the development process and the implications for the Saudi Arabian financial system. This revealed the theoretical hypothesis to be tested. The importance of financial intermediaries for the development process was manifested here, and the vital role financial deepening and widening plays in the long-run success of development. Thus, the underlying objective of the thesis is to determine to what extent intermediation has been involved with development? Were the banks allowed to deepen their finance or merely widen it? Did the Saudi Arabian government control the financial intermediaries thereby hampering their involvement in the development process? Or, was it because the Saudi Arabian government was pressing for development that it could not wait for its intermediaries to develop first?

It was first necessary to examine the different economic sectors within the Kingdom

starting with the oil sector and its finance, as the major export commodity from the Kingdom. The importance of oil for the development process was revealed, and a study of oil revenue showed that the government could easily depend on its income to finance development for the most of the 1970's and early 1980's. This was apparent when the other economic sectors were examined to see whether banks were involved in lending or not. At the same time an examination was made of the objectives of the government in financing certain development projects. Could the financial intermediaries in the Kingdom contribute to the development process if they tried to? Or was the government lending at such attractive rates that it would have been impossible for them to offer similar packages?

A study of the Saudi Arabian government's fiscal and monetary policies was also necessary to understand the drive behind development, and to see whether or not intermediaries were involved in raising finance for government deficits through the issue of bonds...etc. As a result, the role played by the Saudi Arabian Monetary Agency (SAMA) had to be examined and its involvement with the financial intermediaries discussed.

The NCB was then chosen as a case study and, its traditional role in the economy was examined. In fact, through the NCB, the history of financial intermediation within Saudi Arabia begins to unfold. These included interviews conducted with the founder, Sheikh Salem Bin Mahfouz, an intrepid entrepreneur. The role of the informal market and its early contribution to the government was revealed. The difficulties faced by the NCB in its early years and its role as banker to the government, even after SAMA was established, were also brought to light.

A study of the NCB's financial statements to see the banks overall performance in relation to the economy was then necessary. A discussion of the most important items in the balance sheets and profit and loss statements for a period of three decades was conducted. The degree of monetisation was the underlying question, and the examination of the spread of the banking habit. Have Saudi Arabian nationals perceptions of banks

changed from the reliance on cash for their transactions to the dependency on checking accounts? An examination of saving and loans was made to determine whether or not they affect the economy, or if they are themselves affected by the economy.

In order to obtain more insight into the NCB's performance in relation to the economy, financial ratios were calculated and analysed to reveal the overall picture of the NCB's development over the period 1969 to 1989. The bank's liquidity levels were examined to see whether or not it has any affect on the money supply. Attention was then directed to the bank's management of its liabilities to see whether or not it was using its funds to maximise its profits. There was also the issue of whether or not the bank found lending opportunities in the Kingdom. A look at the bad debt problem experienced by the NCB was also necessary, as well as its profitability performance in relation to the economy. The Saudisation process brought competition to the doorstep of the NCB. This was reflected in the ratios, and the research shows the bank's reaction to competition and its response to economic forces.

The banking industry was then looked at in greater detail and a study of the major banks in the industry was carried out. The NCB's competitive status was extensively examined, as it moved from a monopolistic situation to one of duopoly, and finally with Saudisation, greater competition was created. This chapter showed the financial widening experienced by the banks in Saudi Arabia and the ever increasing use of technology in their services. The market share of the NCB was examined and the question of why increases and decreases had occurred were posed and answered. The NCB and the other Saudi banks were evaluated, based on their market competitiveness (in terms of asset, equity, deposits,...etc) and efficiency ratios (operating cost, employment performance, ...etc). Based on this analysis several matrices were produced ranking the Saudi banks based on their performance score.

The penultimate chapter deals with the NCB's new managerial strategies and its business plans for the future. What drove the bank to develop new strategies, and what was behind this change in thinking? Several interviews were conducted with the bank's

officials during a visit to Saudi Arabia in January 1995 to discover the bank's operational thinking, and the strategies behind the new changes implemented during the last two and half years. Management changes had been carried out in order to enhance the bank's competitive position. The bank, as part of a review of its activities, conducted several surveys. How did the bank analyse its market position i.e. what surveys did the bank conduct in order for it to ascertain its market position and its internal strengths and weaknesses?

The objectives of the bank's first two surveys were to study customer satisfaction: the first looked at retail customers, while the second was directed at corporate customers and clients of high net-worth. One of the main questions raised was why customers were switching between banks? This helped the bank to understand what it had lacked in services and facilities that were of sufficient importance to customers, that they would change their bank. Brand mapping analysis was used to identify the bank's position amongst its peers according to certain selected factors. Another objective of these surveys was to understand the NCB's image. What type of customer banks at the NCB and in what age group? This would help determine the size of the future market share. The type of account held by clients was then under analysis. One aim of these surveys was to ascertain clients' opinions of the bank's services i.e. what do they think of the quality of services in terms of efficiency, friendliness and length of queues.

The third survey was concerned with the NCB's staff attitudes. Were the staff satisfied with their responsibilities? What was their attitude towards the new strategical changes adopted by the bank? Staff were asked to outline their career aspirations in order to determine their attitude towards the meaning of success and the way to achieve it. The survey also determined staff attitude towards continuous training and education and whether or not they felt that the NCB was providing adequate support for this. Further questions dealt with staff knowledge of the bank's products and whether there was perceived to be equal opportunity within the working environment.

The final survey, the mystery shoppers approach, was concerned with the branch

services of the different banks in the Kingdom in comparison to the NCB. This was a survey that was to take place at regular intervals in order to measure the efficiency in the delivery of banking services, the quality of service provided by tellers, customer services, telephone operations and premises. Had the NCB's branches improved their performance within the industry and had they improved their performance compared to their own previous position? Hence, the bank had finally become aware that in order for it to survive it was no longer enough for it to be "the NCB"; it needed to provide a good service and quality products, and therefore excellent staff is of the essence.

In the appendix the results of further analysis of the NCB and its performance in relation to the economy is presented. An attempt was made to see whether the NCB played an active role in the development process in Saudi Arabia, or if it was a mere spectator complementing the government and its development agencies in the industrialisation process? Did the bank experience a crowding out effect from a government that was overzealous in its development plans and expenditure? The relationship between the NCB's finances and the government's finances was examined graphically. The aim of the appendix is to examine whether or not the NCB played an active role in the economy, in terms of the financing of development, or if the government finance, mainly from oil revenue, was closely related to macroeconomic aggregates.

The intention of this research is to reveal the forces responsible for the evolution of the Saudi Arabian financial system, and to provide an evaluation of its financial intermediaries in relation to the industrial progress and development of the economy. It is hoped that this will provide an insight into the future of the banking industry in the Kingdom.

Chapter Two

Financial Policies in Developing Countries

It is generally presumed that one would find banks present at the very core of a country's financial edifice. In fact, in developing economies, one would expect that banks would perform a major part, since in these countries other financial intermediaries do not prevail.

In most developing countries, the banking sector is viewed as the *sine qua non* of its economic success and is expected to supply the necessary monetary credit to maintain the steady, yet dynamic progress of the economy. Unfortunately, this was never the case in Saudi Arabia. In the last three decades of the country's development process, the commercial banks found themselves playing a passive role in the economic activity of the Kingdom, since the government possessed both the financial means and power to steer the country's transformation.

In order for a country to develop, it must invest, and in order for it to invest it needs financing. Hence, it would be the norm for a country to encourage saving so that these funds are then used for investment. However, in a country such as Saudi Arabia, where government income from oil was abundant, the government had all the finance it needed to develop. Nevertheless, it still needed banks to distribute these funds, but it was not commercial banks it used, rather its own development bank agencies. Saudi Arabia could not wait for its national banks to evolve to the levels necessary for them to be able to participate in the development process. The government was far too eager to achieve economic development at an accelerated rate. In the early 1970's, the only existing banks with multiple branches were the NCB and the Riyadh Bank, and these were unable to absorb and manage the high level of funds received by the government from oil revenue, and to distribute them appropriately to the most efficient channels of investments.

Today, Saudi Arabia has reached a different stage in its development process. It can no longer rely mainly on its income from oil for development. It must now steer its financial intermediaries to efficiently utilise and invest the available savings in order to continue the country's drive towards economic development. It is necessary at this stage to investigate as to what extent the banking system has evolved in Saudi Arabia. Has it developed in line with the progress of the economy? Or, has it merely "ambled along" with economic development, and in reality merely had a superficial impact? Was it given

the chance to develop? Or was it continuously hampered by the over ambitious goals and objectives of the planners? Most importantly, has Saudi Arabia as a result of its development process, enabled its financial system to deepen or has it merely widened? Hence, now that Saudi Arabia's income from oil has dwindled and its financial reserves became depleted, it must now allow its intermediaries to participate in the development process of the country, and it is up to the government to ensure that a suitable economic climate is created for those intermediaries to succeed. For this to be accomplished, commercial banks must first assume their true role in the country's overall economic aspiration, which means that they must also first ensure that their organisation and its management are efficient and competitive.

To what extent are banks a prerequisite for development, or are they a consequence of development? In order for us to answer this question, it is necessary for us, at this stage, to look at economic development theories, and to determine whether or not banks have an important role in development and also to compare the theoretical expectations with the actual Saudi Arabian performance.

2.1 Monetary Policy

In a developed or developing economy, monetary policy is manipulated to stimulate savings. This is done through financial intermediaries. At this point, let us say commercial banks - since they are virtually the only form of financial intermediation that exist in Saudi Arabia - encourage people to save money by offering them secure interest, with minimal risks attached. The intermediaries develop a branch network, which allows them to target both large and small savers. In a thriving developed economy, financial intermediaries will then competently assign the funds to the most lucrative sources. Thirlwall (1994) argues that it is vital that interest rates are consistent with the expectations of the financial market. He goes on to argue that a successful and developed financial system, would have achieved four well established requirements, which would help the financial system to accomplish its ultimate goal of financial deepening and hence to nurture the necessary and continuous increase in aggregate savings. Thus, the first requisite to attain this goal would be that the barter economy is fully replaced by a monetised one; secondly, there must be a central bank; thirdly, the development of

financial intermediaries and finally the mobilisation of an efficient and regulated capital market.¹ All these will be further discussed in this chapter.

2.2 Monetisation and the Supply of Money

Monetisation defined as "the enlargement of the sphere of the monetary economy"² is often taken for granted in today's literature. Chandavarkar emphasises and discusses the importance of the level of monetisation in a developing economy and explains the relevance of the monetisation ratio defined as "the proportion of the total of goods and services of an economy that is monetised in the sense of being paid for in money by the purchases."³ It is generally expected that monetisation is important to the study of economic development but little work and study has been made of its theoretical and empirical bearings on the developing economies.⁴ Chandavarka in his paper stresses the part played by monetisation in monetary policy and its formulation.⁵

Nevertheless, it is accepted that an economy that does not use money as an exchange medium, is a dated one and that it is no longer necessary for money to have its exact value in gold or silver. Today, monetary value is a fiat one i.e. debt circulated by central banks and accepted as legal tender. As activities in the economy develop and markets expand and become more specialised, another financial instrument is created, namely convertible deposits i.e. deposits that can be cashed immediately and generally bear no interest. Then, as the financial system progresses further a new instrument appears, time deposits; immediate withdrawal is not allowed but interest is earned on the amount deposited. These convertible & time deposits are considered as liquid assets. However, cash is accepted as the most liquid of all assets. Gillis et al. argue that the issue of "liquid financial assets" is of great significance when dealing with financial policy in developing countries. The transfer of funds in and out of liquid financial assets, could be the major force responsible for the making or breaking of a country's financial policy. The movement of finance from fixed assets such as land, property, ...etc., into accounts held at banks, increases the liquidity in the market, which is then lent to investors and hence results in economic growth and development.⁶

Todaro explains that monetary policy is the manipulation of two essential economic

requirements. Firstly, the levels of circulated money which is made up of currency and commercial bank current accounts (M1), and secondly the level of interest rates. He argues that economic activity can be explained by the levels of the money supply i.e. the broader the money supply the greater is the economic activity, and hence development.

At this stage, one needs to define the term money supply. It is the aggregate of liquid assets in a country's financial system. There are usually three definitions of money:

1. Narrow Money (M1) = actual money in circulation outside banks (C) plus demand deposits in banks (D)
2. Broad Money (M2) = M1 + time and savings deposits (T)
3. Broadest Measure of Money (M3) = M2 + liabilities of specialised institutions (O)

Gillis et al. explain that the majority of low income and many middle income countries tend to hold more liquid assets in the early stages of development. They go on to say that, as income steadily increases and the financial system develops it is the less liquid assets - such as stocks, bonds (both government and businesses) and other physical assets that can be transferred to cash with only a slight risk of loss to the holder, that become more prominent in the financial system. Thus, as income increases from extremely low levels, one would notice that the first growth experienced would be in the demand deposits, then in time deposits. As the financial system matures and incomes rise to high levels, there would be growth of the less liquid assets mentioned above. It is often the case that commercial banks are unable to offer these primary securities. However, it is worth noting here that liquid assets are not the sole factor responsible for financial growth. As the pecuniary economy expands, financial markets widen, but they are also apt to deepen as a broader assortment of financial assets mushroom. It is this issue that is of concern to the researcher in relation to the Saudi Arabian financial market.⁷

Monetarists argue that, by manipulating the expansion of the money supply, the authorities in developing countries can coordinate their countries' economic activities and hence control inflation. The Keynesians postulate that a growing money supply would raise the levels of loanable funds and that if the loanable funds are greater than the actual market demand then the rate of interest will drop. They go on to argue that, since private

investment is expected to have an inverse relationship to the existing interest rate levels, then it follows that as loanable funds in the market increase, interest rates will drop and entrepreneurs will therefore borrow more to invest since the cost of borrowing has decreased. As investments rise, this will result in an increase in the total demand, and hence greater economic activity which leads to an increase in GNP and employment. By the same token, when aggregate demand and inflation increases, authorities tend to use repressive monetary policies formulated to cut back the growth of total demand. This is done by decreasing the money supply (i.e. reducing the amounts of loanable funds available by increasing bank reserves and interest rates). In Saudi Arabia, this is done through the increase of statutory reserves since increasing interest rates is not officially permissible in a country where interest is taboo. This results in lowering investment levels and presumably will reduce inflation.⁸

In order for a country to be able to regulate and vary its money supply and the cost of loans, it will need to operate a well planned, interactive and proficient capital market. This often does not exist in developing economies. Another factor that would facilitate the control of the money supply is if the developing countries' economies would be more open. The aggregation of foreign currency earnings is an important but extremely volatile derivative of domestic financial resources. Another hindrance to the computation of the money supply would be currency substitutions.⁹ In Saudi Arabia, the riyal is pegged to the US Dollar and has been kept at SR3.75/\$ for a long time now, which means Saudi nationals can hold Dollar accounts at practically no risk of loss. The final set back to controlling the money supply would be the existence of the informal money markets. In Saudi Arabia those would be the money changers/lenders. Here, the government has no control over these organisations. However, in recent years several Banking Control Laws have been passed, thereby reducing the moneychangers' power, to the extent that they are only allowed to act as a *Bureau de Change*.

The second requirement of monetary policy in developed economies would be the manipulation of interest rates. It is generally accepted that low interest rates means higher investments and thus growth in output. This fails to explain the fact that sometimes an investor's choice to invest completely ignores interest rates. Further, the assumption that output would grow automatically, fails to recognise that often it is difficult for output to

expand because of supply restraints, even though demand is high. The ultimate result of this would be increased prices, hence inflation. ¹⁰

Monetary expansion is also necessary to permit a larger volume of transactions to be carried out. Consequently, the government can use this expansion in the money supply to invest in development projects. As money in circulation increases, it boosts the development of banks and credit organisations, who in turn stimulate investment and savings. ¹¹

2.3 The Financial System

Gillis et al. state that "it is well established in the literature on money and international trade that, given perfect capital mobility and fixed exchange rates, small countries will find monetary policy ineffective." ¹² By the beginning of the 1980's, this view had changed. Many argued that when financial policy was efficiently manipulated, it could provide stability for a short period of time. A less widely acknowledged view is the assumption that financial policy can affect economic development in the long run.

In fact, early opinions about the influence of financial policy on economic development were, if anything, complaisant. ¹³ However, in the late 1960's, these opinions were contradicted by Edward Shaw and Ronald McKinnon. ¹⁴ Their ideas will be extensively discussed later in this chapter. However, in the last twenty years it has become more apparent that financial policies play a significant role in the mobilisation of savings and its distribution to the most profitable of investments. ¹⁵

Much research has been carried out to determine the importance of finance to the development of industry within an economy. Goldsmith (1955, 1966, 1968), Cameron (1967, 1972) and Patrick (1966) all argued that the formation of a financial system is vital to a country's economic progress, as it can either enhance or curb growth. Goldsmith's (1955, 1968) work on the US observes that as the economy develops so do financial intermediaries and their services, this was also noted by Cameron (1967, 1972) in his studies of countries in the late nineteenth century. ¹⁶

Gillis et al. categorises the functions of a financial system into various vital services

that ensure the uninterrupted flow of the economy. The financial system, first and foremost gives an exchange medium, namely money. It secondly, facilitates the mobilising of savings from many different channels and then distributes them to investors. This is normally done through financial intermediaries e.g. banks. Thirdly, as a result of the second point, it shifts and diffuses risk throughout the economy. Finally, it supplies an array of policy tools that ensure the well-foundedness of economic activity.¹⁷

2.4 The Development of the Banking System

The majority of developing countries have a banking system that can be divided into the following: A central bank (SAMA in the case of Saudi Arabia), a commercial banking system (of which the NCB is the oldest and largest), development banks and finally informal financial agents (namely the moneychangers/lenders in Saudi Arabia).

2.4.1 The Role of Central Banks in Developing Economies

Central banks carry out a wide spectrum of activities i.e. regulatory, banking and they also have to oversee the banking industry in general. They have large public duties and a wide range of managerial responsibilities.

The central banks' functions can be divided as follows: First, it is in charge of the issue of currency; and secondly, it acts as the banker and lender to the government. The central bank can ensure that the government is given access to the available financial resources in order to invest in the public sector. In the past, the Saudi Arabian government was able to rely solely on its income from oil for the maintenance and development of the public sector. Now, as its income and resources have depleted, it must look to other sources of finance, namely, through SAMA. Thirdly, it holds statutory reserve requirements from the commercial banks, which allows it to control the money supply. In recent years it has started to issue government development bonds, which help to control the money supply and more importantly, encourages the expansion of the bond market itself. This helps the development process without the need to drastically increase the money supply. Fourthly, it supports the establishment of alternative financial organisations, in particular, those with the ability to give long-term loans for the purpose

of development projects and those who can create markets for government securities. This is essential for the financial deepening process, a process that has just started in Saudi Arabia. Fifthly, to ensure the level of aggregate demand is maintained in order to achieve steady growth, and finally to make sure that loans given by the commercial banks are channelled to those sectors of the economy with development potential in order to continue the country's strive towards becoming a developed economy.¹⁸

Todaro (1994) points out that central banks in developing countries have many obstacles to contend with, but I have only chosen those that are directly applicable to the Saudi Arabian economy. He argues that in a developing country, the economy is overshadowed by a small number of exports and an enormous range of imports, with the likelihood of prices being outside the country's control. This scenario is typical of Saudi Arabia. He then goes on to discuss the developing countries' financial systems and describes them as "rudimentary" and with the following attributes:

Firstly, their commercial banks are foreign-owned and often only finance domestic and export industries (in Saudi Arabia prior to Saudisation the foreign banks only financed exports and looked after the interest of their own expatriates, however, with the Saudisation process these banks have now become completely involved in the Saudi Arabian economy - government permitting).

Secondly, according to Todaro (1994), the financial system has an informal, lending network which provides loans to the majority of the rural society. In Saudi Arabia, the informal market is predominantly controlled by the money changers/lenders, but generally these are not exploitative compared to their counterparts in other developing countries.

Thirdly, according to Todaro (1994), often it is very difficult to actually quantify the money supply as the domestic currency is easily substituted for another and this hampers the government's attempt to regulate its expansionary or contractionary policies. This is also true of Saudi Arabia due to the riyal pegging process and its complete convertibility.

Fourthly, the national workforce is often unqualified and unprofessional, lacking the requisite experience for the efficient management of both local and international financial

requirements. Saudi Arabia realised that its local labour force was inexperienced and unskilled from the start and therefore, it has continuously encouraged its nationals to further their horizons. However, it still relies on expatriates for technical expertise.

Finally, the governments of developing nations have almost always exerted their control over many aspects of financial policy e.g. interest rates, foreign exchange rates, import licenses...etc., aspects that developed nations' governments try to avoid intervening in. In Saudi Arabia the government has also done this but only to a limited extent, as the currency is convertible. Intervention has largely been prompted by practical considerations, as with industrial licenses. The Saudi Arabian government does not see financial policy as a means of winning short term political support, but rather a long term means to promote the overall development of the country.¹⁹

Todaro then explains alternatives to central banks, categorising the Saudi Arabian situation as "open-economy central banking institutions, where both commodity and international capital flows represent significant components of national economic activity, the monetary environment is likely to be subject to the dominating influence of world commodity and financial market."²⁰ Thus, he adds, "the central banking institution will be engaged primarily in the regulation and promotion of a stable and respected financial system."²¹ This, SAMA has undoubtedly done, but what remains to be seen is whether or not the country has truly developed financially i.e. we will show in this study that the Saudi Arabian financial system has already experienced financial widening and continues to do so, but what is really important is to see whether or not the financial system has experienced the deepening process, a process that shows whether or not a country is on a path leading to the ultimate goal of becoming a developed country.

2.4.2 Financial Intermediation

The financial system is central to a flourishing economy for several reasons.²² As a country's financial system gradually transforms and develops and it becomes more elaborate and divergent in terms of its financial resources, it is inevitable that intermediaries have to be established in order to carry out their role in the economy. Gibson and Tsakalotos (1994) give six functions for intermediaries. First, they help to

introduce a local currency to the economy thereby decreasing the inefficiencies that are often identified with barter. Chandavarkar (1977), however, contests this point and states that "it is misleading to say that monetisation can result from increased financial intermediation." ²³

Secondly, and more significant, their role of encouraging deposits from a large number of savers and then allocating these savings to different investors. Saving can be divided into two different types of assets, liquid and non-liquid. ²⁴ Gibson and Tsakalotos (1994) observe that as an economy progresses the amount of finance that is held in liquid forms tends to be greater. They point out two main benefits for distributing savings to investors through financial intermediaries. They decrease the expenses that would otherwise be necessary when attempting to bring borrowers and lenders together and they also encourage liquidity by receiving short-term deposit and lending them long-term.

Thirdly, intermediaries play a big part in curtailing the cost of information and hence minimising the risk linked with investment borrowings. Fourthly, they are able to spread their losses i.e. a bad debt can be covered by several good loans. Fifthly, they are able to meet the necessary sizeable loans associated with major investment projects, since the combination of all the different sizes of deposits when amalgamated makes for substantial amounts. Finally, because of intermediation funds that are saved in one sector can be used for investment in another. Hence, investment can be directed to the highest yielding sector of the economy. ²⁵

At the onset of economic progress, the majority of intermediation is conducted by commercial banks. However, as economic development progresses, new types of intermediaries start to establish themselves and eventually take on a greater role in the intermediation process. These intermediaries are mainly investment banks, insurance companies and the securities market.

Gurley and Shaw (1960) maintain that the evolution of the financial system takes place through three phases. The first is where only outside money exists. ²⁶ The second stage is where outside money, ²⁷ and to a small degree direct claims prevail. The final stage is when financial intermediaries are more inclined to supply funds than the equity markets. In fact, Collier and Mayer²⁸ stress that in the development stages of an economy

when firms are establishing themselves banks play the major role as opposed to the financial market and it is only when these firms become well established in their own rights can they think of turning to the equity market for financing their investments through the issue of shares. Gibson and Tsakalotos (1994) argue in their paper the important role that is played by the financial intermediaries especially when formulating a reform strategy.²⁹

In Saudi Arabia, commercial banks must develop and widen their services, becoming equal to their counterparts in developed countries. However, insurance companies are considered taboo in the Saudi Arabian society, as it is treated like interest i.e. it goes against Islamic teachings. As for the securities market, it is still at its infancy and has a long way to go. It is essential that the securities market is developed in order to ensure financial deepening in the Kingdom.

Hence, financial intermediation is responsible for the overall decisions concerning savings and investments. However, there exists two types of financial intermediaries: formal and informal. The formal is where saving and borrowing are carried out through an "official" financial intermediary, namely, commercial banks and development banks, in the case of Saudi Arabia, while the latter is where lending is conducted unofficially i.e. through moneylenders in Saudi Arabia.³⁰

2.4.2.1 Commercial Banks

The commercial banking system is responsible for two major roles: firstly, to generate credit and secondly, to stimulate savings, which it then appropriates for the purposes of investing in the most productive projects for the nation (it is hoped). The importance of generating credit can be attributed to two vital reasons: first, it can counteract the financial system's deficiency to equate projected savings and investments, and secondly, it supply's a means by which economic expansion is financed. Banks are able to boost savings by increasing interest rates and thus alluring savers to deposit more of their funds at the banks' different branches. Banks are then able to lend these savings to a sector different to where the saving had occurred in the first place. Most importantly, banks must be widely available and located all over the country, if they are to truly influence the average

saver.³¹ Lewis observes that the size of aggregate savings is, to a certain extent, determined by the number and distribution of savings organisations. He states that "if they are pushed under the individual's nose people save more than if the nearest savings institution is some distance away."³²

In Saudi Arabia, commercial banks have been able to mobilise saving to some extent but they have failed to play a more dynamic role in encouraging new industries and financing those already in operation. This is attributable to the fact the Saudi Arabian government has over emphasised the importance of its development banks, leaving little, if any, lending opportunities to commercial banks. However, this will be discussed and confirmed by analysis later in the study. Nevertheless, as the government slows down its economic activities, the commercial banks have found themselves assuming a more prominent role in the development process, a role that is taken for granted in developed nations.

Commercial banks must be encouraged to act as a spearhead for financial undertakings that carry an element of risk rather than to act as safety deposit boxes. They must aspire to provide services and technical facilities that are not available locally. Often, it is because of their inability to provide the necessary support (technical and financial) to investors, that new financial intermediaries develop, namely development banks, just as they have in Saudi Arabia.

2.4.2.2 Development Banks

Their traditional role in developing economies can be described as follows: First, to give financial credit to industry, secondly, to support the evolution of the capital market and finally, to encourage the most important sectors of the economy.³³ In Saudi Arabia, development banks were created by the government in order to expedite the development process and to ensure that funds were allocated to vital economic activity such as infrastructure development, which is an essential prerequisite for most other industries. In Third World countries, commercial bank loans are often short term and are likely to be given for those investments that carry the lowest risk. The existing commercial banks do not really encourage large-scale enterprises because of the increased risk involved, and the

longer period of borrowing. The appropriate venture capital that would contribute to the countries economic development is not always provided by the commercial banks and projects are often rejected.

However, due to the government's income from oil, Saudi Arabian businesses rarely turned to commercial banks for industrial loans. The government created specialised funds, each dealing with a different economic sector. The government employed highly skilled and professionally qualified management teams in these development funds so that the project may be appraised correctly. The involvement of development funds often entailed professional and managerial interaction in the projects they fund. In Saudi Arabia, loans by development banks were given at extremely attractive rates, making it impossible for the commercial banks to compete in the field of project finance. However, today, due to the Saudi Arabian government's continuous deficit and the decline in the price of oil, commercial banks can now participate in this development process. They have taken a back seat for a long time so SAMA must continuously give them a push in the right direction. This was done by SAMA issuing government development bonds to commercial banks only. This is viewed as a first step towards the formation of a capital market. The next step would be for the development funds to issue their own bonds, and also for them to encourage the business ventures that were established through their help to float or sell their stocks and shares in the market. This will provide an impetus for the widening and deepening of the capital market, which some believe can help the success of a developing economy. This will also create more funds for investors to develop further useful projects.

2.4.2.3 Informal Finance

In the case of Saudi Arabia this is mainly provided by the services of moneychangers/lenders. Prior to the development of the financial system and the existence of commercial banks, the central bank and development banks, Saudi Arabia had to rely on moneychangers/lenders for their financial needs. Even the Saudi Arabian government, in the early stages, had relied on them. This is discussed in Chapter 7 of this dissertation. However, with the increased income from oil and the evolution of the financial system, the government and merchants no longer needed these informal credit

markets. Nevertheless, the average Saudi Arabian still turned to them for help, especially in the remoter areas where commercial banks are non-existent. Even where commercial banks provide services, there is so much red tape that it becomes daunting for the less educated borrower to obtain finance.

The informal market in Saudi Arabia continues to co-exist alongside the commercial banks, even today. It is often funded by affluent families who have been involved with it for many generations. Many of the families are landowners and traders and through their social contacts, they often have access to the formal market which means that they are able to borrow large sums from the commercial banks and then lend to the small borrowers. It is normally the case that they have known this small borrower very well for a long time, and they also know that he is reliable. The risk to them is therefore negligible. Also, the borrower knows that this is the only source of borrowing for him and if he does not pay back, he can never get credit again. It is worth noting here that moneylenders/changers have very low overheads and hence their return tends to be greater than that of the banks.

In Saudi Arabia, the government has tried to curtail the influence of moneychangers/lenders, making it difficult for them to operate. This has forced some of them to register as trading companies in order to be able to continue in their business e.g. Al-Rajhi, later discussed in the dissertation. However, the major problem in Saudi Arabia is the non-availability of personal loans. Since collateral cannot be taken by banks, they are often reluctant to lend to individual borrowers unless the borrowers can have a guarantor who holds large sums at the bank itself.

The informal market will continue to operate unless, with the development of the financial system, new credit institutions appear, which are both competitive and efficient and are of the type that formulate sound financial policies. Organisations that would attract borrowers who have had, in the past, to rely on informal markets for their financial needs, are essential for the progress of the banking sector.

2.5 Shallow and Deep Finance

When an attempt is made to see how developed a country is, we often evaluate the growth,

in the real size of the financial system i.e. we investigate whether a country's financial assets are growing at a quicker rate than aggregate incomes. What this means, is that, the larger the financial assets, the more funds are available for investors to spend on industries that would contribute to a country's development process.

Gillis et al. have noted that "in all but the highest income LDCs, private-sector financial savings predominantly take the form of currency and deposits in commercial banks, saving and loan associations, postal savings accounts and, in some countries, mortgage banks."³⁴ Which they conclude, basically means that, for the majority of developing countries in order to calculate the actual size of the financial system, one only needs to look at the expansion in the portion of liquid assets in GDP and if this has grown, then, it would imply that a policy of financial deepening is being adopted. However, with shallow finance, this growth is at a sluggish rate, static or would even drop. That is to say, the actual size of the financial system has contracted. This is tested in chapter five.

Saudi Arabia has been able to use its income from oil in the past to maintain development and when this was no longer enough, it turned to its reserves. Thus, even though it had a shallow financial structure, its income continued to grow, but at a slower rate than that accomplished by nations with deeper financial structures. In today's economic climate, as the price of oil has decreased drastically and will continue to do so and also due to the Gulf war, the government's financial reserves have dwindled. It has become of paramount importance that the country deepens its financial structure in order to maintain its income growth.

Gillis et al. state that "the hallmark of deep financial strategy is the avoidance of negative real interest rates,"³⁵ while "shallow finance, on the other hand, typically involves sharply negative real interest rates."³⁶ However, in a country such as Saudi Arabia, interest is viewed as a taboo and the financial system must work its way around it. Interest is always disguised by the use of different terminologies. As the financial system expands, it is able to mobilise savings more efficiently and then allocate it to the most resourceful investors. Financial intermediaries, whatever their type (see earlier discussion), tend to prosper under deep financial structure. As income and saving and investment grow, the need for intermediation increases and the financial system can

contribute more to the country's economic development when the structure is deeper.

Gillis et al. characterise shallow financial policies with the following attributes:- "high legal reserves requirements on commercial banks, pervasive non price rationing of credit and most important of all, sharply negative real interest rates." ³⁷ Gillis et al. explain that often governments of developed and developing countries recognise the importance of manipulating interest rates and therefore make sure that they are in complete control over their fluctuations. Hence, if funds are in abundance and the cost of borrowing is kept at a reasonable low rate, then even investments that might have been ignored because of their low returns would seem more attractive.

In many developing countries, including Saudi Arabia, loans are often difficult to acquire partly because of the cost of borrowing, but also banks are reluctant to lend to unknown clients. It is often the case that charges on loans may be above the opportunity cost of capital. Gillis et al. go on to explain that "in most LDC's only those borrowers with either the highest quality collateral or the 'soundest' social and political connections, or those willing to pay the largest "under-the-table" inducements to bank officers, will be successful in securing finance from the organised financial system." ³⁸ This statement in part is applicable to Saudi Arabia, and naturally such rules do not ensure that finance is given to the venture with the most return or advantage to the economy.

Gillis et al. state that shallow financial policies cause "higher capital-output ratios", which result in less expansion of the national income, as the increases in aggregate saving tend to be less than when the actual interest rates are positive. Gillis et al. conclude that shallow strategies tend to slow down income and employment growth "even when the interest elasticity of savings is zero." ³⁹ Further, if the level of saving is influenced by the levels of interest rates, then a shallow financial policy will have devastating consequences for growth in income, since "the ratio of private savings to GDP will also contract." ⁴⁰

Deep financial policies, on the other hand, follow a different set of objectives according to Gillis et al. "(1) mobilising a large volume of savings from the domestic economy... (2) enhancing the accessibility of savings for all types of domestic investors; (3) securing a more efficient allocation of investment throughout the economy; and (4) permitting the financial process to mobilise and allocate savings to reduce reliance on the

fiscal process, foreign aid, and inflation." ⁴¹

In order to successfully accomplish deep financing, the policy makers must follow strategies that would insure "positive real interest rates" or avoid, as best they can, acutely negative real interest rates. To achieve financial liberalisation, it is necessary that higher interest rates are provided for both investors and depositors. This is considered the onset of the move from shallow to deep financing. Hence, as interest rates increase, savers become more thrifty and raise their savings, which in turn results in the increase in the aggregate credit available for investors. Gillis et al. state that the evidence available on this indicates that in countries where policy makers have tried to nurture moderate positive interest rates during an intensive time period, the countries have experienced high rates of financial growth. Gillis et al. go on to suggest that "when finance is deep, inflation tends to be moderate", ⁴² and "higher-risk, higher yielding investment projects stand a far more better chance of securing finance under deep rather than shallow finance." ⁴³

They go on to say that as per-capita income increases, then the country's investment objectives tend to become more long term and naturally this would need long term loans. Unfortunately, commercial banks are often not equipped to make such loans, since the majority of savings held by commercial banks tend to be for short periods of time. Hence, as economic development and financial expansion continues, the necessity for long term financial organisations becomes inevitable. Saudi Arabia has relied heavily on its development banks for this purpose and now that the government can no longer fund all the necessary long term projects, it must encourage the development of specialised investment banks or perhaps sell shares of its development banks on to the general public, ensuring the availability of extra capital that can be invested in development projects. This will hopefully encourage the development of a stock exchange. All this would be a step towards financial widening. Even though the Saudi Arabian government has sold government development bonds to commercial banks, the banks can only take them on for the maximum of 5 years. However, had there been a secondary market, the banks could have passed them on, which would naturally mean longer term investment loans. It must be noted here, that these specialised organisations will only appear if the Saudi Arabian government intervenes to encourage these developments, and may even initiate the process while it still has some funds available.

2.6 Financial Widening

In contrast to deep and shallow finance, financial widening is the process where the financial system expands the spectrum of financial services, e.g. banks, stock markets, bonds...etc. As a country's financial system develops one would expect this to occur. It is undoubtedly to the country's advantage if its financial system both deepens and widens. The World Bank Report 1989 stressed the vitality of developing other forms of financial intermediaries, especially non-bank institutions, such as insurance companies, pension funds...etc., as these type of organisations are potentially important sources of long-term finance. Widening the facilities and types of services provided to customers can encourage the increase in savings, although there has been some debate over whether payments into pension funds and insurance companies are a substitute or a compliment to bank savings. For example, establishing co-operative banks in rural areas in developing countries may result in households being encouraged to both save and borrow for investment. These contributions may seem small when observed individually, but looking at the aggregate savings involved for these areas they become an important contribution towards financial deepening.

2.7 Financial Liberalisation

In many developing countries, commercial banks are often faced with many lending restraints and have to contend with interest rate ceilings on available loans that are frequently less than the domestic (informal) and world market rate. Therefore, they find themselves in a situation where they have to ration the loanable funds that are available. Hence, financial repression arises where the aggregate funds saved are well below the aggregate loans required. Since the interest earned on savings is well below what can be received from the markets, large savers would choose to deposit their money elsewhere. In Saudi Arabia, many affluent savers tend to invest or deposit their assets abroad where interest rates are much more alluring. Thus, because the saved funds are not large enough, commercial banks tend to ration their lending, and prefer to give loans to large and well established borrowers, as this means less overhead administrative costs than there would have been if they were lending to smaller and new market lenders. This forces small borrowers to turn to the informal market i.e. moneychangers. ⁴⁴

McKinnon (1989) defines repression as "when governments tax and otherwise distort their domestic capital markets, the economy is said to be financially repressed." ⁴⁵ Thirlwall (1994) defines financial repression as "a situation in which government and central banks regulations distort the operation of financial markets." ⁴⁶ He then goes on to list three regulations which, I may add, are typical of the Saudi Arabian financial system: firstly, ceilings on the nominal rates of interest to both deposit and lending rates Gibson and Tsakalotos (1994) note that in countries with excessive inflation, one result of low nominal rate of interest is that the real rates of interest transform to negative levels. In fact, the World Bank Report (1989) (figure 4.2) has shown that the average real rate of interest in developing countries has been extremely negative since the 1960's while in developed countries it has been usually positive although lower than the nominal rate. In Saudi Arabia interest is not really referred to publicly, but privately it is; secondly, forcing banks to hold a certain amount of their deposits as reserves - in Saudi Arabia this is set at 20 percent and this would naturally hamper their ability to lend. Governments may also impose lending requirements such as compulsory loans at favourable interest rates, refinancing schemes, concessional funding from development finance institutions and credit guarantees... etc.⁴⁷ The result of all these regulations imposed on the financial systems according to the World Bank Report (1989) often result in misallocation of funds and sluggish rate of growth of the financial sector of a developing country. Thirdly, the expectations from banks that they would lend the government funds in order to finance a budget deficit.⁴⁸ In Saudi Arabia, it is not so much the government that requires loans but government officials that are often very powerful and make it difficult for the banks to decline. However, in recent years, the King and the government have been very adamant that banks must not be put in such a situation.

Gibson and Tsakalotos (1994) argue that the definition of financial repression that is generally accepted and includes all forms of government intervention in financial markets is too sweeping, "as it is not only intervention which leads to genuine inefficiencies in financial markets but also intervention that can be seen as a response to market failure." ⁴⁹

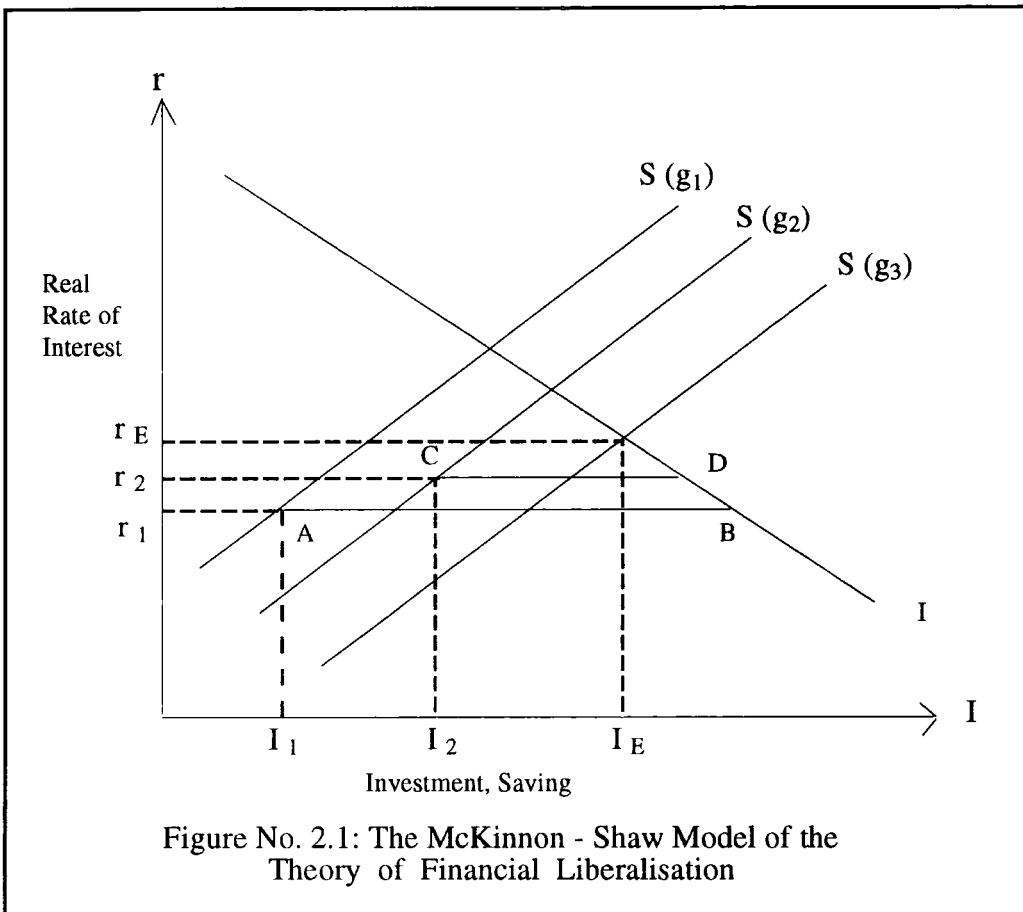
Gibson and Tsakalotos (1994) then ask the question "what are the implications of these regulations for financial intermediation in developed countries." ⁵⁰ The World Development Report (1989) suggests one implication, and that is the mushrooming of

informal financial markets i.e. money lenders/changers, the second implication,⁵¹ according to Gibson and Tsakalotos (1994) would be that savers will no longer be tempted to deposit their funds at banks with the reduction in real interest rates and the purchases of fixed assets would seem more viable. As a result of this they argue that "the role of financial intermediaries is thus reduced and demand for broad money falls as a percentage of GDP."⁵² However the major implication of financial repression as argued by Thirlwall (1994) and Gibson and Tsakalotos (1994) is that the flow of deposited funds to the formal intermediaries may decrease, and they may then choose not to lend on merit. This would result in funds being channelled into investments that may not aid the development process. This would lead to a lower growth rate than would have otherwise been possible.

The economic development literature has, for a long time, emphasised the significance of the expansion of the money supply and financial deepening to a developing economy, referring to the three articles mentioned earlier e.g. Gurley and Shaw (1960) and Tunwai (1972), McKinnon (1973) and Shaw (1973). The latter separately and in the same year, first stressed the perils of financial repression in a developing economy and the importance of financial liberalisation to the countries to ensure their economic success.

McKinnon and Shaw's model mainly concentrated on financial repression depicted as an interest rate ceiling on savings and borrowing. They believed that economic growth is affected by the real rate of interest since that real rate of interest determines savings and investment. Hence, savings are assumed to be positively related to the real rate of interest at every level of economic growth. They also imply that when governments of developing economies decide to determine what the interest rate should be then this would result in keeping the real rate of interest below its equilibrium level. This is known as financial repression, that is a fixed rate of interest is determined by the government r_1 (figure 2.1) would result in a portion of saving that gives investment of I_1 .

Hence, if interest rate ceilings are applied which means that r_E will not be allowed, it follows then that non-price rationing will take place. Consequently, two



vital results will surface: firstly, saving will continue to be small as a result, so will investment. Secondly, because of the low level of savings funds available for credit, it would be inefficiently distributed. These two phenomenon will as a result depress the growth rate of the economy and its financial systems. In fact the line AB is the amount of investment projects that would not be developed because of the unavailability of funds to the business community.

If the government then decided to increase the interest rate ceiling to r_2 . This will result in a rise in the number of efficient investments, as entrepreneurs will now only invest in ventures with greater levels of returns. This will cause economic growth to increase which means g_1 will shift to become g_2 . Thus, with the rate r_2 , investment will now be I_2 as savings have increased. Credit, nevertheless, is still rationed and CD now becomes the amount of investment that is unable to obtain financing. If, however, the rate of interest is allowed to freely flow out to its equilibrium level r_E , the growth rate would have increased as a result of the increase rate from r_1 to r_E . Hence, at g_3 , investment will be equal to I_E as a result of increased savings and what is more important no rationing

occurs.

Thus, McKinnon (1973) and Shaw's (1973) theories of financial liberalisation advocate the elimination of ceilings on interest rates in developing economics where the financial system is repressed. This would lead to a rise in savings which means greater amounts would be available as loans, but more importantly loans will be given to more efficient projects, all this will, therefore, lead to growth and economic development. However, McKinnon and Shaw's view of the transmission mechanism through which savings, interest rate and growth occur is somewhat different.

McKinnon (1973) complementarity hypothesis advocates that, in the development process, saving and the growth of capital are interdependent. He argues that, due to a combination of investment costs and the dependence on self-finance, intermediaries would have to gather funds prior to when the investments can be carried out. It is therefore important that the interest rate is held at appropriate levels so that the intermediaries can increase their deposited funds and investors can then borrow. However, he argues that interest rates must not be over and above the real rate of return on investment so that it makes it worth the investors efforts.

On the other hand, Shaw's debt-intermediation view advocates the necessity of financial liberalisation. In order to allow financial deepening, he argues that high interest rates will stimulate savings but would not encourage investments with low returns. He goes on to stress that the growth in the number of financial intermediaries, causes liabilities due to the increase in real interest rate levels which would encourage banks to lend the funds to projects that would ensure the greatest productivity .

However, there are scholars who have criticised the financial liberalisation theory. They have stressed the fact that cash saving is only one form of thriftiness. In fact, as interest rates grow, it is not possible to guarantee that people will only make cash savings. They may be tempted to purchase semi-liquid assets which would, therefore, leave the aggregate saving figures unaltered. Their argument continues to point out that whatever fluctuation that may be experienced by price would have an influence on income. If they compensate each other, then the influence on aggregate savings would be insignificant. In fact Dornbusch and Reynoso (1989) were critical of the financial liberalisation policy and

registered their discontent about such an ideology. According to them, it is expected that increased interest rate will undoubtedly increase savings.

The McKinnon and Shaw hypothesis of financial liberalisation have been implemented in some developing countries with quite interesting results. Fry in a number of papers studied the relationship between real rates of interest and savings. Fry (1988) looked at the national savings of 14 Asian countries for the period 1961-1983 and came up with a result that indicates that the real interest rate on deposits brings into play a positive and important result for national savings. While, on the other hand, Giovannini (1983) carried out a similar study to that of Fry (1988) but with only seven of the Asian countries for the period 1960's and 1970's and records that "the results indicate that a positive and significant real interest elasticity of savings is hard to come by."⁵³ Cho and Khatkhate (1990) also conducted studies along the same line as the above two researchers with the regression of five Asian countries, their results agree with those of Giovannini (1983).

Similarly, Gupta (1987) investigated a pooled time-series for 22 Latin American and Asian countries for the period 1967-76. His results also show that there was no indication that when interest rates are increased, savings also increase. Nisanke (1990) in his study of a number of Sub-Saharan African countries came up with similar results i.e. that when financial liberalisation was taken up by these countries they did not experience an increase in savings. This is not dissimilar a result to that obtained by De Melo and Tybont (1985-86) who looked at the Uruguay experience after 1973 financial reforms and found no indications of a significant positive effect of real interest rates on total savings.⁵⁴ Warman and Thirlwall (1994) in their study of Mexico for the period 1960-90 conclude that "even though financial liberalisation in the form of high real interest rates increases the flow of financial saving. There is no evidence that high real interest rates lead to higher total savings, investment and economic growth."⁵⁵

Gibson and Tsakalotos (1994) having looked at the majority of the above studies conclude that "the wide variety of results reflects problems with the data. Savings are notoriously difficult to measure even in the most advanced industrial countries."⁵⁶ In the same paper they present their experience with Chile and argue that "Most of the evidence suggests that savings did not increase in spite of the large rise in real interest rates."⁵⁷

When looking at the McKinnon and Shaw's hypothesis in relation to the increase in the quantity and efficiency of investments, it is necessary to establish whether or not a rise in deposit rates would raise the funds accessible in the economy, one must then determine the linkage between accessible credit and investments. Fry's (1980, 1981) research establishes a positive linkage between the interest rate and credit and also between investment and the credit levels attainable. Gibson and Tsakalotos (1994) are, however, critical of his method as he does not include the real rate of interest in his investment function. They explain that "if more credit is only forthcoming if the real deposit rate rises and if the real loan rate rises when the real deposit rate rises, then the net effect on investment may be ambiguous - the positive impact from credit availability may be offset by the negative impact of higher interest rates."⁵⁸ And this is what Warman and Thirlwall (1994) experience with their Mexican data previously mentioned. Gibson and Tsakalotos (1994) argue that the analysis conducted on the link between investment and liberalisation using the equations which hypothesise that the relationship between the accessibility of credit and the real rate of deposit are almost always bivariate regressions and do not try to model credit formation within an economy using a coherent theoretical framework.⁵⁹ Fry (1988) argues that there is an indication that a rise in the real rate of deposit would raise the calibre of investment. Gibson and Tsakalotos (1994) also argue against this as they believe that "such results may be biased as a result of omitted variables."⁶⁰ In their study on Chile, Gibson and Tsakalotos (1994) note that "investment did not show any large increase, either in quantity or quality."⁶¹

Finally the McKinnon-Shaw hypothesis shows that the relationship between savings and investment leads to economic growth. The World Bank Report (1989) argues a positive relationship between the real rate of interest and growth in their study of 33 developing economies during the period 1965-85. However, Dornbusch (1990), took these results and reran the regressions but, he did not include those countries that had extremely negative interest rates. His results showed that there was no linkage between growth and real rate of interest.

Gibson and Tsakalotos (1994) and Gonzales Arrieta (1988) criticise the way in which empirical evidence has been analysed. Arrieta (1988) finds that the debate on issues of interest rates and savings and its effect on investment and economic growth will

continue as long as it is faced with "huge limitations mainly arising from data and analytical considerations."⁶²

The inherent assumption which overwhelms the neo-classical economic school is that markets, if left in a *laissez faire* state should be able to operate efficiently. The financial liberalisation theory is a typical example of the neo-classical ideology. Hence, if the credit market is left to operate freely i.e no government intervention, then it follows that investment and savings will equal each other. Gibson and Tsakalotos (1994) argue that the theory of market economics has two failures. Firstly, markets do not always arrive at an equilibrium state on their own, since market outlooks may differ. Hence, looking at savings and investments, an increase in savings does not necessary mean an increase in investment, since not both are dictated to by interest rate only. Investments are also influenced by market opportunities and requirements. They argue that credit rationing still takes place even in those markets where there are no government interventions and competition in the loan market is idealistic. The second criticism to the neo-classical view is its poor trust in the part played by the financial intermediaries and the influence they have on economic achievement. Neo-classics argue that institutions are in the great part absent, they come together only for a short period to trade, these trade dealings happen promptly, and it is then up to the auctioneer to make sure that the market clears. Hence, the dealers in the neo-classical ideology are envisaged as mere solitary negligible entities, whose only interaction takes place through the market. It is generally maintained that the neo-classical belief is in direct disagreement with what really occurs in the real world where the markets operate via an elaborate grid of organisations such as, governments, banks, businesses, trade unions, cooperatives ... etc. These organisations are vital in the collection of information that leads to a decrease in uncertainty i.e. risks.⁶³

Much debate has taken place historically to show the importance of institutions, notably that of Goldsmith (1955, 1966, 1968) and Cameron (1967, 1972). Goldsmith (1966) in his research on Mexico surmises that financial organisations, especially government ones, were an important element in the countries industrialisation process, by granting medium-term (10-15 years) loans to industry and by supplying finance to new and innovative ventures and education. Patrick (1966) argues the significance of the establishment of a strong financial network. He differentiates between demand-induced

finance and supply-leading finance. He comments that, often finance has been presented as if it inertly alters, according to demand expectation, as long as no government interests occurs dictating to financial intermediaries, and hence the right financial system will spontaneously evolve. Patrick suggests that more attention must be given to the supply-leading role that finance is able to engage in, he argues that financial intermediaries are able to successfully encourage growth and development, especially at the onset of a period of economic progress. Stammer (1972) argues that "economic development in Hong Kong has taken place in a *laissez faire* environment." ⁶⁴ He argues that financial intermediaries played a small part in the finance of industry and it was the Chinese families who instigated development and continued to do so through their reinvestment of profits in their old business and the creation of new ones, hence not needing any other finance from outside. Patrick (1972) argues that Stammer's paper contradicts itself, in part he argues that Stammer stresses "the availability of commercial bank loans and advances virtually from the start of industrialisation, often to relatively untried business and against little security"⁶⁵ so that "the Hong Kong commercial banks have, to some degree, accepted risks which elsewhere are the responsibility of equity investors."⁶⁶ Patrick (1972) points out "the emphasis on this external finance contradicts the emphasis on Chinese family, internal finance; you cannot have it both ways."⁶⁷ Patrick shows also some scepticism of Stammer's view of an economy that is self-financing.⁶⁸ Sockice (1991) stresses the relevance of institutions in formulating the necessary long-term trust between market partakers and emphasises the importance of this relationship which effects the overall performance of an economy and its interaction with the international market leading to better economic achievement. The most recent of these studies was that by Gibson and Tsakalotos's (1994) on the South Korean experience it found that its government and financial institutions played an important role in the development process.

The second argument that contradicts the ideologies of financial liberalisation is one posed by the post-Keynesian school, which argues that financial liberalisation supposes that aggregate loans are determined by aggregate deposits kept at banks, and this means that the supply of credit is beyond the control of banks. This does not take account of the fact that banks can create credit i.e. by borrowing from the central bank which means that

the supply of credit is under the control of banks. What this means is that what affects savings and investment is actually investment and if interest rates are increased, then this would put off investors, especially investors in projects where the return on investment is lower than the interest rates.⁶⁹ Supporters of this argument are Davidson (1986) and Asinakopulos (1986). The former advocates that in order to mobilise more investment there should be funding, which can be supplied by banks who could borrow through the manipulation of legal banking accounting methods as opposed to waiting for savings to increase. While the latter argues that the investment market size could diminish due to the inadequacy of funds, it can by no means be reduced due to a lack of savings. He goes on to argue that if banks are able to mobilise credit if not forced to expand their deposits, then a rise in aggregate savings will not affect the aggregate credit provided to private investors. Hence, the aggregate credit will not be influenced by the availability of loan but rather by the demand for them. However Warman and Thirlwall (1994), in their study on Mexico, discovered that financial savings react positively to interest rates which as a result boost the supply of credit by banks to investors.⁷⁰

Another problem with the financial liberalisation theory that Thirlwall (1994) feels is, the connection between the formal and informal intermediaries - the latter being uncontrolled. If formal intermediaries find they have access to more finance due to the increase in interest rates, the aggregate supply of loanable funds could be decreased because of the central bank's reserve requirements on them. This is something that the informal market does not have to adhere to. Hence, if financial liberalisation is to flourish then, demand deposits must become a better alternative for cash and foreign bonds, as opposed to loans from the informal market.⁷¹

Taylor (1983) argues along the same lines as Thirlwall. He believes if bank savings increase as a result of an increase in the rate of interest then the effect of this available credit will depend on the source of the savings. He suggests two sources non-productive assets such as gold, jewelry...etc, or deposits with the informal market. If the source is the former one, the effect on accessible credit is most probably positive, if however, it is from the latter then the result is likely to cause economic contraction. This is due to the fact that banks face reserve requirements while the informal market does not. Van Wijnbergen (1983) formulated a model of an ideal developing country and comes up with the same

result as Taylor. He also believes that inflation is likely to rise as a result.⁷² Hence, Taylor (1983) and Van Wijnbergen (1983) argue that liberalisation is stagflationary and this, they believe, is more in line with the experience of developing economies.

Todaro, on the other hand, argues that financial liberalisation and the creation of a formal money market, is not the real solution for developing a country's financial system. He takes South Korea, Taiwan and Japan in its early days, as examples where financial repression existed and yet these countries were able to succeed because of their government's cautions and systematic interference, which as a result, encouraged economic development. Even though the eradication of artificial interest rates, might encourage aggregate savings and result in appropriation of funds towards more effective investments. Governments must ensure that financial reorganisation is carried out with other more stringent criteria that would permit small farmers and investors to obtain the necessary loans they require. However, the government of the developing nations must participate in the management of the banking and financial sectors, to stop any manipulation of credit by the affluent businesses and businessmen.⁷³

Many developing countries in the past fifteen years or so, have moved toward financial liberalisation with less manipulation of interest rates and less credit control. Often, central banks have encouraged the competition between the different formal intermediaries and have reduced barriers to entry into the domestic banking industry, by encouraging foreign banks and by passing banking control laws that allow the formation of new banks and other financial institutions. The only type of bank or institution allowed in Saudi Arabia must be set-up by nationals. Thus, many planned economies have specified objectives that would encourage competition between banks and have thereby forced many banks to restructure their organisations. We will show how the NCB has been restructured. In fact, much of the experience of developing countries shows that financial liberalisation must be carried out simultaneously with macroeconomic reform, and that countries that have tried to liberalise their financial system prior to making macroeconomic reforms have been faced with volatile capital flows, rising interest rates and organisational mayhem. Therefore, financial liberalisation will not be able to truly flourish unless the government undertakes the reorganisation of failed banks and businesses in the economy by controlling and managing them to ensure their success once

more.⁷⁴

Chorng-Huey Wong (1992), in an article, looks at how developing countries have recently started to reorganise their monetary controls and thus ensure dynamic use of indirect or market-based instruments, in order to reach their macroeconomic goals. The instruments are used to indirectly manipulate money, credit and interest rates, by altering the levels of liquidity of commercial banks and other financial institutions. However, these monetary policy reforms are spread over a period of time and cannot take place simultaneously. These reforms, however, will influence and affect the liberalisation of the financial system. Therefore, it is important to sequence these reforms, as has been proven through the experience of developing countries which have undertaken such policies.⁷⁵ McKinnon (1991) advocates that two reforms must take place in the macroeconomy before financial liberalisation. Firstly, the government must be in full control of its fiscal policies, since due to liberalisation the government's income from banks will no longer exist, it must, therefore, first find other sources of income to replace this lost income, McKinnon suggests tax collection. The second reform is the manipulation of domestic banks for the sake of monetary policy.

Chorng-Huey Wong (1992) explains that the first step in the procedure needs to be carried out by the central bank which has to introduce new monetary instruments such as treasury bills.

The second step would be to ensure that financial intermediaries are regulated and checked. The central bank must investigate to see where loans are given, and monitor the banks capital levels, to ensure that loans are not all given to a certain group of organisations. If central banks see that some of the financial organisations are facing difficulties, it must step in, to help in reorganising, and it may be even inject further capital or force the weaker bank to merge with other stronger banks. This would ensure that the financial institutions would be less likely to face bankruptcy or financial problems that would occur as a result of fast credit growth and financial liberalisation. The financial system must be very strong if the central bank is to encourage the development of a financial market.⁷⁶

Hence, the third step to be taken is to develop a financial market. The interest rates

must be gradually allowed to flow, starting with interbank lending rates and the reduction in reserve requirements. Banks should be allowed to move more freely and barriers to the entry of other banks should be reduced. It would be to the country's advantage if the central bank was able to form a system where market information is efficiently circulated. Government debt bonds should be designed with the market in mind. Any continuous fluctuations in the macro economy may lead to the failure of financial liberalisation.⁷⁷

Fourthly, Chorng-Huey Wong suggests that, it would be to the central bank's advantage to continue to control some of the direct instruments so that it is not faced with the loss of its monetary control. Policies that would control the growth rate of credit as opposed to that of deposits, or policies that would dictate a maximum interest rate, may be acceptable when the indirect instruments are at an embryonic stage. The central bank's objective should be to concentrate on the indirect instruments and only to use the direct ones when it is absolutely vital, and as soon as conditions settle, direct controls should be completely disregarded.⁷⁸ D. Villanueva (1988) agrees that it would be to the country's advantage if its policy advocates a "switch to indirect monetary control through reserve money management. This switch can take place with or without interest rate liberalisation."⁷⁹ He argues that once the interest rate is liberalised then the actual change to indirect controls would be vital to the success of competition within the banking industry. However, he argues that these reserves may not be effective if the penalty for breaking them is too low. At the same time if these reserves are raised to high levels and the banks are not given interest on them, they will be forced to increase their service charges to their customers in order to cover their losses, hence an "adverse effect on savings mobilisation and allocation."⁸⁰

Fifthly, operating procedures need to be improved under market-based systems of monetary control, however, these can be quite different between countries, depending on the countries economic and financial development, along with its varied exchange procedures. The central bank can lay down its objectives e.g. to reach certain levels in the broad money, domestic assets, etc.⁸¹ Point six is directly related to five, as once these operating procedures have been set up, they must be monitored continuously and figures must be produced periodically and on time. This would ease the central banks analysis of budgeted and actual figures.⁸²

Step seven, stresses the necessity of coordinating fiscal and monetary policy, in order not to face discrepancies between expected demand and the actual availability in the financial market, which as a result, could lead to unwanted variations in the interest and exchange rates. Hence, as market-based systems are formulated, the interest and exchange rate elements become vital sources in implementing monetary policy to influence the real economy. It is, therefore, essential that the government develops monthly forecasts of the important elements of government expenditure, revenue, etc. This information will help the government to decide on the aggregate number of government securities that must be sold other than those sold to the central bank, in order to insure that monetary development is progressing along the right track.⁸³

Chorng-Huey Wong stresses the importance of stabilising interest rates and the establishment of a repurchase market (secondary market) for government securities. If commercial banks are unable to get rid of government securities when they need to be more liquid, they would be forced to pass some of the costs to their clients i.e. higher interest rates. It is, therefore, of vital importance that the government encourages the development of a secondary market. Hence, the government must first increase the amount of transactions that take place in the primary market and simultaneously it must also eliminate the possibility of below market returns on securities. The government should have laws that force banks to hold statutory requirements and a certain number of government securities, in order to ensure a continuous flow of liquid assets in the banking system. Finally government must encourage stock trading through ensuring the availability of funds for dealers and other members of the market. The setting up of a secondary market is not just vital for the purposes of maintaining liquidity of the securities traded in the primary market, but also because it would make it possible for the central bank to regulate monetary developments that may occur between auctions.⁸⁴

2.8 Conclusion

The Saudi Arabian financial system has evolved from an economy relying on the informal market for finance to the development of modern financial intermediaries and the

establishment of a central bank. All this is looked at extensively in chapter seven. Formal intermediation continues to develop in Saudi Arabia under the close supervision of the SAMA. However, no financial liberalisation policies were applied as controls were not stringently enforced. In fact, commercial banks were allowed to operate quite freely as the government had no real need for finance derived from the financial intermediaries and oil revenue was more than adequate during the 1970's and 1980's. As a result of this the financial intermediaries were seldom tapped for loans to finance investment, as government agencies provided finance at very attractive rates. It is in this context that the financial system has developed.

Government policy has not been to manipulate and guide the financial system in order to ensure the country's economic development. Rather, it is the revenue from oil that has been the singular dynamic which has driven the Saudi Arabian economy. In fact, and as shown later in appendix A, it will be apparent that financial intermediation is a consequence of GDP growth rather than a cause of it, while oil revenue, looked at in the next chapter, was the major force behind the economy's development process. As oil prices increased the governments drive to industrialise accelerated and as the price fell development slowed down. It is this development that is considered in chapter four, with the underlying issue being how far the development of financial intermediation has facilitated the growth of other sectors harnessing the funds from the oil sector.

Notes:

- (1) Thirlwall, P. Growth and Development Hong Kong: Macmillan, 1994, pp. 277-278.
- (2) Chandavarkar, A. G. "Monetisation of Developing Economies." International Monetary Fund Staff Papers, Vol. 24, No. 3, November 1977, p. 665.
- (3) *Ibid.*, p. 665.
- (4) Goldsmith, R.W. Financial Structure and Development Yale University Press, 1969, p. 304.
- (5) Chandavarkar, op. cit., p. 715.
- (6) Gillis, M.; Perkins, D.; Roemer, M.; and Snodgrass, D. Economics of Development New York: W. Norton, 1992, pp. 333-334.
- (7) *Ibid.*, p. 334.
- (8) Todaro, M. P. Economic Development London: Longmans, 1994, pp. 600-601.
- (9) *Ibid.*, p. 601.
- (10) *Ibid.*, p. 602.
- (11) Thirlwall, op. cit., p. 278.
- (12) Gillis et al., op. cit., p. 332.
- (13) *Ibid.*, p. 333.
- (14) Shaw, Edward. Financial Deepening and Economic Development New York: Oxford University Press, 1974, and McKinnon, Ronald I. Money and Capital in Economic Development Washington DC : Brookings Institution, 1973.
- (15) Gillis et. al., op. cit., p. 333.
- (16) Gibson, Heather and Tsakalotos, "The Scope and limits of Financial liberalisation in Developing Countries: A Critical Study." Journal of Development Studies, Vol. 30, No. 3, April 1994, p. 581.
- (17) Gillis et. al., op. cit., p. 333.
- (18) These points were taken from Thirlwall (1994) and applied to Saudi Arabia
- (19) These points were discussed by Todaro (1994) pp. 603-604 and merely applied to Saudi Arabia.
- (20) Todaro, op. cit., pp. 604-605.
- (21) *Ibid.*, pp. 604-605.
- (22) See Goldsmith, R W. Financial Institutions New York: Random House, 1968. and Carmeron, R. Banking and Economic Development: Some Lessons of History New York: Oxford University Press, 1972. and Gurley, J. G. and Shaw, E.S. Money in a Theory of Finance Washington DC: Brooking Institute, 1960, for an examination of the relevance of financial intermediaries.
- (23) Chandavarkar, op. cit., p. 670.

- (24) Liquid assets here are those held in cash or can be converted to cash in contrast to non-liquid ones e.g land, property, ..etc.
- (25) Gibson and Tsakalotos, op. cit., p. 582.
- (26) Where outside is described as money that is supported by non-debt making assets, such as, notes and coins as issued by the authorities.
- (27) Outside money defined here as money supported by debt making assets.
- (28) Collier, P. and Mayer, C."Financial liberalisation, Financial Systems and Economic Growth." Oxford Review of Economic Policy, Vol. 5, No. 4, Winter 1989, pp. 3-6.
- (29) Gibson and Tsakalotos, op. cit., p. 583.
- (30) Poulson, Barry W. Economic Development, U S A: West Publishing Co., 1994, p. 277.
- (31) Thirlwall, op. cit., p.281.
- (32) Lewis, A. The Theory of Economic Growth London: Allen and Unwin, 1955.
- (33) Thirlwall, op. cit., p. 281.
- (34) Gillis et al., op. cit., p. 354.
- (35) Ibid., p. 354.
- (36) Ibid., p. 354.
- (37) Ibid., p. 356.
- (38) Ibid., p. 358.
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- (44) Todaro, op. cit., pp. 609-610.
- (45) McKinnon, R. I. "Financial liberalisation and Economic Development: A Reassessment of Interest Rate Policies in Asia and Latin America." Oxford Review of Economic Policy, Vol. 5., No. 4., Winter 1989, p. 29.
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- (48) Thirlwall, op. cit., pp. 278-279.
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- (69) Thirlwall, op. cit., pp. 297-280.
- (70) Ibid., p. 280.
- (71) Ibid., p. 280.
- (72) Wijnbergen, S.Van. "Interest Rate Management in LDC's." Journal of Monetary Economics, 12, 1983, p. 445.
- (73) Todaro, op. cit., pp. 610-611.
- (74) See World Bank Report, (1989).

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- (76) *Ibid.*, p. 16.
- (77) *Ibid.*, p. 16.
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Chapter Three

The Role of Oil in Financing Saudi Arabia's Economic Development

Saudi Arabia is the world's largest export supplier of crude oil, making it an important player in the international economy. It holds a key position within OPEC and its moderate stance there helped to promote its relationship with the West and Far Eastern nations. Oil is an integral part of the Saudi Arabian economy and the main source of government finance. The revenue from oil is a crucial determinant of both the lending opportunities for the commercial banks, and the level of deposits in the commercial banks.

As government revenues are dependent on oil, this in turn determines government expenditure which usually finds its way to the population. When the government spends its revenue on the development of projects and infrastructure, it is Saudi Arabians - or expatriates - who are ultimately involved in these. The money they receive in the form of wages and salaries is in large measure injected back into the Saudi Arabian economy. As a result, the economy experiences a multiplier effect from oil revenue. Much of this finds its way into bank deposits within Saudi Arabia and consequently there is a link between oil and deposit growth by expenditure multiplier effects. However, it must also be noted that bank lending opportunities are dependent on oil indirectly, partly through local expenditure generating effects on domestic business, but also because oil revenues are used to pay for imports. So imports are dependent on oil generated private expenditure, but also they are somewhat dependent on government expenditure itself. Oil revenue is also linked to import substitution: Saudi Industrial Development Fund will provide part of the financing for any particular import substitution venture, but the other part has to be provided by the client himself which may be obtained from a commercial bank in the form of a bank loan.

So basically to a considerable extent the demand for bank loans is also determined by oil. Thus, both the liability side, in terms of bank deposits, and indeed the asset side, in terms of bank lending, both are linked with oil. This will be extensively analysed later on in this thesis.

3.1 The Origins of Saudi Arabian Oil Production

The American oil companies were concerned with expanding internationally, especially in the case of Standard Oil of California (SOCAL). California was rapidly depleting its oil

resources and as it was concerned with maintaining its position, SOCAL started to look elsewhere, Saudi Arabia being one place. In 1933 SOCAL signed its first concession for oil exploration in Saudi Arabia.¹ Essentially, the Americans came in and provided all the exploration and drilling and the first oil well was discovered in the Dammam Dome on 3 March 1938.² Once it was apparent that Saudi Arabia had in its possession oil, in commercial quantities, many companies, namely Texaco, Standard of New Jersey and Mobil, sought ways in which they could tap into the country's natural resource. The most attractive recourse was to join SOCAL and then form some sort of partnership with the government. This was achieved, and the outcome was the formation of the Arabian American Oil Company (ARAMCO), which was American owned and controlled. The American companies controlled basic oil production as well as setting levels for output. SOCAL made commercial and market orientated decisions, and was not involved in any political decision making. The United States government did what it could to expedite relations with Saudi Arabia, without involving themselves in any major issues. The Saudi Arabian government's aim was to see its revenue from oil increase in the long term. While they were not concerned with procuring complete ownership, eventually this occurred as a result of developments in the other oil states in the Middle East.

At the outset it was agreed that the Saudi Arabian government would receive 4 shillings of gold for every ton of oil it produced.³ It would not exercise any control over production and no tax would be paid by the company.

In 1950 the terms of the concession were renegotiated and the result was that ARAMCO paid fifty percent of its gross income to the government as a form of tax. Payment was to be on the realised price as opposed to the posted price. This, however, was altered to the latter in 1958. Then later on in 1965 royalties were added to the decree. Those levies were set at 12.5 percent of the posted price.

3.2 The Impact of OPEC

When the Organisation of Petroleum Export Countries (OPEC) was first formed in 1960 its main objective was to prevent the posted price of crude oil falling any further. Its members were initially Saudi Arabia, Iran, Iraq, Kuwait and Venezuela. Venezuela at the

time was emerging as an important oil producing country and had decided alongside Iran to try and stop the oil companies, namely the Seven Sisters, from reducing the price of oil. OPEC did very little during the first ten years of its life and was not very successful as an organisation.

A wave of change came when countries like Libya, with its new leader Gaddafi, tried to obtain a larger volume of oil revenues for itself. This was done by circumventing the large oil companies and dealing with the newly formed state-owned ones i.e. from Europe and Japan. These national companies were looking for new sources of oil and were willing to pay the price that Gaddafi dictated. These companies offered tempting terms to lure the oil producing countries (who by now were already irritated by the trade terms imposed by the larger companies) into granting them concessions. At the time the demand for oil had increased dramatically, partly because of the low prices but also due to economic growth. A major Environmental Protection Act passed in the United States in 1966, encouraged the use of oil as opposed to coal, hence increasing oil consumption. The closure of the Trans-Arabian pipeline in May 1970 by Syria contributed to the escalation of oil prices. All the above events led to an increase in oil prices of \$1 in Rotterdam, which reached a price of \$3.33 in 1970.⁴

In 1970, negotiations began which resulted in the agreement arrived at in Teheran on 14 February 1971. The posted price per barrel was to be increased to \$2.15 compared to the previous price of \$1.80. Income tax was to be increased to 55 percent of the posted price but as oil prices were quoted in dollars, and as the dollar was declining, its purchasing power was less. The oil producing nations agreed that the price of oil should be indexed to a basket of currencies.⁵

One of OPEC's objectives was to see the production of oil controlled by source nations instead of the oil companies. This was established as an OPEC policy in the New York agreement of October 1972. Thus, the Saudi Arabian government drew up an agenda for the gradual takeover of ARAMCO.

The real crunch came in 1973 with the Arab-Israeli war. There was a boycott of all oil supplied by the Organisation of Arab Petroleum Exporting Countries (OAPEC) to the

United States and the Netherlands, as the United States and the Netherlands were perceived to be supporters of Israel. However, this boycott was not successful as oil was channelled to these countries by various methods i.e. Arab oil was diverted to Japan and the Japanese bought less from countries such as Nigeria and that oil went to the United States or the Netherlands.

However, the boycott was effective in causing the quadrupling in oil prices. This was welcomed by the Arab countries in particular, who were also anxious to take control of all their oil production. They realised that if they could control the supply then it was inevitable that they would be able to control prices. On 16 October 1973 the committee of OAPEC representatives met, and for the first time the price of crude oil was fixed. "Legislation replaced negotiation."⁶ "It was at this stage that the oil producing nations became the 'real' owners of their oil."⁷

OPEC has been perceived by many, especially in the 1970's as a cartel. It set the prices of crude oil and tried to regulate the overall production levels of all the OPEC members. The manner in which this was done was by setting prices and then letting the buyers purchase what they could afford given those prices. It can be said, then, that to some extent it was the buyers who regulated the prices. It is worth pointing out at this stage that the authors of "The Saudi Arabian Economy" argue against the above widely supported view. They use five points of criteria - which they feel only apply to OPEC - obtained from George Stigler's article "A Theory of Oligopoly".⁸ These criteria are that the cartel must have a small number of participants, barriers to entry must exist, members who break the rules must be punished, covert price cuts must be followed, and finally market demand and cost stipulations need to be resolute. They refute the idea of OPEC being a cartel using the point mentioned above as the basis for their arguments. They claim that "OPEC scores poorly on most of the counts and is, therefore, not expected *a priori* to be an effective cartel" (see: Myth of the OPEC Cartel, chapter 3 of Johany, Berne and Wilson 1986).

The authors of the previously mentioned book argue that if OPEC is to influence the price of crude oil it must, therefore, affect the amount supplied. They emphasise that up to the late 1970's OPEC had not proved itself as a unified group that fixed the supply and

stood by it. However, it is worth pointing out that in the 1980's OPEC moved into being a supply rationing cartel since it tried to set quotas for individual member states of the organisation. It was not possible to do this in the 1970's as the members did not agree on what the quotas should be. Thus OPEC had to set price differentials. However, the quadrupling of the price of oil in the early 1970's resulted in a reduced demand for oil. This was partly brought on by the recession in the West, with income rather than price effects dominant at least in the short run. The price elasticity of demand for oil was basically fairly inelastic, but as income went down, demand went down, so there was a positive income effect. Though, however, the price elasticity of demand was fairly inelastic in the short run, in the long run people began to look elsewhere for alternative sources of supply and for oil substitutes. The alternative sources were the North Sea and Alaska, and to some extent Mexico. These were high cost production areas but at those existing high prices it was profitable to bring them into production. Also, because of this high price many countries developed other methods to create energy i.e. they turned away from oil as a way of generating electricity and invested heavily in nuclear power, solar energy, and other alternative energy sources. Thus, it can be said that to some extent the demand for oil for purposes of electricity generation was reduced. However, oil was still needed for different forms of transportation, but the demand for oil for the generation of electricity declined substantially and the price rises of 1979/80 brought that to a head.

3.3 Oil Supply and Demand in the 1980's and Early 1990's and the Implications for Saudi Arabia

It is apparent then, that in the 1980's there had been a fairly sluggish demand for oil and an over-supply of it in the market. This had caused the price of crude oil to collapse. Apart from the market conditions and forces mentioned earlier, it is interesting to note that Sheikh Yamani's - (then oil minister for Saudi Arabia) - policy in the mid 1980's was to expand Saudi production which he hoped would reduce the price of oil somewhat and encourage the West to return to the use of oil once more. Unfortunately this policy was over emphasised and resulted in a drastic fall in the price of oil. However, from the point of view of Saudi Arabia it is arguably not so disastrous since Saudi Arabia contains vast amounts of oil; a quarter of the worlds oil reserves. For this reason according to Yamani,

if the price of oil were to stay low it would encourage people to keep using it i.e. there would always be a market for the Saudi oil. On the other hand, if the price remained at high levels, Saudi Arabia could be left with all its oil supply; with nobody wanting to buy it.

Saudi Arabia has been so called, the 'swing producer' in OPEC and it has had a significant influence on OPEC oil prices, since it is able to vary its production levels much more than other producers. Saudi Arabia has had a considerable impact on world production as the most important OPEC country, because of the sheer size of its potential production, rather than its actual production. Of crucial significance is its ability to vary output between about 4 million barrels (minimum requirement, partly for revenue purposes but also because these amounts are needed to keep the petrochemical and gas liquifraction plants in operation) and 12 million barrels. Thus Saudi Arabia has a tremendous amount of flexibility. The swing could be enormous if it so wished, and this obviously gave it tremendous power in the market; but it also put it under great pressure as the main advocate within OPEC.

As demand for oil continued to fall worldwide, Saudi Arabia had to absorb this decline by decreasing its production levels. It is worth noting here that the reason why Saudi Arabia had to be the advocate was due to its style of marketing its crude in comparison to other members' methods. The majority of Saudi Arabia's exported oil was normally lifted by its previous partners in ARAMCO. Until December, 1985, 60 percent of its exported crude oil was in the form of Arabian Light which was used as the official market crude for the whole of OPEC. Hence, Saudi Arabia could only sell its oil at the official selling price, which meant that in an over supplied market this price was greater than the actual market price, which as a result discouraged the purchase of Saudi Arabian crude oil.⁹

Due to financial pressures from within the Kingdom, Saudi Arabia was forced to declare its unwillingness to play the role of 'swing producer' within OPEC. They felt that they should be allowed to produce their quota in the same way as other member countries would. Hence, Saudi Arabia commenced to sell its quota but not at the official selling price more at a price which enabled it to sell its total quota.¹⁰ However, at the end of 1985

OPEC members decided on a "*de facto*" abandonment of the fixed price system which had been going on for 12 years in favour of a higher market share strategy. As a result in mid 1986 oil prices dropped to a low of \$6-9 per barrel after having held the average price of \$28-34 per barrel up to the end of 1985. Nevertheless, in 1987 after realising the disastrous effects of the market share strategy the members returned to their previous agreed strategy of fixed prices.¹¹

Then in 1988 Saudi Arabia adopted a policy of trying to maintain fairly stable prices, but the problem's faced by the Kingdom were firstly low demand and secondly high supply. The price of oil remained below \$14 per barrel which was quite discouraging when viewed in the context of a declining dollar and also taking into account that the price was once \$40 per barrel in the early 1980's. Thus, there was a drastic decline in revenue.

During the Iraq/Iran War Saudi Arabia's oil exports were not jeopardised. The country's advantageous geographical position had allowed its oil transportation to be relatively unaffected by the war. It had a Trans-Arabian pipeline which went directly to Yanbu in the Red Sea. From Yanbu the oil was either taken by shuttle tanker to the Suez Mediterranean pipeline and then loaded on the Egypt coast at the Mediterranean or alternatively oil was taken to the Suez Canal on small tankers as the Canal could not take large ones. However, some oil still went through the Arabian Gulf, especially that which was destined for Japan and the Far East.

In 1989 Saudi ARAMCO decided to boost its oil production capacity to its early 1980's levels i.e. 10 million barrels per day despite the fact that in 1989 a barrel of crude oil was only worth less than \$10 at the 1979 prices.¹² Nevertheless, this decision was made as a result of a study carried out by ARAMCO showing that the demand for crude oil was likely to change significantly in the ten years ahead.¹³ The cost of increasing production to 10 million barrels per day, however, was estimated at between \$15 billion and \$30 billion. The expansion program was to be carried out in two stages, the first for the period 1990-1995 at a cost of \$6 billion and the second from 1995 and at a cost of \$10 billion. It is likely that these plans will have to continuously be revised depending on the market forces and funds available to ARAMCO.¹⁴

As tension mounted between OPEC members during 1990 due to the continuous overproduction of those members with excess capacity, namely Kuwait and the UAE, which resulted in fluctuations in oil prices. Iraq invaded Kuwait on 2nd August, 1990 and with the subsequent United Nations embargo of Iraq and Kuwait, Saudi Arabia had to step in by lifting the quotas and allowing maximum production to stabilise the market i.e. to 7.4 million barrels per day. Another reason for Saudi Arabia's swift action one can argue, as is the case with Venezuela and UAE, is that they also hold a large amount of the world reserve of oil and it is in its interest to see prices are kept at reasonable levels in order to keep world demand growing in the long run.

By early 1991 Iraq had withdrawn from Kuwait, the former chaotic, and the latter devastated, and Saudi Arabia had increased its oil production to around 8 million barrels per day and planned to keep it at that. Hence, Iraq's invasion of Kuwait had helped Saudi Arabia to realise its long term ambition of controlling oil prices, by having the ability to increase its oil to 10 million barrels per day. In the short run this meant that if any member of OPEC decided to increase market share by producing over their quotas, Saudi Arabia can just flood the market with oil at a cheaper price, hence, quashing the other member's aspiration. It also means that if OPEC wished to increase oil prices it will not be able to unless Saudi Arabia agrees to go along with the idea.¹⁵

Saudi Arabia continued to produce oil at the rate of just over 8 million barrels per day for three consecutive years 1992, 1993 and 1994, (See table 3.1 for actual exported amount). It has been determined to keep its share of OPEC output at around a third of the members' total output. It is predicted that Saudi Arabia's oil production could double in the coming fifteen years, although this will depend on international market conditions. Saudi ARAMCO has been improving its facilities so that it can both deliver and distribute refined products and crude oil.

In the long run because of the large amounts of oil within its boundaries Saudi Arabia will always have a useful source of revenue for its citizens. But the power of oil and especially that of Middle Eastern oil has in practice diminished. The price of oil shot up drastically in the 1970's and it was inevitable that it would have to readjust itself due to market forces and conditions and reach an acceptable price that suits both buyers and

Table 3. 1 : Saudi Arabia: Exports of Crude Oil and Refined Products 1961-1993 (1000 Barrel /Day)

| Year | Amount | Year | Amount |
|------|--------|------|--------|
| 1961 | 1330 | 1978 | 8073 |
| 1962 | 1492 | 1979 | 9202 |
| 1963 | 1619 | 1980 | 9636 |
| 1964 | 1754 | 1981 | 9503 |
| 1965 | 2038 | 1982 | 6147 |
| 1966 | 2432 | 1983 | 4310 |
| 1967 | 2655 | 1984 | 3629 |
| 1968 | 2934 | 1985 | 2725 |
| 1969 | 3014 | 1986 | 3978 |
| 1970 | 3564 | 1987 | 3438 |
| 1971 | 4481 | 1988 | 4171 |
| 1972 | 5764 | 1989 | 4408 |
| 1973 | 7346 | 1990 | 5806 |
| 1974 | 8244 | 1991 | 7752 |
| 1975 | 6932 | 1992 | 7868 |
| 1976 | 8422 | 1993 | 7679 |
| 1977 | 8950 | | |

Source: OPEC Statistical Bulletin 1994

sellers.

Saudi Arabia is interested in retaining the demand for its oil for the foreseeable future. Its policy has also been to try and diversify. It does not export large amounts of refined products, but, it does export petrochemicals. Saudi Arabia sees itself in the future as a major force in the world of petrochemicals market. The decision to go into the petrochemical industry was undoubtedly a good one, even if it is not at the moment financially very lucrative. In the long run it will prove to be a worthwhile investment. The capital investment in the petrochemical industry was partly put up by foreign investors and partly by the government, and today it accounts for approximately 5 percent of the world petrochemical position. This is obviously a significant amount and one would anticipate that this would increase in the future. Indeed perhaps in the long run Saudi Arabia will be looking into investments in the Western petrochemical companies.

3.4 Export, Production and Revenue from Oil

Prior to the discovery of oil, Saudi Arabia was one of the most impoverished nations of the world. Its main source of revenue was the duty paid by the pilgrims to Mecca. With the discovery of oil in commercial quantities in 1938, Saudi Arabia's prospects brightened and with the outbreak of World War II in 1939 the sale of oil was inevitable. Revenues increased to \$3.21 million in 1939 from a trivial sum of \$340,000 in 1938. Then in 1940

war conditions began to dominate the scene and the increase in oil production and export was limited. Overseas pilgrimage was also stopped by Britain. As a result of all this, government revenues dropped from \$3.21 million in 1939 to about \$1 million by 1941. The total amount received by Saudi Arabia between 1941-1943 averaged about \$1.1 million per year. This sum was not enough to keep the government running so King Abdul-Aziz turned to Britain for aid.

The end of the war cleared the way for an expansion of oil production and an increase in royalties. As ARAMCO expanded, revenues from oil grew and as a result Saudi Arabia no longer needed support from outside. During the war the Saudi Arabian government had received a sum that had rose from \$3 million to about \$4 million. However, in 1946 the payment grew to £10.4 million and later in 1950 it reached \$56.7 million. The government had not become complacent and on the 1st January 1951 a 50/50 agreement between ARAMCO and the Saudi Arabian government took effect. This agreement resulted in an increase in the government's revenue. This is apparent in the oil production table 3.2. For the years 1950 and 1951, one can observe an increase in production of 39 percent. For the same period the revenue, as shown in table 3.3, nearly doubled from \$56.7 million in 1950 to a staggering \$110 million in 1951.

The growing world demand for oil, particularly from the reconstructed European industries, together with Saudi Arabia's incessant desire for greater revenues, resulted in the brisk enlargement of Saudi Arabia's oil output. The annual output increased to about 200 million barrels in 1950 and reached 351 million barrels by 1954. However, the production of crude oil grew at a slow pace during the second half of the 1950's. Then from 1961 to 1966 total output increased at a rate of about 12 percent per annum. From table 3.2 showing oil production one can observe that although ARAMCO and AOC show substantial expansion in crude oil production during the second part of the 1960's, Getty oil on the other hand showed a decline in its output from 34 million barrels in 1964 to a figure as low as 23 million barrels in 1969. The decline reflected a change in consumption taste from the high-sulphur content crude to the low-sulphur content one. This trend prevailed in the late 1960's. However, from 1967 to 1969 ARAMCO faced a slowing down in the rate of increase in crude oil output. This was due to the Israeli-Arab war of

TABLE 3.2 : SAUDI ARABIA : ANNUAL PRODUCTION OF CRUDE OIL (MILLIONS OF US BARRELS)

| Year | ARAMCO | GETTY | ARABIAN OIL | TOTAL |
|------|--------|-------|-------------|-------|
| 1938 | 0.5 | - | - | 0.5 |
| 1939 | 4 | - | - | 4 |
| 1940 | 5 | - | - | 5 |
| 1941 | 4 | - | - | 4 |
| 1942 | 5 | - | - | 5 |
| 1943 | 5 | - | - | 5 |
| 1944 | 8 | - | - | 8 |
| 1945 | 21 | - | - | 21 |
| 1946 | 60 | - | - | 60 |
| 1947 | 90 | - | - | 90 |
| 1948 | 143 | - | - | 143 |
| 1949 | 174 | - | - | 174 |
| 1950 | 200 | - | - | 200 |
| 1951 | 278 | - | - | 278 |
| 1952 | 302 | - | - | 302 |
| 1953 | 308 | - | - | 308 |
| 1954 | 348 | 3 | - | 351 |
| 1955 | 353 | 4 | - | 357 |
| 1956 | 361 | 6 | - | 367 |
| 1957 | 362 | 12 | - | 374 |
| 1958 | 371 | 15 | - | 386 |
| 1959 | 400 | 21 | - | 421 |
| 1960 | 456 | 25 | - | 481 |
| 1961 | 508 | 29 | 4 | 541 |
| 1962 | 555 | 34 | 11 | 600 |
| 1963 | 595 | 33 | 24 | 652 |
| 1964 | 628 | 34 | 32 | 694 |
| 1965 | 739 | 33 | 33 | 805 |
| 1966 | 873 | 30 | 46 | 950 |
| 1967 | 948 | 25 | 50 | 1,024 |
| 1968 | 1,036 | 23 | 55 | 1,114 |
| 1969 | 1,092 | 23 | 59 | 1,174 |
| 1970 | 1,295 | 29 | 63 | 1,387 |
| 1971 | 1,642 | 34 | 65 | 1,741 |
| 1972 | 2,098 | 29 | 75 | 2,202 |
| 1973 | 2,677 | 24 | 72 | 2,773 |
| 1974 | 2,997 | 30 | 69 | 3,095 |
| 1975 | 2,492 | 31 | 60 | 2,583 |
| 1976 | 3,054 | 30 | 56 | 3,139 |
| 1977 | 3,291 | 32 | 35 | 3,358 |
| 1978 | 2,944 | 30 | 56 | 3,020 |
| 1979 | 3,377 | 30 | 73 | 3,479 |
| 1980 | 3,525 | 29 | 70 | 3,624 |
| 1981 | 3,513 | 27 | 46 | 3,586 |
| 1982 | 2,310 | 24 | 33 | 2,367 |
| 1983 | 1,597 | - | - | 1,658 |
| 1984 | - | - | - | 1,493 |
| 1985 | - | - | - | 1,159 |
| 1986 | - | - | - | 1,840 |
| 1987 | - | - | - | 1,535 |
| 1988 | - | - | - | 1,890 |
| 1989 | - | - | - | 1,848 |
| 1990 | - | - | - | 2,340 |
| 1991 | - | - | - | 2,963 |

NOTE: Total may not agree due to rounding. SOURCES: ARAMCO Annual Operations Report, 1981, p.14; SAMA Annual Reports, various years; ARAMCO Facts and Figures 1983; Ministry of Petroleum and Mineral Resources, Economics Department, Petroleum Statistical Bulletin, 1979, pp 17-20; Petroleum Economist, April, 1988, p. 144.

1967, which had caused the continuous disruption of the Tapline in Syria.

From 1970 to 1973 the total output of crude oil doubled i.e. from 1,387 million to 2,773 million barrels and crude oil production continued to grow steadily during the 1970's. The revenue from oil in Saudi Arabia has shown a large expansion during the 1960's and the early 1970's. As a consequence of the Teheran Agreement of June 1971 and the Geneva agreement of February 1972 which resulted in the increase of the posted prices and tax rates, the expansion in the value of both Saudi Arabia's revenues and exports was far greater than the expansion in the size of exports in the 1971-1973 period.¹⁶

A huge increase resulted in 1974 when the revenue from oil increased by more than 400 percent within a year due to the quadrupling of oil prices, see table 3.3. By 1976 oil revenues had grown by more than 25 times the 1970 level, while the level of output had more than doubled in the same period.

It is apparent that foreign trade in Saudi Arabia relies totally on the oil production and its price. Both crude and refined oil, the former constituting the bulk, account for

Table 3.3 : Saudi Arabia: Oil Revenues 1939 -1994
(\$ million)

| Year | Amount | Year | Amount | Year | Amount |
|------|--------|------|--------|------|----------|
| 1939 | 3.2 | 1958 | 298 | 1977 | 36,540 |
| 1940 | 1.2 | 1959 | 313 | 1978 | 32,234 |
| 1941 | 1.0 | 1960 | 334 | 1979 | 48,435 |
| 1942 | 1.1 | 1961 | 378 | 1980 | 84,466 |
| 1943 | 1.1 | 1962 | 410 | 1981 | 102,095 |
| 1944 | 1.7 | 1963 | 608 | 1982 | 70,479 |
| 1945 | 4.3 | 1964 | 523 | 1983 | 37,352 |
| 1946 | 10.0 | 1965 | 664 | 1984 | 31,470 |
| 1947 | 18.0 | 1966 | 789 | 1985 | 18,323 |
| 1948 | *52.5 | 1967 | 904 | 1986 | 13,555 |
| 1949 | 39.1 | 1968 | 926 | 1987 | 17,489 |
| 1950 | 56.7 | 1969 | 949 | 1988 | 16,638 |
| 1951 | 110.0 | 1970 | 1,214 | 1989 | 18,860 |
| 1952 | 212.0 | 1971 | 1,885 | 1990 | 31,122 |
| 1953 | 170.0 | 1972 | 2,745 | 1991 | **44,800 |
| 1954 | 236.0 | 1973 | 4,340 | 1992 | **45,560 |
| 1955 | 341.0 | 1974 | 22,574 | 1993 | **39,590 |
| 1956 | 290.0 | 1975 | 25,676 | 1994 | **35,686 |
| 1957 | 296.0 | 1976 | 30,755 | | |

SOURCE: Figures from 1939-61 are from Young (1983, p.125); SAMA Annual Reports, various years; OPEC Annual Statistical Bulletin 1984. * Figures for 1948 looks like a clerical error. If revenues were proportionate to oil production it would be about \$32 million instead of \$52.5 million. ** MEES, various issues, the figure for 1993 was estimated, while the figure for 1994 is a projected one.

most of the nation's exports. The revenue gained is used for the development of the country. This emphasised the significance of oil to the Kingdom and hence one can understand why it is of vital importance that the government desires to develop a domestic industry that would in the long term help to decrease the Saudi Arabian economy's dependence on oil. The period from 1969 and 1981 was one of buoyant conditions in the world oil market. This was reflected in the revenues from exports that rose from a mere SR 5.7 billion in 1969 to a staggering SR 368 billion in 1981. However, after this boom there came a glut in the world oil market, which as a result caused both the price and the quantity produced of Saudi Arabian oil to be adversely affected. The total government's revenue dropped, and by 1985 total government revenue was a mere SR 131.7 billion.¹⁷ On the other hand, government expenditure increased from SR 6 billion in 1969 to SR 283 billion in 1981. However, since 1981 the government expenditure figures have gradually decreased, partly due to the decrease in the government's revenue, and also due to the fact that the majority of infrastructure projects had been completed. In 1985 the government expenditure equalled SR 181.5 billion.¹⁸

For the period between 1970 to 1982 the Kingdom of Saudi Arabia enjoyed a balance of payment surplus - except in 1979/80. The current account surplus grew from SR 320 million in 1970 to approximately SR 52 billion in 1974. However, with the expensive development plans that went into the government's agenda this soon reached a deficit figure of SR 5 billion in 1979. In 1981 the current account balance showed a surplus. This was a direct result of the increase in oil price, which also made possible a SR 118 billion surplus in 1982. This did not continue and in 1985 the current account balance had shown a deficit of SR 24 billion, SR 45 billion for the subsequent year and a deficit of approximately SR 52 billion in 1987. This can be attributed to the decline in the world oil prices.¹⁹ In 1988 the deficit figure increased to around SR 61 billion.²⁰ Saudi Arabia continued to experience a balance of payment deficit into the mid 1990's, see table 5.2 in chapter 5, due to the decline in oil prices and the continuous large amount of government expenditure especially those incurred due to the Iraq/Kuwait war, as it is estimated that the cost of the war to Saudi Arabia was between \$55 -60 billion.²¹

It is apparent that there is little difference between the production and export figures

for Saudi Arabia since very little domestic consumption of oil takes place. Virtually nothing but oil is exported from the country. Refining occurs in the country but this is almost all for domestic use. Very little refined oil is actually exported. One of the reasons for not exploiting this opportunity is perhaps the fact that the insurance premium for the shipment of refined oil is far greater than that for crude oil, as refined products are by nature volatile. Another factor that may have slowed Saudi Arabia from exploiting the possibility of refining is the fact that in order to export refined oil, one needs to divide it into different products for the actual shipment which makes the economics of the whole process more doubtful. With petrochemicals oil is processed through many different stages therefore more value is added and simultaneously one is also using the - otherwise wasted - energy feedstock. In contrast refining is not so energy intensive. Given that Saudi Arabia exports very large quantities of oil it would require heavy investment to set up refineries to handle such large quantities. Also if Saudi Arabia had done this on a large scale it would have probably resulted in an adverse effect on the differential between the refined price and the crude oil price. What is more important is that refining is not conceived to be diversification and this would defeat the purpose of the government's objective of reducing its reliance on oil by diversifying into other industrial activities, especially when the country's gains on technological grounds are far superior in the field of other oil related industries such as petrochemicals than that obtained from refining.

Finally, one must not forget the influence that ARAMCO exercised and its overall control of policies until it was finally passed to the hands of Saudi nationals. It was not in ARAMCO's interest as a multinational to encourage refining in Saudi Arabia since this meant that business would be taken from its owner's refining subsidiaries which were scattered world wide.

3.5 Oil Diversification

The Saudi Arabian economy is heavily dependent on its ability to export its oil. This means that economic activity within the Kingdom is largely determined by the price of crude oil in the world petroleum market, which is highly volatile. Though OPEC can influence prices, the influence is not often successful. Until the early 1970's Saudi Arabia

had not been over zealous in diversifying into oil related industries and downstream activities, other than oil refining. Recently, however, the Saudi Arabian perspective has changed.

In 1962, the General Petroleum and Mineral Organisation (PETROMIN) was formed under the auspices of the Ministry of Petroleum and Mineral Resources. Its aim was to participate in diverse industrial and commercial oil-related activities.²² PETROMIN is a government agency which received its capital funds from the state itself. It also has the government's *carte blanche* to participate - through joint venture, purchase, take-over as a subsidiary and mergers - in organisations or companies which are involved in projects in the same field of operations.

PETROMIN has vigorously attempted to accomplish its mission through its involvement in activities ranging from oil retrieval to marketing the oil and oil-related products. It is concerned with the exploration and drilling of oil and has been able to expand the Kingdom's refining capacity. Examples of this can be seen from the refineries established in Riyadh and Jeddah. PETROMIN has also been successful in the refining and blending of lubricating oils and in establishing crude oil pipelines, one of which is the East-West crude oil pipeline (Petroline). This is noted to be one of PETROMIN's major accomplishments. PETROMIN is also responsible for the marketing and exploration of oil and gas as well as distributing them domestically. It has been able to contribute to the oil supply covenants between the government of Saudi Arabia and that of different importing nations. As ARAMCO's assigned off-takes were diminished, PETROMIN was able to enhance its position as an important exporter of Saudi Arabian crude oil.

PETROMIN is involved in the diversification of Saudi Arabia's oil and gas related industries. It has carefully attempted to fulfil its undertaking by trying to increase the production of oil and also to make use of the energy resources - namely oil and gas - to create heavy industry. This can be seen from factories set up in Jubail and Yanbu. The primary industries established here were jointly owned by the private sector and either PETROMIN or the Saudi Arabian Basic Industries Corporation (SABIC). The former deals with the refineries, and the latter with the rest. The government aims to promote the petroleum and mineral related industry and in doing so it offers considerable subsidies to

those who wish to enter into joint ventures with the government. In 1973 the Public Investment Fund (PIF) was established in order to reinforce the activities of PETROMIN, SABIC and other similar bodies. Here business opportunities were found in investing in energy-intensive industries such as petrochemicals, industrial gases and glass. This in turn created jobs in the field of marketing, management, engineering and other industry related occupations.

The quadrupling of oil prices in the early 1970's increased Saudi Arabia's revenues to around \$1 billion and gave it the necessary leverage to set up large scale energy intensive industries such as petrochemicals and steel. The purpose was to enhance exports of the end products. Thus was set out in the first development plan 1971 - 1974, with the objective of creating a petrochemical industry.

One of the advantages of exporting petrochemicals is that they operate in a more stable price environment than that of crude oil. Another advantage is that Saudi Arabia is getting more value added as it is doing more itself and is therefore getting the benefit of the processing. However, in the case of Saudi Arabia the advantage of petrochemical production is not seen in terms of financial profitability, since the profitability of the petrochemical industry depends very much on the price of the feedstock, i.e. if the oil is provided at low prices for the petrochemical industry then naturally it will make profits, but if the price is charged at a reduced level then it will affect the profitability adversely. Moreover, the feedstock price offered to the Saudi Arabian petrochemical industry has to be fairly low in order to give it the necessary competitive edge in the export market. Looney (1983), declares that the "Creation of gas-based industries in the Kingdom makes sense if the relative cheapness of the country's gas can be used to overcome some comparative disadvantages which the country faces." ²³

This policy of making use of subsidised feedstock, was one of the underlying reasons for the friction between the European Community and the Gulf Corporation Council.²⁴ Protectionist tariffs have been imposed both in the USA and the European Union on Saudi Arabian and other Gulf States' petrochemical products making it difficult for them to compete within the economies of the developed nations. Hamauzu (1986) suggests that "The Saudi problems in facing the world petrochemical industry stem from

the large scale as well as the uniqueness of the petrochemical industry in Saudi Arabia."²⁵

Hence, the Saudi Arabian petrochemical industry had to be competitive if it wished to survive in the world market. Saudi Arabia could not control those markets. Therefore, all it could do was to offer its industry low feedstock prices, thus enabling them to keep the industrial costs down and encouraging others to buy Saudi Arabian petrochemicals.

It should be recognised that Saudi Arabia was not really interested in the financial return from the industry. It was mainly concerned with acquiring the necessary technology and know-how to run a large scale industry such as this. The aim was to make Saudi Arabia a major world centre for petrochemical production. Saudi Arabia recognised that this was a type of industry it should be involved with, given that it is an important oil exporting nation. This is a reasonable argument since one of the attributes of the petrochemical industry is that it is very energy intensive. The gas which previously was flared off could now be used, it has been in fact suggested that the amount of gas flared in 1982 was equal to feedstock equivalent to that needed for 13 ethylene plants each producing 500,000 tons per year.²⁶ However, there is another opportunity cost, as with liquefaction the gas here could have been exported. The production of petrochemicals is nevertheless seen as a means of encouraging the development of local industries that would rely on the petrochemical products as raw materials for their end goods, e.g. plastics. Those industries are usually financed through the Public Investment Funds, and this could reach to 60 percent of the total cost of the project. The foreign joint-venture firm usually takes on 15 percent of the cost, while SABIC obtains a 15 percent equity share and the rest of the necessary finance required is usually provided by the commercial banks.²⁷ SABIC itself is a government-owned joint-stock company.²⁸ It is obvious that the scope for agricultural development is limited in Saudi Arabia, making industry the likely alternative. Thus, Saudi Arabia seeks to industrialise and it is logical to industrialise on the grounds that it is the available resources which provides the basis for a potential comparative advantage.

In 1976 SABIC was created by the government to handle the necessary financial involvement and risk inherent in large scale industries. The majority of industries have been established in the cities of Yanbu near the Red Sea and Jubail on the Arabian Gulf.

The charge of creating and supporting the industrial cities was collectively distributed between three bodies, as follows: (i) The Royal Commission of Jubail and Yanbu was given responsibility to "plan, co-ordinate and implement infrastructure programmes"²⁹ for the twin cities. (ii) The oil-related undertakings, such as refineries, tank farms, natural gas, liquefaction plants...etc, were to be under the umbrella of PETROMIN, while (iii) SABIC was to construct and establish the heavy industry.

The conversion of Jubail and Yanbu from desert land to two dynamic cities emphasises the Saudi Arabian government's desire to diversify into different hydro-carbon based and energy intensive primary industries. Twenty of these are based in Jubail³⁰ and six are based in Yanbu.³¹ They use gas which would have been previously flared off. This makes the cost of supplying the gas equal to the cost of gathering and treating it. It is also worth mentioning that by doing so, the air pollution levels are decreased. The primary industries are funded mainly through PETROMIN and SABIC and partly by the private sector the majority of which are foreign companies. The government anticipated that this would trigger off the development of secondary and supporting industries which would use the output of the primary industries as raw materials. The secondary industries would be involved in the manufacturing of products such as plastics, copper, steel and aluminium products, and was estimated that 68³² secondary industries will be established in Jubail and 34 firms in Yanbu.³³ These industries would be developed by private firms which would be encouraged by the government through incentive schemes. However, the secondary industries would not be an important contributor to the Saudi Arabian economy until the primary industries came in to full operation. In comparison the support industries, which produce products that are needed by the other industries or for construction purposes, have been in operation since 1980, 63³⁴ of which are in Jubail and another 15 in Yanbu.³⁵

It is apparent that the majority of the funding received by the projects established in Jubail and Yanbu was supplied by the Saudi Arabian government itself, therefore, the demand for commercial bank credit in relation to these projects was very low. However, Jubail has a day-time population of more than 41 thousand³⁶ while Yanbu has over 21 thousand³⁷ inhabitants. The majority of this population is employed and, therefore,

needed the services of commercial banks to process their pay cheques, deposit their money or even borrow for various purposes. This created a multiplier effect for the commercial banks. Thus, the industries at Jubail and Yanbu indirectly generated business for the banks, but the actual effect is very limited, because it is the Saudi Arabian government which has put up the financing.

There has been a great deal of investment in the Jubail and Yanbu projects, however, the returns from these investments might be disappointing in financial terms but in the long run the pay-off can be quite considerable. SABIC's policies were to form joint-venture with large foreign companies, thereby granting itself access to the necessary expertise and technology required to achieve success in these fields. Another underlying objective was to use the foreign companies connections and skills in marketing to promote the Saudi Arabian petrochemicals in those companies' home countries and surrounding territories. In the long run Saudi Arabia hoped to have obtained the necessary technology and know-how through training its own nationals, thereby reducing their reliance on external assistance. Another objective has been to improve SABIC's returns and efficiency performance. In fact, in 1993 the saleable goods from Saudi Yanbu Petrochemical Company (Yanpet) was 75 percent over the original design capacity, while the ethylene cracker almost doubled its productivity from 455,000 tonnes in 1986 to 800,000 in 1993.³⁸ Saudi Arabia has about 5 percent of the world petrochemical production capacity as already indicated. This was despite the fact that SABIC had slowed down its investment in the late 1980's due to the low return. In the long term Saudi Arabia aims to do more and will perhaps become a major force in petrochemicals. However, Hamauzu (1986) refutes this view in his paper, as he argues that Saudi Arabia's petrochemical industry is "an enclave lacking a forward linkage despite the huge investment in petrochemical projects and supporting infrastructures in Jubail and Yanbu. Its role as a locomotive for Saudi economy is minimal, and is likely to remain so for the foreseeable future."³⁹

Chapman (1991) argues that "the low feedstock cost of the oil-rich countries do not necessarily guarantee a comparative advantage in basic petrochemicals."⁴⁰ He argues that construction costs were higher than those in developed countries and the problems faced

were greater but, nevertheless, projects were completed ahead of schedule. He advocates that even though the cost of feedstock is lower in the Middle East operating costs will still be too high compared to those operating in the industrialised world, mainly because of the lack of trained personnel, which means that manpower will have to be brought in from abroad to run the plants. He goes on to suggest that the success of the Saudi Arabian petrochemical projects will also depend on their delivery costs as apposed to production costs. He argues that when plants were set up in Western Europe their success depended on an oil price of \$125 per tonne. Hence, it was only if oil prices rose above this figure that Saudi Arabia would be able to compete with the Europeans. However, once the plants had been completed Saudi Arabia found that oil prices had dropped below the \$125 per tonne figure. Nevertheless, by the early 1990's oil prices rose once more to above the \$125 per tonne threshold.⁴¹

Saudi Arabia has recently began to invest heavily in refining, by constructing both a new fluid catalytic cracker and a hydrocracker. However, the \$2,000 million expansion of the Ras Tanura was halted for a period of time when the Saudi Arabian Marketing and Refining Company (SAMAREC) and ARAMCO merged in 1993, but it is expected that it would be completed by 1995/96. It is worth noting here that this move has been a strategic one as there has been a fall in demand for fuel oil, as many power generators have been converted to gas instead of fuel oil due to environment pressures. In fact, demand has changed in the Saudi Arabian export market from fuel oil to unleaded gasoline and gas oil.⁴²

SABIC has continued its quest to become an efficient and quality orientated international producer of petrochemicals, plastics, resins, fertilisers and metals, using the components of competitively priced natural gas as feedstock, a goal that has been realised by 1993.

Saudi Arabia may decide to pursue different policies in the future, namely, buying Western downstream petrochemical activities. Then it could supply its methanol, ethylene,...etc. to those industries which it holds a stake in. This would provide it with marketing opportunities. This policy can be seen more as a marketing ploy, rather than a financial one.

Whatever policies or strategies Saudi Arabia decides to pursue it will need to solicit the help of its financial intermediaries as it can no longer afford to depend on income from oil for financing. Privatisation could be another option but the government will have to think hard before it commits its very expensive investments into the hands of private investors. It is unlikely that foreign funds will be allowed to participate. In fact, recently privatisation has taken place with some of the non oil industries and this will be discussed in the next chapter.

Notes:

- (1) Johany, Ali D.; Berne, Michel. and Wilson, J. Mixon Jr. The Saudi Arabian Economy London: Croom Helm, 1986, p. 30.
- (2) Ibid., p. 30.
- (3) Ibid., p. 50.
- (4) Danielson, A. L. The Evolution of Opec New York: Harcourt Brace Jovanovich, 1982, p. 188.
- (5) Johany et al., op. cit., p. 51.
- (6) Ibid., p. 51.
- (7) Ibid., p. 52.
- (8) Stigler, G.S. "A Theory of Oligopoly." Journal of Political Economy, Vol.72, Feb. 1964.
- (9) Al-Chalabi, Fadhil J. OPEC at the Crossroads Great Britain: Pergamon Press, 1989, p. 83.
- (10) Ibid., p. 84.
- (11) Ibid., p. 77.
- (12) Middle East Economic Digest, Vol. 33, No. 48, 8th December, 1989, p. 4.
- (13) Ibid., Vol. 34, No. 18, 11th May, 1990, p. 4.
- (14) Ibid., Vol. 33, No. 49, 15th December, 1989, p. XII.
- (15) Ibid., Vol. 35, No. 12, 29th March, 1991.
- (16) El Mallakh, Ragaei. Saudi Arabia Rush to Development London: Croom Helm, 1982, p. 61.
- (17) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1406 (1970- 1986)." p. 2.
- (18) Ibid., p. 2.
- (19) Ibid., p. 32.
- (20) Middle East Economic Digest, Vol. 31, No. 24, June 1987, p. 5.
- (21) Financial Times, "Survey of Saudi Arabia." 22nd December, 1993, p. 5.
- (22) PETROMIN: Handbook, Petroleum Statutes, Article 2, p. 122.
- (23) Looney, R.E. Saudi Arabia's Development Potential Toronto: 1982, p. 184.
- (24) This is discussed extensively by Rodney Wilson, "Euro-Arab Trade Prospects to The 1990's." The Economist Intelligence Unit Special Report, No. 1105, January 1988.

- (25) Hamauza, T. "Industrialisation in the Gulf: Its implications for Far Eastern and South East Asian Countries." University of Durham Centre of Middle Eastern and Islamic Studies, Occasional Papers Series No.29,1986, p. 92.
- (26) US Department of Commerce, 1986, p. 59.
- (27) Presley, John R. A Guide to the Saudi Arabian Economy Hong Kong: Macmillan, 1984, pp. 66-67.
- (28) Johany et al., op. cit., p. 33.
- (29) Royal Commission of Jubail and Yanbu, Annual Report, 1398H, p. 6.
- (30) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1406 (1970 - 1986)." p. 138.
- (31) Ibid., p. 139.
- (32) Ibid., p. 138.
- (33) Ibid., p. 139.
- (34) Ibid., p. 138.
- (35) Ibid., p. 139.
- (36) Ibid., p. 136.
- (37) Ibid., p. 138.
- (38) Middle East Economic Digest, Vol.38, No.20, 20th May, 1994, p. 12.
- (39) Hamauza, op. cit., p. 93.
- (40) Chapman, K. The International Petrochemical Industry Evolution & Location Great Britain: Basil Blackwell Ltd., 1991, p. 182.
- (41) Ibid., pp. 182-184.
- (42) Middle East Economic Digest, Vol.38, No.46, 18th November, 1994, pp. 2-3.

Chapter Four
**Financing the Non-Oil Economic Sectors
in Saudi Arabia**

It has been the underlying objective of the Saudi Arabian government to develop all sectors of its economy in order to promote a more balanced development. With this goal in mind the Kingdom has used its oil revenue to finance its non oil economy. The government has recognised that it would be a long time before it reaches its aspirations and becomes less dependent on oil as a source of income. However, in order for it to achieve its independence it must diversify and develop industries so that it can export other goods. Recognising this the government first set out to establish a strong foundation, an infrastructure that both the public and industry can rely on. This the government has accomplished to a considerable extent. The government also focused on developing its agricultural sector, although at a considerable cost. Simultaneously it has encouraged the development of down stream oil industry and has set up funds to support the import substitution industries. However, all this has been done through the public sector, the government supplies financing, administration, advice and organisation which means that very little was left to the private sector and financing from commercial banks.

In 1932, Abdul-Aziz Bin Saud combined the Sultanate of Nejd and the Kingdom of Hijaz to form the Kingdom of Saudi Arabia. He then proclaimed himself ruler of this unified Kingdom, thus establishing the origins of the Saudi Arabian monarchy. However, during the struggles to reach this end, the House of Saud and the puritanical Wahabi Muslim sect had become identified as the same. It was Abdul-Aziz's main goal and that of his fighting force - known as the 'Ikhwan' - to restore and purify the Muslim faith to what it once was. The Kingdom of Saudi Arabia as a land, consisted of scattered clay built villages, vast areas of arid desert and harsh climatic conditions where a nation of nomadic tribes and modest farmers were forced to survive.

Before the discovery of oil Saudi Arabia was one of the poorer nations in the world. The government's yearly income was the equivalent of \$500,000. The bulk of this was earned from charges imposed on the pilgrims and tithes paid by the wealthy merchants.¹ It was substantially agricultural particularly in the south west region on the borders of Yemen. Here rain fed agriculture existed along with nomadic pasturage and irrigated agriculture around the oasis. Some fishing existed but this was minor compared to other Gulf states. However, of importance was the trade of the Hijaz in relation to the pilgrims

to Mecca. This generated a certain amount of economic activity with pilgrims flocking from all over the world to Saudi Arabia. This was historically important and to some extent it was also important in terms of the evolution of banks in Saudi Arabia from their original state as money changers to what they are today.

With the discovery of oil in 1938 and the eventual revenues that followed, bringing unimagined wealth, the Saudi Arabians were faced with the predicament of how to maintain their existing culture and religion while simultaneously making full use of the Western technology that had now become obtainable. With religion as a continuous and imperative part of the leadership and the choice of technology often conflicting with religious opinion, the objective of modernisation, nevertheless, often overwhelmingly dominated so long as it did not offend the Muslim faith.

4.1 The Agricultural Economy

Before the discovery of oil, Saudi Arabia was predominantly an agricultural country much of which was in the form of nomadic pastoralism. This was due to the severe climatic conditions, notably, the vehement heat and sand storms that affect a major part of the country. This, in turn, determines the use of resources, methods of production and, to a large extent, the type of crops produced. Access to sophisticated systems acquired through revenues from oil has contributed to the enhancement of the agricultural sector in the Saudi Arabian economy. Plentiful oil results in low cost fuel for transportation, and keeps down the cost of running farm equipment and machinery. The revenue from oil has also helped the development of communications, including the surfacing of roads that has encouraged the link between the populated areas where the market lies with those where the agricultural products are actually cultivated.

Since the commencement of the Saudi Arabian government's industrialisation programs, the agricultural sector has experienced a tremendous fluctuation in its composition and size. The number of people employed in the agricultural sector in Saudi Arabia represents a small proportion when comparing it with other developing nations. Nevertheless, agriculture remains the primary sector in terms of occupational engagement by Saudi Arabian nationals. In the early 1970's approximately 70 percent ² of the labour

force were involved in the rudimentary farming techniques passed on to them from their forefathers. This number declined to 695,000 persons ³ roughly 9.59 percent of the country's population in 1975 and reached approximately 6.4 percent i.e. 600,000 persons in 1980.⁴ This has hindered the government's objective of self-reliance and increased its dependency on imported sustenance goods. The movement from agricultural to urban employment could mainly be attributed to the low income received by the farmers; but also to the availability of other essential facilities in the urban areas such as medical care and education services. In 1990 the number of the population employed in the agricultural sector was 569,200 ⁵ a decline of 2.57 percent during a ten year period, which indicates that there is still a move out of agriculture, but at a much slower rate.

Another reason for the decline in agriculture could be the methods used when compared to those available elsewhere. The systems used internally in the traditional sector seem obsolete when compared to the highly technologically efficient equipment and methods used abroad. This makes the Saudi Arabian produce less competitive in the market place. This position is made worse with the changing pattern of consumption experienced in Saudi Arabia due to the surge in personal incomes as well as the large number of expatriates living there who possess different tastes. Expansion of the cities and the subsequent expansion into the surrounding agricultural lands such as those around Riyadh and Madinah has also contributed to the decline in agricultural products. However, it is not the decline in itself that has caused concern as this is an expected phenomena in a growing economy, the main concern is the rate at which it has occurred.

In an attempt to reverse and rectify the process experienced in the agricultural sector, the Ministry of Agriculture and Water (MOAW) has endeavoured to increase agricultural productivity and to maximise the use of urban land available. In order for the government to reach its goals, it has invested in research and development enabling it to choose the most suitable crops available to produce the best possible harvest. In addition, better methods of irrigational techniques could maximise the use of the water resources available for the agricultural sector in the country. Furthermore, the government offers vast subsidy programmes which present incentives to producers and animal farmers. In doing so the government attempted to insure that the benefits from oil revenues reached

all its citizens including those in remote and secluded agricultural areas. Thus land was made readily and freely available provided its intended use met with government approval. Long-term interest free loans for purchase of machinery and investment were readily available along with short-term interest free loans with the objective of supporting farmers facing adverse seasonal fluctuation in their crops. Subsidies were offered for many agricultural activities such as the purchase of livestock, poultry, dairy equipment, pumps, engines, pesticides, fertilizers, animal feed, seeds...etc. the government also contributed to the basic needs of the remote rural population by establishing roads, wells, irrigation systems and in many cases veterinary services.

Since the availability of subsidies production has generally increased. The outstanding example is wheat production which was monitored closely by government officials since it represents a basic food. Its output increased by 140 percent just a year after the commencement of the subsidy programme in 1973.⁶ This increase was due to the following factors, the increase in land used, improved farming methods and the superior type of seeds sowed. The subsidy programmes are under the control of the Saudi Arabian Agricultural Bank (SAAB) - which offers a variety of financial services to the agricultural sector, and the Grains Silos the Flour Mills Organisation (GSFMO) which buys the local wheat at a price above that prevailing in the market. It is also involved in the production of concentrates for animal feed. Another organisation that offers support to the agricultural sector is the SIDF - though this was initially formed to support industry - by providing loans. Its assistance to the foods processing industry indirectly benefits agriculture by providing a local marketing outlet.

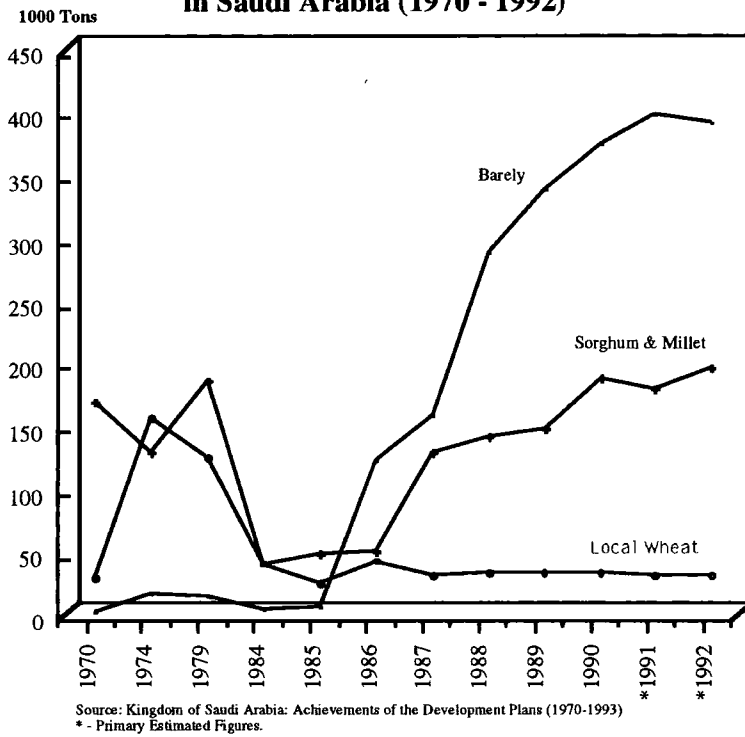
The majority of the traditional farms were rather small. There has, however, been a rapid increase in the number of large-scale farms, most of them operating with highly sophisticated machinery. This kind of farm typifies the newly established wheat, poultry and dairy farms. The development of these farms was made possible due to the availability of agricultural land not yet exploited in addition to the cheap capital funds wholly provided by the government. As a consequence commercial bank financial involvement in the agricultural sector has been limited - unless the bank itself owns the agricultural land which it may develop. An interesting example of the new type farm is

Haradah, South of Riyadh.⁷ This is under the administration of the National Agricultural Development Company (NADOC) - a joint-stock company of which the Saudi Arabian government possesses 20 percent. Created in 1966 as the King Faisal model settlement, it initially met with some difficulties. However, it has been successful in growing large amounts of wheat.

It is apparent that the government's support of the agricultural sector begins with research and development and ends with the government purchasing the end product at prices well above those in the market. The government offers the farmers machinery and equipment at subsidised rates, in addition to support in the form of cheap electricity, fertilizer and seeds. The main objectives of those policies are to introduce sophisticated new technology and skills to this sector; to increase farm income; to decrease the costs involved in production, to expand the size of farm lands and ultimately to convince the agricultural population to continue to work in that field as opposed to seeking other types of occupation. However, there is room for much improvement before the government can actually rely on agriculture as a source of government revenue rather than a burden.

Saudi Arabia's main crops consist of wheat, millet, barley, sorghum and other cereals, see figure 4.1. Vegetables include tomatoes, and fruits, such as dates and citrus fruits and to a lesser extent grapes, melons and water melons. The farming of those products is scattered around the country with Taif, Asir, Jaizan, Al-Quasin, Riyadh and the Eastern Province representing the key agricultural areas. Some farming exists - however, small in comparison - around other parts of the country, mainly around the oases. As figure 4.2 shows in 1985, 25 million tons of wheat were produced representing an annual growth of 29.1 percent. This is a sharp comparison to the mere production of 26 thousand tons in 1969-1970. As a result of this enormous growth the country has been able to meet all its domestic needs.⁸ There were in fact a grain surplus which was difficult to market. One problem was persuading people to change their tastes and change their basic diet. Often imported rice is eaten in preference to locally grown wheat. The Saudi Arabians do not consume bugle wheat in any significant quantity unlike the Arabs of North Africa, where wheat is the staple foodstuff. However, the government could try to encourage import substitution industries that rely on wheat as a major factor in their

Figure 4.1: Cereals Locally Produced in Saudi Arabia (1970 - 1992)



product. Thus, Saudi Arabia was faced with a marketing problem, and not a production one.

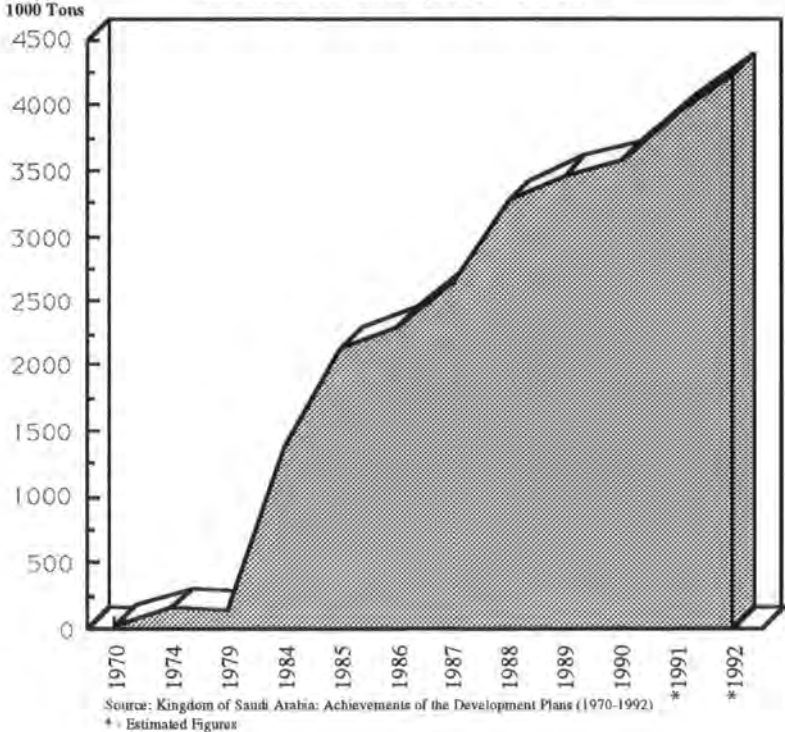
4.1.1 Food, Pricing and Production Problems

The underlying question of economic subsidies was the determinant of Saudi Arabia's wheat problems. It was faced with two options, either to continue as it has done in the past with price supports which meant over supply and inevitable wastage, or; on the other hand, it can provide direct income supplements i.e. supplement the farmers income on condition that the crop mix was changed, even if the prices of some of the alternative crops were much lower. If the government chose to follow the latter option it may well find it to be cheaper than the former one. In fact, in terms of the farmers' income this option may give them the same if not a better return. However, the farmers may view this differently. They may feel that they are forgoing a good price for their crops - viewing the issue from a production oriented angle - and becoming very dependent on social security - which can only be seen as a negative prospect. Nevertheless, by having low prices for the crops the farmers will produce less. However, they will earn enough from the crops to sustain themselves plus the income supplement that the government will give them to keep them and their families on the same living standards as previously enjoyed. The advantage of

this would be that the government will not have the undesired surpluses which have to be stored, transported and finally disposed off, all of which cost Saudi Arabia money. The difficulty is that the farmers will not have a goal to achieve if they are not given the chance to produce. The government can also set production levels and any one who goes over and above these set quotas will have to sell the difference at a cheaper price. The problem, however, will be to determine what the amount is and how to allocate it to the individual farmers. This will be very contentious and could result in tremendous conflicts between different tribes and groups. Another point worth mentioning is that if the government gives the farmers income supplements it could result in laziness and a lack of investment.

Faced with the continuous increase in wheat production, see figure 4.2, the government changed its policies somewhat. It decreased the purchase price of wheat from SR 3.50 in 1984/85 to SR 2.00 in the following year.⁹ The government knew that the wheat support price could not be decreased further since this could dampen future investments and interests in the agricultural sector. Despite this decrease in price wheat production continued to escalate. Near the end of 1986, the government forced the five

Figure 4.2: Total Wheat Production in Saudi Arabia (1970 - 1992)



largest wheat producers to switch over one-third of their cultivated land to barley. In the 1980's the importation of barley had been on the increase and was held at approximately 4-5 million tonnes in the last three years. Even though the government had attempted, in many ways, to encourage the switch to barley, nevertheless, it faced many obstacles: firstly, the government support price for barley was half what it is for wheat; secondly, the yield from barley was around 1.67 tonnes per hectare whereas the yield from wheat was approximately 4 tonnes per hectare¹⁰; and, thirdly, the government offered high import subsidies for barley. Therefore, it was apparent that the Saudi Arabian government would have to revise its price support system offering farmers better incentives if they switch to barley. However, even if the subsidies for both crops were equal, farmers would continue to produce wheat since it gives a better yield per hectare, thus, a larger profit.

These problems are difficult to solve, nevertheless, they are as important as the actual production, with marketing a key issue that also needs to be looked at. Saudi Arabia drifted into this situation without fully analysing the consequences. It had only looked at the technical aspects and had failed to examine and analyse the long term economic situation. The question in the case of Saudi Arabia was of opportunity costs, since perhaps the money spent on the crops, production of which are in excess of the public demand, could have been spent on something else that the country as a whole would benefit from. The problem with wheat in Saudi Arabia is not dissimilar to that which exists with European agriculture, it is not so much a question of third world agriculture, but more a question of marketing, pricing...etc. These are important issues for Saudi Arabian agriculture that need to be considered. However, it would all be determined by the government's expenditure policy and how it wished to disperse its income. It could have continued to do as it had done in the past and produce more and more wheat which cannot be sold, but simultaneously it could have tried to stimulate the demand for wheat and discourage the demand for other products that Saudi Arabia cannot produce. Alternatively, it could follow a policy which encourages the production of less wheat, which may force it to face the question of what to produce instead.¹¹ The government made the latter choice and then commenced with its new policy of decreasing its actual purchase of subsidised wheat from the farmers and turned its attention to barley. This forced farmers to reduce the production of wheat and switch to barley which was

used in great quantities. In 1992/93 the sale of imported barley distributed to customers in Saudi Arabia was equal to 5.8 million tons.¹² Then wheat subsidies were reduced from \$1.87 billion in 1993 to \$850 million in 1994. The government bought 2.8 million tons of wheat from the farmers in 1993/94 down from 3.3 million tons in 1991/92. The government hopes to reduce the production of wheat to the self sufficient levels of 2 million tons.¹³ However, the production of grains continued in Saudi Arabia and in 1993 the GSFMO produced about 1,085 thousand tons of flour, 229 thousand tons of animal feed and 345 thousand tons of wheat bran.¹⁴ The Kingdom has now shifted from being a net importer of wheat, dairy products, eggs, poultry, meat and vegetables to a net exporter of these products.

Fruit and vegetable growth has not been as dramatic as that of wheat. The production of dates has grown from 240 thousand tons in 1970 to 456 thousand tons in 1985, and it was able to produce 522 thousand tons in 1989, while reaching the 604 thousand figure in 1992. The production of grapes reached 80 thousand tons in 1985 compared to 24 thousand tons in 1970, and 98 thousand tons in 1989, compared to 124 thousand by 1992. The production of tomatoes has increased from 100 thousand tons in 1970 to 331 thousand tons in 1985, producing 397 thousand tons in 1989 and reached 480 thousand tons in 1992. (See figure 4.3 for an overall view of the production of fruit and vegetable in Saudi Arabia for the period 1970 to 1992.) The production of poultry, on the other hand, for the period 1985 was 177 thousand tons, which represents a large amount compared to a mere 7 thousand tons in 1970 and also showed an increase to 267 thousand tons in 1989; increasing to 282 thousand tons in 1992. In 1985, 132 thousand tons of eggs were produced in Saudi Arabia; this figure represents an increase of 5,000 tons over the previous year, an increase that equals the total production of 1970, reaching 113 thousand tons by 1989, this amount continued to be produced for the next consecutive years to 1992. Red meat also experienced an increase, from 19 thousand tons in 1970 to 126 thousand tons in 1985, reaching 133 thousand tons in 1989 and 142 thousand tons in 1992. Milk production increased from 156 thousand tons in 1970 to 414 thousand ton in 1985, reaching 475 thousand tons in 1989 and 538 thousand tons in 1992.¹⁵ Figure 4.4 shows the overall view of the production of animal and sub-product in Saudi Arabia for the period 1970 to 1992.

Figure 4.3: Fruits and Veg. Production in Saudi Arabia (1970 - 1992)

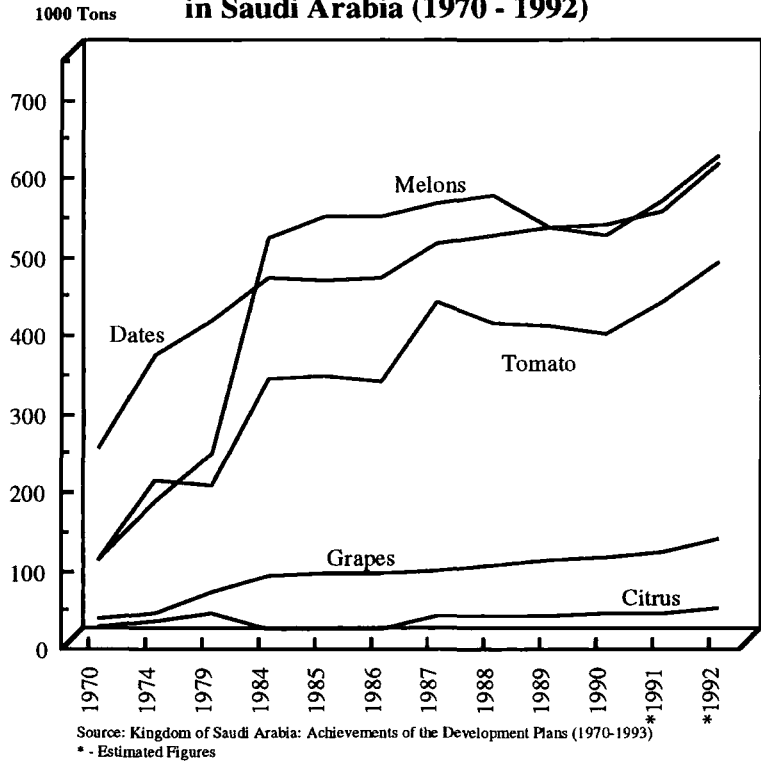
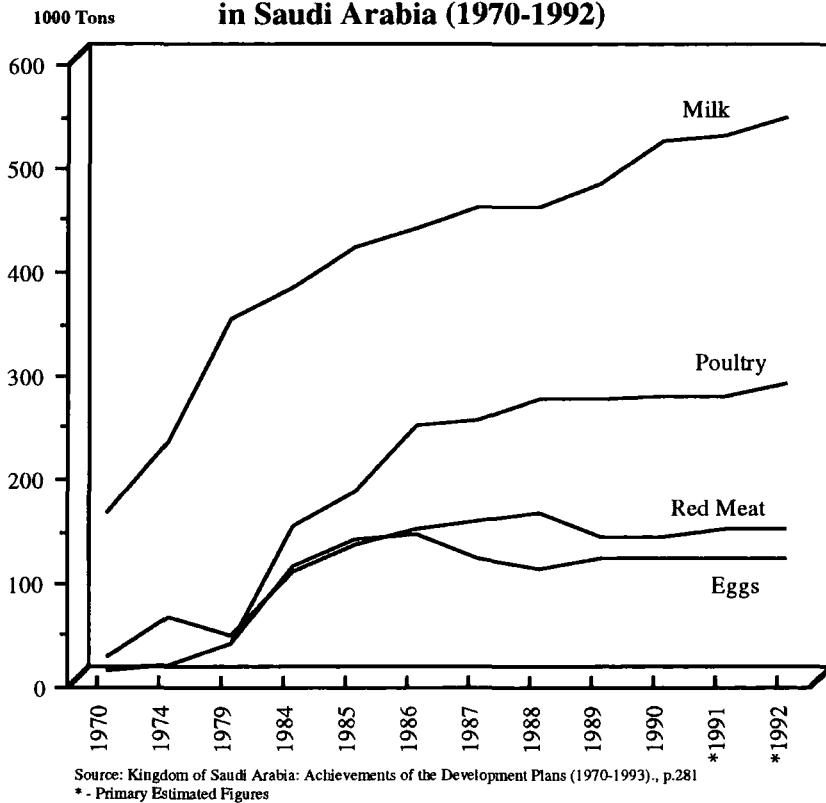


Figure 4.4: Animal and Sub-Products in Saudi Arabia (1970-1992)



The growth in agricultural production has not been as rapid as that experienced by the Saudi Arabian economy as a whole. Nevertheless, there has been a substantial increase in the total production of agricultural products. More to the point is the transformation of the traditional style of farming to highly technical machinery and sophisticated methods of farming, in both the livestock and produce sectors. Today Saudi Arabian production of some of the above mentioned goods - namely, wheat - is enough to satisfy the domestic market with excess left for exportation - however, if export does occur a loss would be sustained by the government since it initially purchases the product at a price greater than that set by the world market. This has all been made possible because of the government's drive to implement the necessary policies to achieve its goals for the agricultural sector. In its strive for development it has offered many tempting and encouraging subsidies to its farmers, and has even gone as far as offering price floors for purchasing the products at a price greater than that offered by the market.

In today's Saudi Arabia, a dual economy has developed, with traditional farming on the one hand, and new lucrative large-scale agro-industrial farming on the other. The Saudi Arabian government, has to a large degree, put a great deal of effort and capital into the development of the new type of farms. It would be wrong, however, to presume that as a result little has been done for the traditional sector. In fact the government has protected this sector in many ways and has tried not to neglect or leave it behind. The Saudi Arabian government has endeavoured to develop the traditional sector, but, perhaps not as extensively as it has done for the modern one. Normally in a dual economy situation the traditional sector would suffer as a result of the driving down of prices caused by the modern sector. In Saudi Arabia this situation does not occur since prices are normally protected by the government. However, it is difficult to ignore the fact that the modern sector is progressing and developing at a rapid rate and much has been achieved due to the high level of technology and the sophisticated methods of farming, while little change seems to have occurred in the traditional sector. It is necessary for Saudi Arabia to encourage the development of linkages between its two sectors so that in the long-run the Saudi agricultural sector as a whole would gain and the overall economy would be enhanced, and only if this is done can the modern sector justify itself. It would be to the country's advantage if both sides attempted to learn from each other. The

modern sector could assist the traditional one in the use of sophisticated methods of irrigation and complicated agricultural equipment that would enable it to produce more and better crops. It is worth noting that the demand for traditional produce in some cases is highly selective, especially regarding livestock. Modern farm animals are cheaper in price than those raised traditionally. However, people are willing to pay more for the traditional livestock as it is considered to be of superior quality. An idea would be for the modern sector to raise the traditional type of preferred livestock. However, this could prove to be difficult in some cases, such as the traditional black sheep. When put in enclosures, as is the practice in the modern sector, they tend to catch diseases; therefore, they need to be kept on the move. It is understandable that the linkages do not occur between those two sectors, since, the type of people involved and their objectives vary tremendously. It is often the case that in modern farms expatriates are employed and the sole objective is to make profits, whereas in the traditional farms it is Saudi nationals who are involved and farming to them is a way of life. The government has to develop a strategy that would encourage the integration and amalgamation of the two sectors with the overwhelming interest of the economy in the fore front.

The agricultural sector has gone a long way because of the perseverance and financing of the Saudi Arabian government, whose objective it is to be self reliant as much as the Saudi geographic climate would allow. For this reason the government continues to give financial support to this sector. This has left little opportunity for the commercial banks since the government is providing subsidised credit and grants to agriculture.

4.2 The Fishing Industry

Saudi Arabian nationals have shown minimal interest in the fishing industry and to date little effort has been made to enhance the development of this sector. In the early 1980's the domestic consumption of seafood reached 44,000 tons, while the domestic catch for that period was only 16,000 tons. The Food and Agricultural Organisation estimates that the potential catch in the areas of the Gulf and Red Sea can reach between 300,000 and 500,000 tons; enough to cover the countries need with ample surplus for exportation. The government has offered subsidies and interest-free loans to private groups in an attempt to

encourage the development of this sector. In the early 1980's, the Saudi Fisheries Company, 40 percent of which is owned by the government, operated a fishing fleet on the Red Sea made up of only 1,200 boats and another on the Gulf consisting of about 200 boats. The total workforce was about 4,400 fishermen.¹⁶ Nevertheless, the fish catch has only increased to 56 thousand tons in 1992.¹⁷ There is much opportunity for enhancing development and even profit in the marine resources, particularly when fish can be consumed as part of a basic diet. This would contribute to the Saudi Arabian government's objective of self-dependence and decrease its reliance on imported staple foodstuffs.

4.3 The Infrastructure

Saudi Arabia's primary objective was to establish an infrastructure capable of handling the tremendous economic developments that were to follow. If it were to succeed in achieving industrialisation, it had to first create satisfactory utilities, communications systems, transportation networks...etc. For without vigorously and successfully accomplishing these essential basic foundations, any attempt to formulate an industrial policy would result in inevitable failure.

4.3.1 Electricity

In order to achieve true industrial progress, it was imperative to set up an electricity network that would provide the necessary energy to run the newly set up plants. The government drew up a strategy that would ultimately insure the availability of electricity for the major part of the country. However, the actual achievement of this enormous task was to be carried out by the private sector, motivated by interest-free finance and the necessary know-how, of which both was provided by the SIDF.

The completion of the first electric power plant was in 1950, and by 1973 eight electric companies covered the larger urban areas, while seven provided for the smaller towns.¹⁸ However, by the 1980's there existed 95 private electric service companies providing different types of cycles and voltages between one town and another, and even

within the same towns. This caused much discomfort to the consumers who suffered voltage changes, power cuts, and a bad repair service. Due to the different voltages provided it was virtually impossible to standardise the electrical goods available in the market. Large institutes such as hospitals often had their own generators.

In the first development plan, the government suggested that a department for electricity services be established whose foundation was to set up and then carry out necessary changes in the electricity sector. This they hoped would assist the private companies to satisfy growing demands, and reach their expansion goals to provide electricity to newly established rural areas. Alongside the previously mentioned duties, it was to conduct research on the electricity tariff in order to arrive at solutions that would allow them to decrease it, and thus encourage the private and industrial sectors to increase their consumption. The Department of Electricity Services was also to design a realistic and logical rate structure, to establish a uniform set of regulations, to introduce standardised accounting procedures, and to verify and study any license applications. This they hoped would help in ironing out problems that the privately owned electricity plants faced; problems such as the poor collection procedures, where, in some cases, bills reaching as much as 50 percent or more of total revenue had not been paid.

Saudi Arabia's pricing policy with regard to electricity was to keep the prices low by subsidising the electricity companies. For example, in 1986 the electricity companies charged domestic users SR 0.07 per kilowatt-hour for the use of up to 3,000 kWh, SR 0.10 for the consumption of 3,000-4,000 kWh and SR 0.15 for over and above 4,000 kWh.¹⁹ Industry, however, was charged SR 0.05 kWh, while the real cost of supplying the electricity was equal to SR 0.13-0.15 per kWh²⁰; the difference born by the government. Due to the low charges much electricity was wasted, especially in the use of air conditioners. The government had often pointed out that it maybe forced to decrease its subsidies causing the price of electricity to rise. The majority of power stations use oil, however, when generating power, which brings the whole question of pricing into a different prospective. In the early 1980's oil prices rocketed to almost \$40.00 per barrel, therefore, electricity subsidies were enormous. However, today, with the slump in oil prices the subsidy is much less. Consequently, the government could decide to choose

electricity prices to reflect its true cost i.e. reflecting the current price of oil, thus implying no state subsidy. The price would, however, be quite variable, creating uncertainty over price which could be detrimental to industry as a whole. It, therefore, makes sense that the government should stabilise prices. In addition, offering low prices can be justified as this aids industrial progress, agricultural development...etc, all of which are essential to the success of Saudi Arabia's ultimate goal of economic diversification. It is also necessary to consider the opportunity cost argument in this context, especially when the oil market position has changed dramatically.

Another implication would be in relation to the profitability of the electricity industry. Initially, the industry was based on cheap loans obtained from the SIDF. One issue is how costly it is to maintain this industry, presuming fixed costs have been written off so that the prices only reflect the marginal production cost, which would probably be quite low. Saudi Arabia also has the opportunity to export electricity if a regional grid is established to link different countries, comparable to that system that is already used between certain EEC countries. This is a lucrative investment that would probably be worth considering.

At the beginning of the 1970's, the government required all new generators be 60 hertz and standardised distribution voltages at 127 and 220 volts.²¹ In the early 1980's, it was discovered that not all machinery fitted this description. The year 1976 marked the formation of the first regional enterprise under the name Saudi Consolidated Electric Company (SCECO) which was to serve the eastern region. The regional companies continued to be owned by local companies - and to some extent the government also held stakes in them - which served interactively under SCECO. The companies were to be in total control of the administrative side of the business. However, ARAMCO was asked by the government to manage SCECO-East because of its management ability and also since it owned a large portion of the generating facilities. In 1979, SCECO were established for the Southern and Central regions, and another was formed for the West region in 1981. The objective behind the setting up SCECO was to connect the generators in a certain area in order to enhance the planning and service provided. The government hoped that in the long run the regional companies would be linked together to create a national network.

The rural areas were supplied by the government-owned General Electricity Corporation (Electrico), which was also encouraged to offer support to the regional companies in areas where electricity was in high demand. Electricity was also provided by the Saline Water Conversion Corporation (SWCC), a government-owned company.

The installed capacity increased dramatically from the mid 1960's. By 1980, the SIDF had agreed to loan the electric companies SR 26.9 billion and had already sunk SR 23.3 billion into them. This amount equalled three times that which was to be spent on other industrial undertakings during the period.²² The outcome of this is apparent when observing the generating capacity and load in the electricity plants in general. Peak load rose from 814 megawatts in 1975 to 4,582 megawatts in 1979; installed capacity increased from 1080 megawatts to 6,258 megawatts.²³ Consumption rose 37 percent a year between those two periods, and the number of consumers increased by 16 percent a year.²⁴ The government kept the cost of electric consumption low. This was to stimulate demand, but it also meant that the government had to subsidise the electricity companies if they were to stay in business. The majority of electricity provided was consumed by industry. By 1992 the country's installed capacity was over 21,561 megawatts, an average yearly increase of about 20 percent.²⁵ The amount of generated electrical power had increased dramatically from 1.8 billion kilowatt-hours in 1970 to 82.2 billion kilowatt-hours in 1993.²⁶

In early 1992 the Saudi government introduced sweeping price cuts on basic utilities such as electricity, which it hoped would boost demand on this sector. In 1993 power generation companies were reporting that they were experiencing increased demand for electricity, an average increase of 10 percent annually, which they felt would use up all the surplus capacity by the mid 1990's. As a result, the government realised the growing need for expanding electrical facilities and invited several bids in 1994. However, due to low government funds not much was done about these bids, in fact very few became a reality. Then in January 1995 the government decided to increase the charges of electricity and to use the revenue to finance electricity projects. The new electricity fees will have limited effect on those consuming less than 2000 kW per month. The charge for industrial firms and those who consume over 2000 kW per month will be billed according

to the sliding scale as domestic users. It is, therefore, expected that consumption will drop by 15 percent. Due to this expected reduction in subsidised electricity consumption the annual loss of the electrical companies will diminish and their revenues are expected to increase by around SR 2 billion in 1995.²⁷

4.3.2 Transportation and Communication

One of the immediate tasks for the government was to create a sophisticated and highly efficient communication and transportation system. Saudi Arabia by nature covers vast areas of land with the population scattered around the different regions. Thus, the government recognised that a well-developed system of communication and a nation-wide transportation network was vital if it was to succeed economically, socially and even politically. Between 1961 and 1973, the communications and transportation share of the total budget expenditure increased from SR 209.9 million to SR 2,113 million; an annual increase of about 21.2 percent.²⁸ The importance of these two infrastructures is apparent from the disbursements of SR 102 billion that was assigned to them in the Second Development Plan. This amount equalled 16 percent of the total budget expenditure.²⁹ However, it is worth noting that the investment in transportation and communication would usually require large sums, and, therefore, when the government decides to develop a new substantial project in this field, one would expect that the apportionment of the total budget expenditure allocated to the infrastructures be high, and as it gets closer to the completion date one can expect this figure to decrease.

Saudi Arabia recognised that in order for it to keep up its highly accelerated economic growth, it needed to offer vast subsidies for both transportation and communications infrastructure so that they could be developed and eventually integrated throughout the economy as a whole. The governments objective was to create an efficient communications and telecommunications network that would make Saudi Arabia a national market and would reduce distribution costs. This would benefit consumers, industry and agriculture, since the establishment of such an infrastructure would reduce the overall cost of serving the market and would facilitate the expansion into new regional markets, making it easier for businesses to enhance their potential.

In the 1970's ports experienced a complete transformation to enable them to cope with future demand. There are five major ports in Saudi Arabia: Jeddah, Yanbu and Jizan on the Red Sea, and Dammam and Jubail on the Arabian Gulf. The port of Jeddah being the major and most significant of the five has been in existence for centuries. It was used by pilgrims and also as a trade port. Between 1960 to 1972, the goods unloaded had increased from a mere 454,800 tons to 1,021,500 tons; an annual increase of 6 percent.³⁰ Around 1976, the Saudi Arabian port facilities could no longer cope with the increased demand. The increase in port duties and charges levied on goods plus the rising transport costs were dominant factors in the inflationary rises that had occurred in the mid 1970's. The government's reaction to this was to create the Ports Authority whose duty it was to increase the unloading capacity. This was accomplished with the introduction of capital intensive operations, i.e. replacing labour with highly technical equipment and machinery. By the early 1980's, the five major ports had experienced a complete change, providing highly specialised facilities for livestock, containers, cement, grain terminals...etc. There was an increase in the commodities imported between 1976 and 1980 from 16.3 million metric tonnes to 31.9 million metric tonnes, a rise of 96 percent,³¹ it continued to rise reaching 78.4 million tons in 1993.³² This was made possible by an expansion in the number and the handling capacity of berths in the majority of ports in the country. An example of this was the port at Jeddah, which in the mid 1970's had 12 berths, but by the late 1970's had 45 berths. By 1993 the Kingdom had 134 berths in total, including 45 industrial berths located in industrial sea ports.³³ Since, the Saudi Arabian port authority carried out an extensive modernisation and expansion programme, and today Saudi Arabia's ports are widely accepted to be among the best equipped, most efficient and cleanest in the world.

Once the goods have arrived at the port of entry it was then necessary to transport them to their final destination. Hence, the need to develop roads. In the early 1950's Saudi Arabia had 45 kilometres of asphalted roads, which had reached 1,708 kilometres by 1961.³⁴ However, in 1972 the roads covered by asphalt had increased to 10,007 kilometres.³⁵ However, by 1980 the length of asphalted and rural roads increased to 28,258 kilometres, while the main and secondary network had risen to more than 20,000 kilometres, making the grand total length of road 51,087 kilometres in the early 1980's.³⁶

By 1993 the inter-city paved roads had reached a total length of 40,700 kilometres, while the earth surfaced roads in rural areas reached 93,000 kilometres.³⁷

The vast territory, severe weather conditions and large distances between populated areas all contributed to the tremendous increase in the air transportation, even though the government had spent large amounts on airports between the mid and end of the 1970's. This was not enough to cope with escalating air traffic which had caused some airports to operate at full capacity. To date Saudi Arabia has around 20 airports, with four fifth of passengers using the airports at Jeddah, Riyadh and Dahrn. In the mid 1970's 4 million people flew domestically, while less than 1 million flew internationally. However, in the early 1980's the domestic figure increased to 9.5 million while the international one rose to 6.8 million.³⁸ By 1993, 12 million passengers a year were arriving at airports in the Kingdom while 11.5 million were departing, of which 1.2 million pilgrims.³⁹ The transportation of cargo increased to 170 thousand tons in the early 1980's; a volume of 30 percent greater than that in 1979 and by 1993 it had increased to 229.6 thousand tons.⁴⁰ The Saudi Arabian national airline (Al-Saudia) owned 19 aircraft in 1975, but this number increased to 69 aircraft by 1979.⁴¹ The increase in its passenger transportation as mentioned earlier, especially domestic passengers, clearly makes Al-Saudia the most important of the government-operated transportation agencies. It is subsidised by the government and had been operating at a loss since 1970.

Only two railways have been established in Saudi Arabia, the Madinah to Amman in Jordan route and the Dammam to Riyadh track. The former has not been in use since World War I. The Dammam to Riyadh rail link of 562 kilometres was established in 1951 by ARAMCO for government use. It was run by ARAMCO in the beginning but by 1966 the government took control and made it into one of its corporations. Around 1979 an estimated number of 275,000 people and 1.5 million tons of cargo were transported using trains.⁴² In recent years there has been much money and effort invested into improving and developing the railways. The body responsible for rail transportation is known as the Saudi Railways Organisation (SRO). In 1985 a new high-speed railway link between Riyadh and Dammam came into service which had cost SR 1,200 million to establish.⁴³ The cost of travelling by rail equals roughly one tenth of the economy air fare and the time

duration compares favourably with that of air travel i.e. if the journey to and from the airports is included in the calculation. Many have taken advantage of this facility and have started to either commute or transport goods via the railway.

Twenty new projects were developed during the Third Development Plan (1980-85), costing SR 1,900 million⁴⁴, SR 1,300 million of which was spent on the 447 kilometre double railway track⁴⁵ which now links Riyadh and Hofuf. SRO has also spent SR 205 million⁴⁶ on the establishment of new railway stations in Riyadh, Dammam and Hofuf. In addition a SR 70 million⁴⁷ locomotive workshop and a railway car maintenance shop costing SR 12.6 million⁴⁸ has been completed in Dammam. Between 1985-86 SRO purchased 40 passenger carriages and 10 high-speed locomotives from Europe and the USA. By 1993 the number of passengers travelling by rail rose to 417 thousand, while rail road freight traffic increased to 1016.5 million tons.⁴⁹ SRO's objectives are to link Riyadh with Jeddah, Makkah, Madina, Jubail and GCC countries.

In 1956 Saudi Arabia's major towns were connected by a wireless radio system. This was developed and grew both internationally and locally in the next few years. Jeddah was the first city to install automatic telephones and by the early 1970's ten different cities had similar operations. In the 1980's Saudi Arabia had recognised that business would not be able to operate in its full capacity if the communication system were underdeveloped. The government had encouraged the decentralisation of companies and directed industrial plants to the new industrial cities such as Jubail. It recognised that the success of this policy can only be accomplished if there is adequate communication between the plant and centres of commerce. As a result there was increased pressure for improved postal and telecommunication amenities. In 1979, 277,000 operational telephone lines were in service; a figure that rose to 1.3 million in 1988 and by 1993 this figure became 1.67 million lines.⁵⁰ Telex lines reached 10,186 in 1980, declining to 9.1 thousand in 1993⁵¹, this being due to the fact that they were overtaken by facsimiles. Many businesses have tended to replace the telex system with this highly efficient and fast method of communication. Since the introduction of the microwave long-distance network the international telephone services have been transformed with direct dialling worldwide. In 1975, 215 post offices were in operation but, by 1980 this figure reached

437. In fact, postal material in 1970 was equal to 47.6 million items and had increased to 408.7 million items in 1983, declining to 324.6 million items in 1993.⁵² It is the government's intention to increase the use of more automated facilities for sorting the mail. However, it is worth noting here that Saudi Arabia's post office service only delivers to post boxes, thus, businesses and the affluent often depend on the services of couriers and faxes.

Saudi Arabia's objectives are to continue the smooth operations of the existing facilities - expanding and adding new services where necessary - and simultaneously to improve the link up of the facilities in the rural areas. In 1986, 550 million US Dollars a year was allocated and used on telecommunication machinery.⁵³ The Kingdom is expected to spend an estimated 4000 million US Dollars by the year 2002. This is much needed since the 1.5 million line network is under pressure at present. It has been estimated that the total lines required are around the 4.5 million figure, this includes the 2 million on the waiting list.⁵⁴ The Posts, Telegraph and Telecommunications Ministry (PTT) also aims to Saudise all its staff in the very near future.

In the mid 1970's the transportation and communications infrastructures were major obstacles in the development of Saudi Arabia, especially as the country experienced an increase in the construction business and the number of imported goods. During the 1970's and early 1980's the government injected large amounts of money into the development of ports, storage facilities, highways, the railways, and improvement of the telecommunication links. Thus, by the mid 1980's the main impediments had vanished and a new system had replaced the obsolete, with the ability to cope with future expansions. The Saudi Arabian government recognised that even though it has a highly modernised system, it would still have to continuously inject funds if it was to keep up with the incessant technological changes that the world was experiencing.

4.3.3 Water

Saudi Arabia's urban infrastructure was extremely under developed in the 1960's, and the situation corresponded to that in the least developed Third World countries. However, with the revenue from oil Saudi Arabia was able to transform most of its country's

domestic services e.g. water systems, traffic monitoring, sewage systems...etc. One of the first objectives of the government was to develop the water systems for every city. The topology of Saudi Arabia is basically that of dry, severe desert land. There has been intensive attempts by the government to supply water to every city, town and village, and many sophisticated water systems have been constructed. The government believed that by improving the water service it will contribute to improving the country's health standards. Not only was water necessary for the cities, it was essential if the agricultural sector was to succeed in its goals and objectives. It was vital that the methods were used to extract underground water, since the dependence on rainfall would be unrealistic. It was estimated that Saudi Arabia's share of fossil water resources is equal to a watering area of 250,000 hectares for a time span of a century.

The government has developed several projects to improve the water supplied e.g. well-drilling, dam-building, desalination plants and water-supply systems tapping the consumers into the water resources. During the second plan, in total 760 wells were either dug, drilled or reconditioned, 237 water-supply systems for different districts were constructed and 150 water systems expanded.⁵⁵ In the late 1960's the Saline Water Conversion Corporation (SWCC) was created to carry out water desalination. In fact, by 1980 it was the world's biggest desalinated water producer. In fact, the capacity of the desalination plants in Saudi Arabia had increased from 5.1 million US gallons per day in 1970 to 508.3 million US gallons per day by 1993, an average annual growth rate of 28.5 percent.⁵⁶ The Ministry of Agriculture and Water is responsible for water projects, both on the regional and national levels. Its task is to monitor the water available and its eventual disbursement. In January 1995, the government established new charges for water, the previous rate of SR 0.15 per cubic meter has been replaced by a five tier sliding scale with the top rate of SR 6 per cubic meter. As a result of this increase households who are using 600 cubic meters per quarter will now pay SR 1,812 instead of paying SR 90 an increase of 1913 percent, while households who consume 2,000 cubic meters a quarter will end up paying SR 10,812 instead of SR 300, an increase of 3504 percent.⁵⁷ It has also set targets so that water is eventually supplied to smaller towns and remote rural areas. The government's objective is also to reduce the consumption of water by the agricultural sector without affecting actual production.⁵⁸ Simultaneously and alongside the

development of water facilities, sewage systems were established. The government has also been able to re-use part of the urban waste water for agricultural and park land areas.

In the early 1970's the Saudi Arabian government undertook the task of diversifying its sources of income, with emphasis on the physical and human reserves. Its objective was to develop a basic industry within the public sector. It was to use the previously flared gas that occurred during the production of crude oil. The gas was to be used as an energy producer for the newly developed industrial cities and also as export in the form of petroleum gases. In the 1970's the rate of growth of the Saudi Arabian economy was unprecedented. This was due to the increased price of crude oil. Oil prices had increased from US\$ 1.80 per barrel to a figure that had reached US\$ 32 per barrel by 1980. The increase in revenue encouraged the government to create, construct or develop all sectors of the economy. The underlying objective was to decrease the country's dependency on oil exports as its only source of income. The growth of non-oil GDP between the early and mid 1970's was at an average rate of 11.6 percent and was equal to 15.1 percent between the mid and late 1970's - a remarkable achievement on both counts. However, as oil prices fell in the mid 1980's so production decreased and the government's policy was to slow down the rate of development. Thus, it slowed the rate of the projects already in motion and postponed the commencement of others. However, development was not brought to a complete halt. The government drew on some of its foreign financial assets to support its expenditure levels.

4.4 The Construction Sector

Saudi Arabia has undergone massive change, which was accomplished by constructing many developments where previously there were none. It is not surprising, therefore, to find that the construction sector was the second largest after oil. In 1982 construction made up 11 percent of GDP.⁵⁹ Primarily, most construction was done by large international firms. This continued to be the case in the beginning of 1980's, where the majority of technically difficult construction projects were undertaken by such firms. However, Saudi Arabia's construction business (some with international firms as partners) soon developed and expanded in ability and size, thus taking on projects that were

previously handled by international businesses. This was encouraged by the government, as long as the Saudi firms remained competitive.

By the mid 1980's the construction business began to experience a severe recession. This was due to the decrease in oil prices, but also because the major projects and infrastructure were either completed or nearing completion. An immediate consequence of this was the inevitable suffering of related sectors in the economy, namely, importers and manufacturers of related equipment and building substances, and then filter through to the economy as a whole. Due to the decrease in the number of construction contracts awarded by the government many contractors found themselves unable to finance other projects by using the advance payments by the new ones. Indeed, the contracts that were won were worth much less when compared to similar ones awarded in the past. Along side this, government agencies were slow in approving and making payments of the projects. Due to the recession and the pressures caused by it, many small contractors were forced out of business and those who survived attempted to become more efficient.

In 1991 the construction sector began to pick up again accounting for 17.6 percent of non-oil GDP.⁶⁰ This was due to the Saudi Arabian government's objective of increasing its oil production capacity, as a result it has been the largest source of construction contracts. This was in addition to its goal of raising both power and water services in order to satisfy a growing population. The private sector has also contributed to this sector in 1992 and 1993 with the development of new shopping centres, offices, commercial blocks, recreation areas, housing compounds throughout Saudi Arabia. The manufacturing sector has also implemented expansionary plans. In fact, the construction sector grew by 7 percent in 1992 and 6 percent in 1993.⁶¹ However, in 1994 it experienced a slow down due to the Saudi Arabian government's cuts on project spending.

It is obvious that the construction sector has been a major contributor to the growth of the non-oil economy and even though its role may have decreased in some years, it will still be an essential component of the non-oil economy and continue to flourish in the long term. It has a key role to play if more emphasis is placed on diversifying the economy and expanding the import substitution sector, especially as the private sector is just beginning to become more involved in the economic development of the economy through

commercial bank financing.

4.5 Trading Activity

Trade also played a major role in the non-oil economy. In 1982 it was responsible for 5 percent of GDP.⁶² The dramatic growth in this sector between the early 1970's and the early 1980's was a consequence of the ever increasing numbers of imported goods. The boom in the construction business, escalated customer purchasing power, and the availability of large amounts of goods on sale helped in the development of economics of scales in merchandising operations.⁶³ By 1975 large numbers of department stores, retail chains, supermarkets and shopping centres mushroomed everywhere. A direct result of this was the dramatic increase in wealth that merchant families experienced. The building boom also tempted many foreign businesses to enter the market. Thus, there was an increase in the demand for hotel rooms, restaurants and other services. To cope with this demand many international hotel chains were built in major cities.

However, in 1986 the government attempted to dampen demand for imported goods especially as it had been running a current account deficit that has been accumulating since 1983.⁶⁴ To curb the demand the government employed tariff duties on certain goods and increased existing ones. Due to the slow down in development, development related imports continued to decline making up only 47.5 percent of imports in 1990. However, as the economy picked up again in 1991 the share of development related items increased to 51.2 percent. It is interesting to note that the percentage of food items that are imported in Saudi Arabia has gradually decreased, from being 31.6 percent of imports in 1970 to 19.9 percent of imports in 1974 and declined even further to 15.8 percent in 1984, reaching 14 percent in 1990 and 13 percent in 1991. This reflects the increase in the manufacturing of foodstuffs in the Kingdom and also the development of local produce from the agricultural sector. However, the percentage of imported textiles, garments and footwear has increased from 4.9 percent of imports in 1970 to 9.5 percent of imports in 1991. This reflects the increase in population and the lack of manufacturing industry in the textile, garment and footwear sectors.⁶⁵

4.6 Import Substitution Industries

In the early 1970's Saudi Arabia made a decision to develop an industrial sector. It decided to establish an industrial sector that would eventually and in the long run produce goods that were previously imported. Saudi Arabia had the choice to continue to import and thus develop its economy into a service one - a system that was adopted by some of its neighbouring Gulf states. The Kingdom is a larger country and, therefore, there is more scope for import substitution industry. There is no doubt potential profit for the merchants if they choose to develop this type of industry. There is a reasonable market within Saudi Arabia and taking advantage of the economies of scale would also make the business more lucrative. Nevertheless, much of the import substitution industries are labour intensive, but Saudis could strive to achieve a more automated industry which would be profitable and would eventually lead to different types of spin-offs, that would ultimately employ Saudis. By choosing a "produce goods policy" as apposed to an importing one, the government hopes to be able to create more jobs for its nationals. The merchants, however, hoped that by choosing this policy they would be diversifying their activities and simultaneously be able to experience more profits due to the value added element associated with production.

In its drive to industrialise, the government offered the private sector generous incentives. In the mid 1970's the SIDF was formed to give interest-free, medium-to long-term financing to cover up to 50 percent of the cost entailed as long as the business was 25 percent owned by Saudis. The remaining necessary finance was put up by the investor himself either using his own personal income or by obtaining a bank loan. The SIDF also charged up to 2 percent administration cost. By the early 1980's, the SIDF had pledged US\$ 10 billion in loans to more than 800 undertakings. The Saudi owned businesses did not pay tax, instead they paid tithes equal to 2.5 percent of their liquid assets. On the other hand, wholly owned foreign companies were subject to income tax, but those companies in joint venture, with Saudis, were given a 10 year tax holiday. Imported commodities needed for the production process were also duty-free. Naturally, in respect to the government contracts, the local firms were given preference. A rent of about US\$ 0.03 per square meter was paid by the firms who established their business in the industrial parks. Road, sewage, water, electricity, and communication amenities were

supplied for the new sites with water and electrical costs at a minimal charge. Energy in the form of gas and fuel were at a fraction of their costs in other countries.

Before loans were granted by the SIDF the project underwent market appraisal. This entailed an assessment by the SIDF of the extent of the local market, production capacity needed, costs encountered, pricing of the product,...etc. Often the SIDF would encourage the local firms to seek foreign partners. This was usually recommended for the sake of gaining technological know-how. In turn, the foreign partner would be asked, by the SIDF, to take on some sort of financial stake, which was viewed as a measure of good will and commitment to the eventual success of the project. Once a project was seen to be feasible, the SIDF would recommend it to the Ministry of Industry, which would then grant it an operating licence. This in effect would give the company in question a practical monopoly on the domestic market. In the long run this policy could prove to be devastating, since it does not allow competition to exist. The infant, industries, are in general, protected. Thus, foreign competing products are virtually excluded. It is not surprising, therefore, that the majority, if not all, of those projects are financially successful and often give the investors large returns.

By the mid 1980's the import substitution sector had grown dramatically, especially in the last 10 years. Over 1,200 industrial plants were established by 1981, the majority of which were small scale such as wood and metal firms for furniture production. However, there were some large firms such as printing establishments, bakeries...etc. A large number of management businesses were created by wealthy merchant families in some cases with foreign investors as partners. By 1983 one of the biggest privately owned welded pipe plants had the capacity to make 80,000 to 120,000 tons of 20 to 60 inch diameter spiral welded pipe, ⁶⁶ while another manufacturer produced 50,000 tons of copper wire and cable.

The Daimler-Benz Company from West Germany entered into a joint venture with a domestic firm in an undertaking to assemble the company's trucks. There was an array of manufactured goods produced such as plastic pipes, refrigeration units, iron castings, sanitary fittings and aluminium windows, doors, and some household items. Most of those import substitution industries were geared towards the domestic market. They are

quite significant, especially when they represent the largest industrial sector in the Gulf area. Also, in terms of the local market, given that Saudi Arabia is a member of the GCC, there is a certain amount of exchange trade occurring between the respective members.

The majority of the import substitution plants made reasonable profits. Minimal technology was used which did not need the employment of complicated maintenance or highly skilled workers. The competing imported products often had high transportation costs that gave the domestic industries some protection from foreign competing firms who had to pay little in the way of tariffs. However, the government also pledged to offer some protection to the infant industries. It did this by imposing a tariff of 20 percent on an array of different goods that are also produced in Saudi Arabia. However, on the whole a free-trade policy was more in line with Saudi Arabian objectives and this was generally pursued by the government. Despite the government's efforts to encourage the import substitution industries by offering tempting incentives, nevertheless, Saudi Arabian businessmen saw manufacturing as a potentially uncertain investment when compared to commercial and property deals and land investment. Some plants were considered worth investing in, for example, those that manufactured cement and associated goods, such as tiles, blocks, and pipes. These were Saudi Arabia's largest manufacturing industries in the private sector. Production capacity was at an annual rate of 6.8 million tons of cement in 1981 and 8.8 million tons in 1982, while production was only 4.7 and 7.1 million tons respectively. Perhaps, what encouraged investments in those plants was the construction boom in the beginning of the 1970's which guaranteed sales and inevitable profits.

At the same time, since 1973 the maximum the total production has provided at any one year would be equal to 40 percent of local consumption which sometimes reached figures below 25 percent. Saudi Arabian businessmen procrastinated over this almost guaranteed, risk-free, investment and when they did invest they largely concentrated on the construction sector of the economy. Thus by 1983, the SIDF refused to offer any finance for construction material oriented plants since construction was gradually slowing down, and the capacity available with existing manufacturers was already too expensive.

Due to the hesitation of the private sector to invest in industrial plants and also the increase in oil returns, the government decided to create and develop basic industries. So

in Jeddah, PETROMIN built a steel-rolling mill in the late 1960's and a urea plant along with a sulphuric acid one in Dammam. With the increase in oil prices in the early 1970's the government undertook the task of extensively developing basic industries. Strategies were developed for the construction of two industrial cities at Jubail and Yanbu which were to use the previously flared off gases in their production processes (more detail is available in Chapter Three). In the early 1980's, industrialised nations faced a world recession which was partly a result of high oil prices. The immediate consequence of this was the dampening of world demand for a majority of goods, such as petrochemicals and refined petroleum products. Petrochemical plants world wide were forced to reduce production and consequently many closed down. The Saudi Arabian petrochemical and refinery plants came into operation whilst this situation prevailed. The United States and West European countries, threatened by the new competitor, decided to take protectionist measures in the mid 1980's. The Saudi Arabian government emphasised the small size of their production in comparison to the remainder of the world and stressed that it was not a threat. The European Community tariffs remain in place however. There had been talk of imposing restriction on imported goods from countries applying such tariffs on petrochemicals, but this never happened.

In the mid 1980's the prosperity of the basic industries and the Saudi Arabian infrastructures seemed to be impinging on the reaction of the private sector along with world market conditions. The Saudi objective for economic development was now in the hands of the private investors. However, in the Fourth Development Plan, 1985-90, SABIC declared its intention to establish new petrochemical processing plants as well as some metal manufacturing. This was to aid local business in their downstream activities.

In the late 1980's the Saudi Arabian government started huge promotional activities to encourage the involvement of the private sector in the development of economic ventures within the Kingdom. It made public, several studies which it had carried out to show the viability of many manufacturing ventures within the Kingdom. This in turn lead to debates on the issue of privatising government companies. Many private investors believed that it was highly unlikely that the government would sell off its most costly ventures such as Al-Saudia, telecommunications,...etc. However, the government's main

apprehension was that if privatisation was to take place how could it guarantee that the new investors would look after the interests of the general public and how could it ensure that shares were not concentrated in the hands of a small group of investors - a dilemma that was faced by the British government when it too decided to privatise its state owned companies. Nevertheless, the government indicated that it might privatise part of SABIC and its subsidiaries.⁶⁷ This the government did, and 30 percent of SABIC was sold to GCC citizens on the stock market. In fact, at the end of 1992 SABIC's market capitalisation was equal to \$10,000 million, which meant that it was the biggest quoted business in the Middle East.⁶⁸ This can be perceived as the first step towards privatisation, as it is apparent that as the Saudi governments foreign assets become more and more depleted, especially with predictions on oil prices not going beyond the \$20 per barrel range, the government would either borrow to continue the county's economic development and finance its deficits, this the commercial banks would gladly do, or it would privatise different parts of its industries as long as it does not jeopardise national security. What is most likely is that it would opt to do both, thus giving itself more flexibility and time.

In 1991 the share of GDP accounted for by the import substitution industry was less than 8 percent, and those were mainly concentrated on: Firstly, projects set up by SABIC i.e. 18 plants that relied on natural gas as a basic feedstock and petrochemical manufacturing. Secondly, private industrial projects such as cement plants, construction and metal manufacturing companies, cable manufacturing plants, soft drinks, vegetable oil, news print...etc. In fact in 1992, petrochemical manufacturing accounted for 22 percent of manufacturing, while petroleum refining was responsible for 40 percent and the remaining 38 percent was other types of manufacturing.⁶⁹ By 1994 industry accounted for 10 percent of non-oil GDP, and had dropped to less than 5 percent of GDP.⁷⁰ It is worth noting here that in developed nations manufacturing normally accounts for 20 percent of GDP. Saudi Arabia has got a long way to go, if it is to realise its aim of becoming a more self reliant developed country.

The dilemma for industrialisation has always been, however, that if a country wishes to pursue industrialisation vigorously, then it will need a sufficient and skilful work-force.

Unfortunately, the majority of the national labour force in Saudi Arabia do not reside near the major industrial parks, very few women work, while a large percentage of the male population are still seeking an education. Obviously, if nationals are not available to take up the positions, then employees will have to be brought from outside. This situation prevails in Saudi Arabia. Workers have to be brought from other parts of the world to take up many vacant positions. Unlike construction, where once the building or road is completed, the workers can be sent back; industrialisation needs a continuous flow of labour. In most economies, industrialisation is established for the sake of employment. However, this is not apparently the case in Saudi Arabia. The advantages that can be gained from this situation are; as technology improves and automation replaces the human factor Saudi Arabia will not be faced with the problems of unemployment. Another advantage is that unions will not exist as most workers are employed on two year contracts. Already, in the petrochemical industry little labour is needed as most of the plants are highly automated. However, the import substitution industry is fairly labour intensive. As a result of the above situation Saudi Arabia is experiencing an imbalanced economy. However, one can argue that many modern economies are moving toward a service economy and perhaps Saudi Arabia had already reached this stage. Many industrialised countries no longer concentrate on the actual manufacturing, but on the marketing, distribution and planning. Thus, if Saudi Arabia can get its nationals involved in these key areas of business, then perhaps that would be all that is necessary. Another paradox of industrialisation would be the extent of foreign exchange gain or loss. When Saudi Arabia produces import substitution goods it decreases the amount of imported goods, but, simultaneously, it increases the amount of imported raw material which are needed to produce the goods.

The expansion and changes that the Saudi Arabian economy has experienced has put pressure on the values and principles of the Saudi society. The large foreign labour forces employed brought with them many socially conflicting behaviour patterns and beliefs that collided with the Saudi norm. With economic growth opportunities becoming available to Saudi nationals allowing them to improve their living standard. The Saudi Arabian government with its policies did its utmost to ensure that all Saudi's benefited from the new found wealth. Thus, free schooling, health care, subsidised foods, utilities,

housing...etc., became available. Nevertheless, there exists large gaps between income groups that may cause problems in the future.

Saudi Arabia has created an infrastructure that is one of the most developed in the developing countries. It has moved its agricultural produce forward to levels that had converted the country from being an importer to an exporter of grains. However, this policy has ignored the high opportunity costs involved. Unfortunately, Saudi Arabia has not been able to do the same for its import substitution industry. The government does offer extremely generous incentives to private investors to encourage them to participate in this neglected sector, but alas with not many results. It is of vital importance that such industry is promoted in order for Saudi Arabia to continue its economic development process. Perhaps the lack of interest from the private sector could be due to the fact that often it is just as easy to make money out of importing the goods as it is going through the whole process of manufacturing. The Saudi Arabian government is now emphasising the importance of this sector to the Kingdom's success. It needs to create conditions which will ensure private investment in the sector. It should encourage the commercial banks to fund manufacturing, and not merely imports, perhaps by issuing guarantees to underwrite such lending, rather than providing primary funding. This issue will be taken up later in the thesis.

Notes:

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- (2) Johany, Ali D. and Berne M.J. Wilson Mixon Jr. The Saudi Arabian Economy London: Croom Helm, 1986, p. 109.
- (3) El Mallakh, Ragaai. Saudi Arabia Rush to Development London: Croom Helm, 1982, p. 79.
- (4) Presley, John R. A Guide to the Saudi Arabian Economy. Hong Kong: Macmillan, 1984, p. 80.
- (5) Ministry of Planning, "Fifth Development Plan (1990 - 1995)." p. 32.
- (6) Johany et al., op. cit., p. 112.
- (7) Ibid., p. 114.
- (8) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans p1390-1406 (1970- 1986)." p. 66
- (9) "Success With Wheat Sees Shift in Subsidy Focus." Middle East Economic Digest Special Report - Saudi Arabia, Vol. 31, No. 24, June 1987, p. 34
- (10) "Agricultural Success Brings New Problems." Middle East Economic Digest Special Report - Saudi Arabia, Vol. 32, No. 16, April 1988, p. 22.
- (11) It is worth noting that Saudi Arabia could be almost self-sufficient in food if there was a change in diet i.e. protein from fish and sugar from wheat, which would be an adequate and balanced diet.
- (12) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 35.
- (13) The NCB Economist, Vol.3, No. 1, January 1993, p.7., Vol.4, No. 1, January 1994, p.6. and, Vol.5, No. 1, January 1995, p.7.
- (14) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 35.
- (15) Ibid., p. 281.
- (16) Nyrop, Richard F. Saudi Arabia: A Country Study Washington D. C.: US. Government Printing Office, 1985, p. 191.
- (17) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 281.
- (18) Nyrop, op. cit., p. 177.
- (19) Robin, Allens & Ritchie, Michael. "Subsidies to Bear Brunt of Utility Cuts". Middle East Economic Digest: Special Report - Saudi Arabia, May, 1986, p. 36.
- (20) Ibid., p. 36.
- (21) Nyrop, op. cit., p. 177.
- (22) Presley, op. cit., p. 60.
- (23) Ibid., p. 60.
- (24) Nyrop, op. cit., p. 178



- (25) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 146.
- (26) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 147.
- (27) See Middle East Economic Digest; Special Report - Saudi Arabia, Vol.37, No.9, 12th March, 1993, p. 29; Vol.38, No.45, 11th Nov, 1994, pp. 45-46; Vol.39, No.10, 10th March, 1995, p. 32-33; and The NCB Economist Vol. 4, No. 1, January 1995, p.8.
- (28) Knauerhause, Ramon. The Saudi Arabian Economy New York: Praeger Publishing, Inc., 1975, p. 96.
- (29) Presley, op. cit., p. 70.
- (30) Knauerhause, op. cit., p. 107.
- (31) Presley, op. cit., p. 71.
- (32) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 182.
- (33) Ibid., p.182.
- (34) Knauerhause, op. cit., p. 98.
- (35) Ibid., p. 99.
- (36) Presley, op. cit., p. 72.
- (37) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 172-174.
- (38) Presley, op. cit., p. 72.
- (39) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 184.
- (40) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 186.
- (41) Presley, op. cit., pp. 72-73.
- (42) Ibid., p. 73.
- (43) Robin Allens & Michael Ritchie, "Infrastructure and Services." Middle East Economic Digest; Special Report - Saudi Arabia, May 1986, p. 35.
- (44) Ibid., p. 35.
- (45) Ibid., p. 35.
- (46) Ibid., p. 36.
- (47) Ibid., p. 36.
- (48) Ibid., p. 36.
- (49) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 178-180.

- (50) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 198.
- (51) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 196.
- (52) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p.194.
- (53) Toby Obene, "Making the Connection Even Better." Middle East Economic Digest Special Report - Saudi Arabia, Vol. 30, No. 18, May 1986, p. 29.
- (54) Angus Hindley, "Saudi Arabia: Laying the Foundations for the Future." Middle East Economic Digest Special Report: Telecom, Vol.39, No. 15, 14th April, 1995, p. 23.
- (55) Presley, op. cit., p. 83.
- (56) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 114.
- (57) The NCB Economist, Vol. 5, No. 1, January 1995, p.8.
- (58) Ministry of Planning, " Fifth Development Plan 1990 - 1995.", p. 147.
- (59) Nyrop, op. cit., p. 141.
- (60) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 79.
- (61) The NCB Economist, Vol. 5, No. 1, January 1995, p.7.
- (62) Nyrop, op. cit., p. 141.
- (63) Ibid., p. 141
- (64) "Trade Winds Blow in a New Direction." Middle East Economic Digest Special Report - Saudi Arabia, May 1986, p. 3.
- (65) Ministry of Planning, "Kingdom of Saudi Arabia - Achievements of the Development Plans 1390-1413 (1970-1993)." p. 98-99.
- (66) Nyrop, op. cit., p. 181.
- (67) Wahib Abdulfattah Soufi, Richard T. Mayer. Saudi Arabian Industrial Investment USA: Quorum Books, 1991, pp. 112-113.
- (68) "Saudi Stock Market: A Major Market Marks Time". Middle East Economic Digest Vol. 37, No. 47, 26 November, 1993, p. 42.
- (69) Middle East Economic Digest, "Special Report Saudi Arabia." Vol. 36, No. 45, 13th Nov, 1992, p. 32-36.
- (70) Middle East Economic Digest, "Special Report Saudi Arabia" Vol. 38, No. 10, 11th March, 1994, p. 46.

Chapter Five

Saudi Arabian Financial and Economic Policy

This chapter will discuss the Saudi Arabian government's development objectives. It looks at the five year development plans and examines their achievements. It also reviews how the government has managed its income from oil to finance economic development. It examines the government's budgetary policy and the effect of expenditure on inflation and economic performance. It questions whether or not financial deepening has occurred in Saudi Arabia and the extent of monetisation. It also covers the financial policies of the Kingdom and raises the issue of fiscal policy, which has not been used effectively by the government in its management of the country's financial and economic policies.

5.1 Government Expenditure, Revenue and the Budget

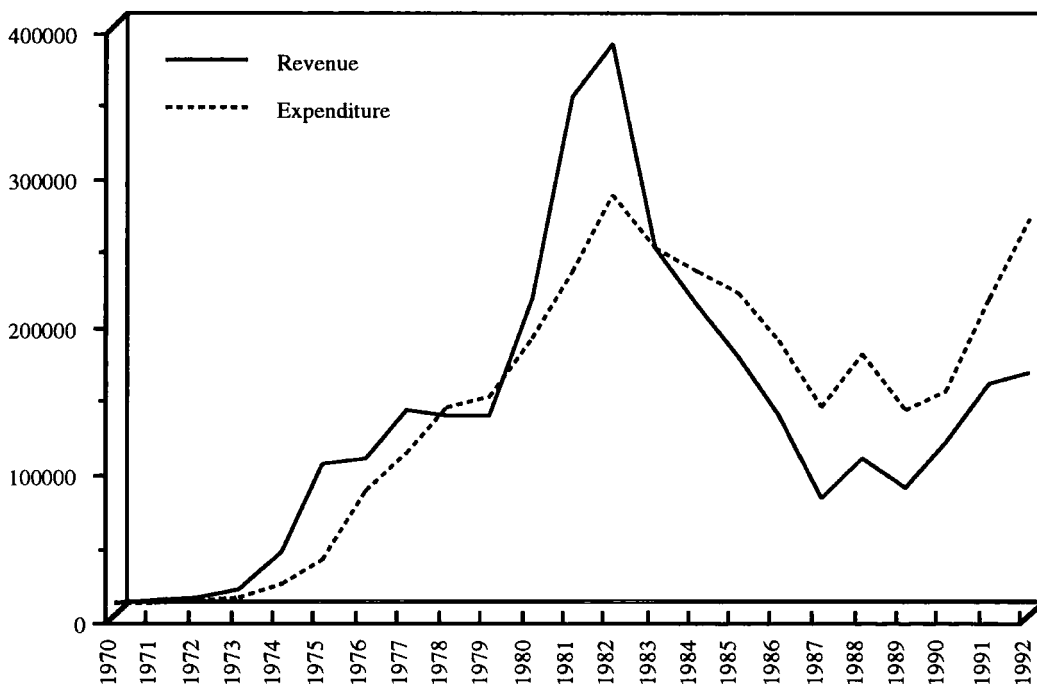
In 1948, budget publications commenced in Saudi Arabia, but they represented mere estimates of expenditure and revenue that were often not adhered to. In 1953, the Ministry of Finance was formed and with the aid of SAMA attempted to organise their earnings and distribution in accordance with the budgets. In the following year the Ministry of Finance was expanded and named the Ministry of Finance and National Economy. It was given greater responsibilities and a *carte blanche* to administer and monitor the accounts of other ministries. However, those policies did not apply to the King. By the 1950's the government was experiencing heavy debts, inflation, budget deficits and the continuous decrease in the value of the riyal against other currencies. Therefore, in 1958 a supportive plan with the guidance of the IMF was established and successfully implemented.

It was made illegal to put forward a budget in deficit before the Council of Ministers and the King. This aspect was overcome by including finances derived from origins other than current revenues and by occasionally dealing with expenditures external to the budget. Sometimes the government would draw on its reserves which had been accumulating from previous surplus years. Since the beginning of the 1960's and after improvements to the budget, the general fiscal results have been favourable. The projected revenues were fairly reliable except when the oil market conditions changed dramatically. The Saudi Arabian government's objective was to show a surplus, therefore,

it often kept actual expenditure figures below those budgeted. Thus, the trend in the early 1970's was to show budget surpluses and the accumulated reserve funds which occurred were due to the continuous surplus result. Simultaneously, development expenditure was always maintained at a figure lower than the budgeted one. This set up encouraged Saudi Arabia to accelerate its economic growth. Hence, the Central Planning Organisation was formed and by August 1970 the First Five-Year Development Plan was adopted and implemented. Its aim was to develop human resources through manpower planning and diversifying into other forms of production, thus decreasing Saudi Arabia's dependency on the sale of crude oil - as the only form of revenue. Saudi Arabia's determination to achieve its objectives was demonstrated by the aim of the plan to increase real gross domestic product by 9.8 percent yearly, a figure slightly greater than the expected growth of 9.1 percent of the petroleum sector.¹

In the 1970's there occurred a tremendous increase in government spending. Government expenditure increased throughout this period except for the earlier years of the decade when the government halted its spending in order to reduce any further increases in inflation - see figure 5.1. Inflation had reached a high during this period and

S.R. Million **Figure 5.1: Saudi Arabian Budget (1970-1992)**



Source: Kingdom of Saudi Arabia: Achievements of the Development Plans (1970-1970), p. 206. and (1970-1993), p.212

was emphatically in a position that could hamper the development programme. It resulted from shortages in resources, namely, raw materials and consumer goods, which in turn threatened the success of public and private investment projects. An apparent result was the creation of an unstable business atmosphere, thus jeopardising the standard of living experienced by certain groups in the society, namely, those at the lower end of the income scale. In the mid 1970's the average annual inflation rate was roughly 30 percent, a figure that started to decrease from 1976 onwards.²

5.2 The Effects of Development Expenditure

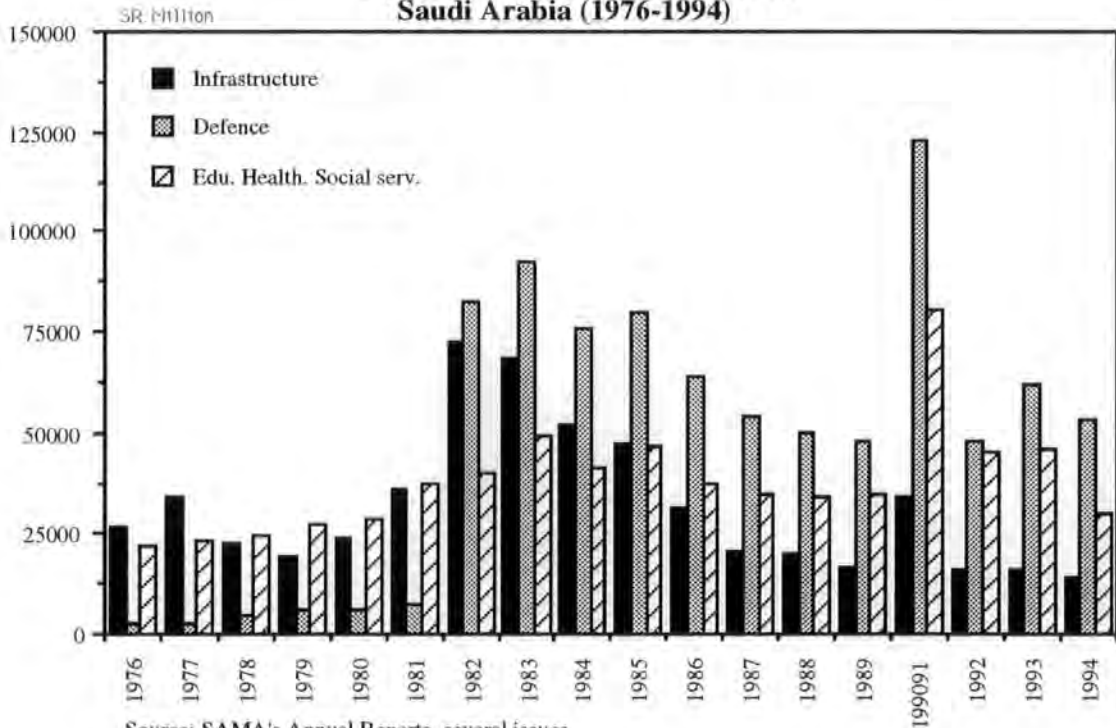
The Saudi Arabian government realised that by continuously increasing its expenditure it may, sooner or later, experience inflation. However, the government's main objective in the mid 1970's was to pursue economic development and it was willing to bear the problems that came with it, namely, price instability. The accelerated rate of development resulted in the economy's inability to absorb the high investment programmes and as a result prices increased. The government's response was to limit its expenditure programme to the 1975 level. Many large projects were rescheduled, price controls were imposed by the government on certain products and low income people were supported through the subsidisation of the staple foodstuffs. Inflation had occurred partly due to the inability of the ports to cope with the large amount of imports that had arisen due to the ever increasing development spending. Ports experienced heavy congestion and as a result delays occurred in the unloading of consumer goods and raw materials.

Therefore, congestion surcharges had to be added to the importation costs as often helicopters were used for unloading the goods. The government funded the port authorities to improving port facilities, an objective that was quickly achieved.

Due to the increase in the number of residents in the cities and the limited amount of available housing facilities, this resulted in escalating rents of 80 percent in 1975.³ During the same period, the cost of food, drink and tobacco also increased by 20 percent, but cloths and material remained constant and at a stable rate. To remedy this situation the government attempted to control rents. It also increased the number of housing projects and offered aid to property developers.

The Second Five-Year Development Plan (1975-1980) estimated that oil production would increase at 9.7 percent per year, while it expected the non-oil sector to grow at a rate of 13.3 percent. This would thus, increase the non-oil sector's relative share of GDP from 11 percent in 1975 to 15 percent in the early 1980's.⁴ In comparison, the oil sector's allocation to GDP was anticipated to decrease from 86.6 percent to 82.1 percent. This showed Saudi Arabia's determination to move from oil into different sources of income. The main aim of the Second Plan was to contribute to the development of the infrastructure - although health, education and defence were also stressed to maintain a high economic growth rate, decrease the reliance on oil and to raise the standard of living -see figure 5.2. In the Third Development Plan (1980-1985) the government kept the above objectives but emphasised the reduction of the influx of expatriates and encouraged and supported the agricultural, industrial and mining sectors. The goals of the Fourth Development Plan (1985-1990) were to maintain the objectives of the previous plans and to encourage the interaction within the GCC. It was also to enhance and promote the private sector, especially those firms associated with the import substitution industries,

Figure 5.2: Public Expenditure in Saudi Arabia (1976-1994)



Source: SAMA's Annual Reports, several issues

involvement within the overall economy.

The Fifth Development Plan's (1990-1995) most significant objective was to show a theme of continuation of the importance of forming "a productive national work force by encouraging citizens to avail themselves of the benefits from the infrastructure and institutions" built by the state.⁵ The plan again emphasised the previous plans' objectives, but called for an increase in the health and education services and the encouragement of the private sector participation in socio-economic development.

During the 1980's Saudi Arabia experienced an overall economic recession. This was due to four basic forces: the falling oil revenues, the completion of major infrastructure projects, the caution over markets for export industries, particularly petrochemicals, and finally the government's desire to limit the number of foreign workers. Table 5.1 illustrates the Kingdom's switch in policies from the Third to the Fourth Development Plans. The swing was from an emphasis on the development of the infrastructure to that of social and manpower developments. The total expenditure figure in the Fourth Development Plan was curtailed by roughly 13 percent. This was undoubtedly in response to the recessionary conditions, and declining revenues.

The basic change in theme in the Fifth Development Plan from the Fourth Plan was a greater emphasis on economic diversification through the encouragement of the private sector (see table 5.1). The plan shows that "in the past, the momentum for economic growth and development has been provided predominantly by strongly expanding

Table 5.1: Saudi Arabian Government Expenditure Under the Third, Fourth and Fifth Development Plans

| | <u>3rd Plan</u> | | <u>4th Plan</u> | | <u>5th Plan</u> | |
|-------------------------------|-----------------|----------|-----------------|----------|-----------------|----------|
| | <u>SR. bn.</u> | <u>%</u> | <u>SR. bn.</u> | <u>%</u> | <u>SR. bn.</u> | <u>%</u> |
| Economic Resource Development | 216.8 | 33.5 | 130.7 | 19.0 | 56.5 | 11.0 |
| Human Resource Development | 129.6 | 16.6 | 135.3 | 19.7 | 139.9 | 28.0 |
| Social Development | 61.2 | 7.8 | 89.7 | 13.0 | 63.9 | 13.0 |
| Physical infrastructure | 249.1 | 31.8 | 144.3 | 21.0 | 97.4 | 20.0 |
| Total Development Expenditure | 701.1 | 89.7 | 500.0 | 72.7 | 357.8 | 72.0 |
| Administration | 31.4 | 4.0 | 70.2 | 10.2 | 31.1 | 6.0 |
| Resources & Subsidies | 49.6 | 6.3 | 117.3 | 17.1 | 108.8 | 22.0 |
| Total Civilian Expenditure | 782.7 | 100 | 687.5 | 100.0 | 497.6 | 100 |

Source: Data derived from Ministry of Planning

government expenditure, but this method of stimulating economic activity will not be revived in the Fifth Plan." So the plan affirms that a new phase of development will emerge but based on a new foundation namely; "private sector initiative and government expenditure."⁶ Therefore, it is expected that a new role will be given to the private sector through this plan. But the challenge remains in the hands of policy makers and their ability to use institutional and policy initiatives to induce structural shifts in the economy through the encouragement of private sector investment and growth. To face such serious challenges the Fifth Plan focused on ten main strategies which were as follows:

- 1 - "Stabilisation of the economy through steady growth of government expenditure.
- 2 - Institutional development
- 3 - Extension of the private sector role
- 4 - Intensification of structural change through growth.
- 5 - Improving quality, efficiency and competitiveness.
- 6 - Intensified utilisation and development of Saudi human resources.
- 7 - Maintaining the welfare and quality of life of Saudi society.
- 8 - Achieving balanced regional development
- 9 - Acceleration of science and technology development, and
- 10 - Strengthening and expanding international linkage."⁷

Despite all of this, it is apparent that little has been achieved to enhance the role of the private sector in Saudi Arabia. The major obstacles to the success of this plan was the second Gulf War which erupted in 1990 and resulted in a large and very expensive bill for the Saudi Arabian government. This meant that funds had to be directed towards the war effort instead of the achievement of the plan objectives.

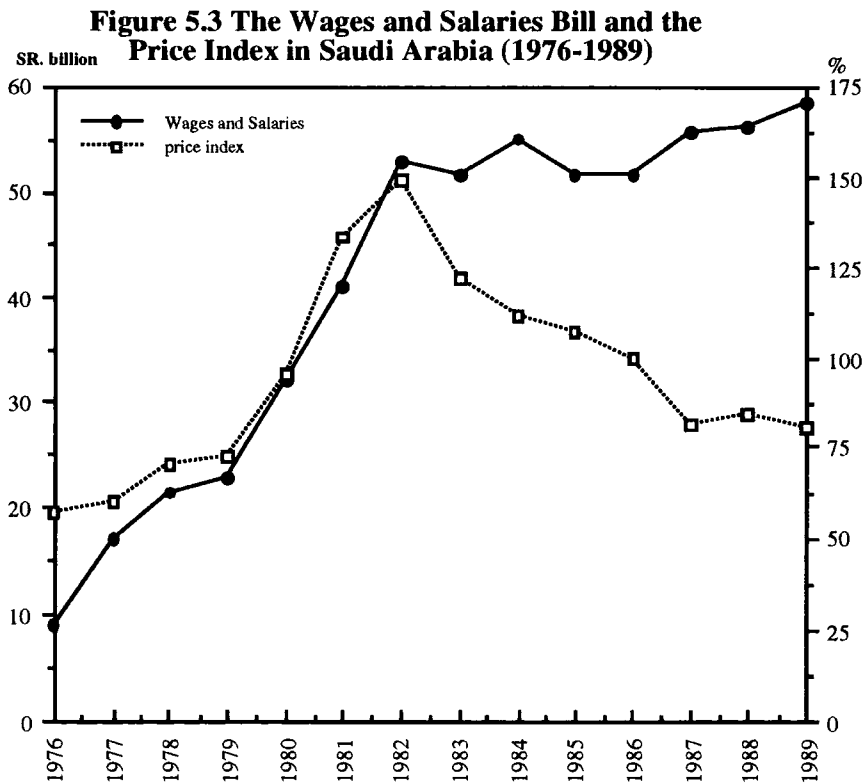
The government of Saudi Arabia dominates the economic activities of the country since it controls the main sources of income, namely crude oil. Thus, the government plays an important role in determining the standard and composition of economic activities within the country, a strategy achieved through different tactics e.g. by investing in large projects and simultaneously by redirecting some of its income to small businesses through loans and other financial support with the aid of government agencies established for this purpose. It has also spent much of its income on social services such as education and health along with large amounts dedicated to the defence of the nation.

5.3 Expenditure Allocations and Inflation

Between 1971 and 1976 the Saudi government continuously decreased the provisions

allocated to wages and salaries. One explanation for such a policy could be that the number of expatriates who work in its departments such as Palestinians, Egyptians and Europeans was reduced, since the government started to encourage Saudi nationals to take up civil service jobs. Near the end of this period the government started its heavy infrastructure development plans and therefore there was a necessity for more experts to be brought in. Hence, the increase of expenditure on wages and salaries might be explained by the increased number of civil servants as well as expatriates working for the government. Over the 1977 to 1990 period, the percentage allocated to provisions for wages and salaries continued to increase dramatically, from 12.7 percent to reach 41 percent respectively. But what is interesting is that the government policy in wages and salaries has reflected the price index trend up to 1982. However, after that year the policy has changed as the budgeted provision of wages and salaries seems to have been stabilised and have taken a different path from the price index trend as the latter has decreased - see figure 5.3. After 1982 the rate of inflation fell, and there was less pressure for salaries and wages to be raised.

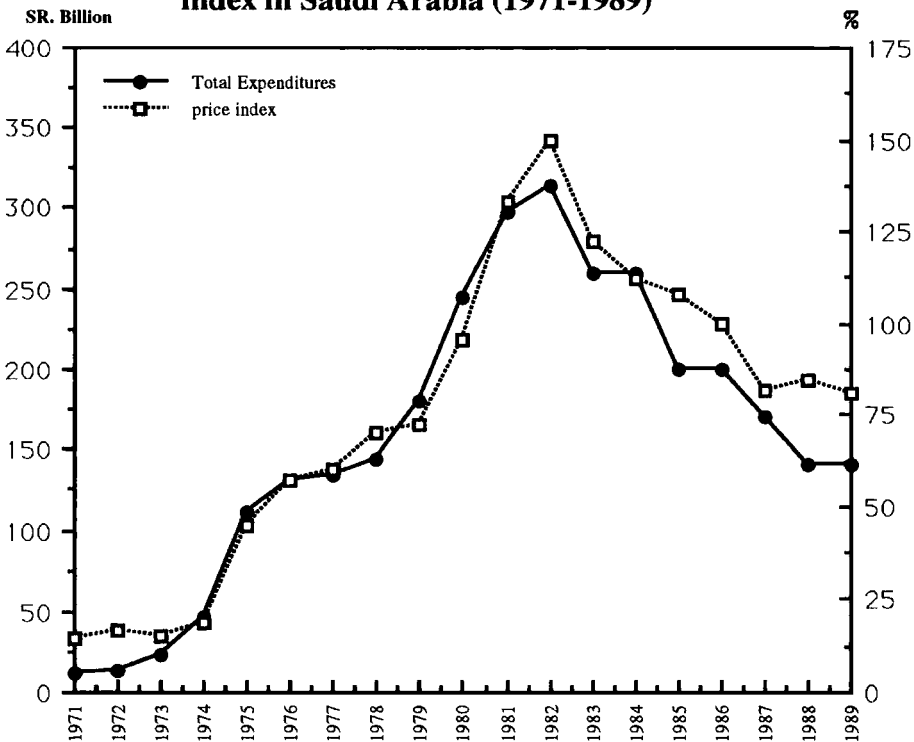
The more consistent government policy was its commitment to projects in the newly



developed sectors of irrigated agriculture, and processing industries. SAMA's figures show that the government has allocated on average between 1971 and 1986 more than 54 percent of the total budget to new development projects in the Kingdom. In some years more than 71 percent of the budget was allocated to the development projects, for example SR 174.7 billion in 1980. In 1981 the share given to development projects exceeded SR 205 billion compared to only SR 5.05 billion in 1971. But after 1985 the share of development project started to decrease from 41 percent for that year to reach a low of 26.4 percent. In 1989 only SR 37.08 billion was spent on development compared to SR 58.27 billion spent on provisions for wages and salaries.

Looking at the growth of the GDP and the price index, one can draw the following conclusion; that even though there was a clear policy plan for the growth of the economy, nevertheless, it was uncontrollable in the short term as can be seen from the growth of the GDP (deflated) which has varied between minus 5 percent and plus 9 percent. It is clear that government budgetary policy was dictated to by oil revenue. Government spending appears to be closely linked to the rise in prices in Saudi Arabia, suggesting that for most of the 1971-1991 period, inflation was demand induced as figure 5.4 shows.

Figure 5.4: Total Expenditures and the Price index in Saudi Arabia (1971-1989)



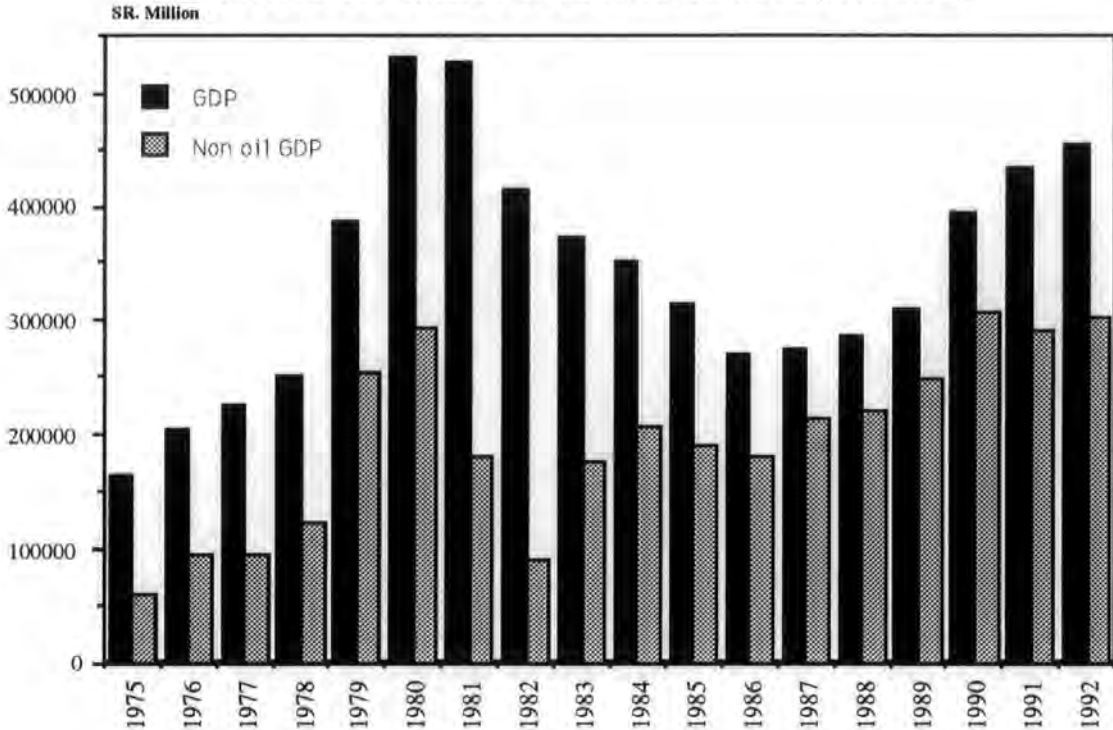
Source: SAMA's Annual Reports, several issues

5.4 Expenditure Constraints

Due to Saudi Arabia's reliance on oil this has made it more dependent on the outside world and as income increased so did the standard of living making people more and more dependent on imports from abroad. Saudi Arabia was also dependent on the outside world for the supply of labour. Manpower is vital to the success of the economy, especially when Saudi Arabian nationals are small in number and not enough of them possess the necessary skills and technological know-how to operate all the newly formed industry. Thus a large portion of the country's GDP was used to pay for foreign resources with a high proportion of it spent for the remuneration of expatriates. It is obvious that crude oil is the main determinant of GDP, however, this varies with production levels and the price of crude oil in the market e.g. this sector was at a high in the mid 1970's and fell in the late 1970's, then again with the increase in oil prices in 1979 it regained its importance, nevertheless, in recent years it has declined again. In comparison the non-oil sector is not as variable as the oil sector overall, though parts of it such as construction displayed cyclical activity which was closely related to the state of the oil sector. This was a major problem in the 1970's when infrastructure development was the main aim, implying by necessity a crucial role for the construction sector.

Figure 5.5 illustrates the influence of oil on both oil and non-oil GDP, it is apparent when the price of oil increases so do both oil and non-oil GDP, reflecting the reliance of other sectors in the economy on the revenues from oil. Hence as oil prices increase the economy prospers. Saudi Arabia's GDP declined from 1982, this reflects the slump in oil prices which as a result affected the whole of the Kingdom's economic performance. However, due to the Iraq-Iran War, and later the Gulf War, Saudi Arabia was able to increase its oil production which meant a better income, and this is reflected in the oil and non-oil GDP. The question is what will happen to Saudi Arabia's revenues from oil when the oil embargo on Iraq is lifted? Nevertheless, Saudi Arabia's per capita GDP in 1990 was higher than all African and Latin American countries and was only below Japan, Singapore and Hong Kong in the Asian continent. In fact, the World Bank describes Saudi Arabia as an upper middle income state in line with Portugal and Hungary. Unfortunately, the Kuwait problem disrupted this success and cost Saudi Arabia an estimate of \$50 billion.⁸

Figure 5.5: Saudi Arabia's Oil and Non-Oil GDPs (1975-1992)



Source: SAMA's Annual Report, several years

In 1993 the growth rate in real GDP was only one percent, this being attributed to the slight reduction in crude oil production along with a decline in prices compared to 1992. Nevertheless, the non-oil sector displayed an increase of 5 percent due to both larger and small industries continuous success, but also to a slight boom in the construction and services sector. This was reflected in the banking sector's performance for that year. However, in 1994 the Saudi banks' profits were lower than the previous year, which perhaps indicates a slowdown in the non-oil sectors.

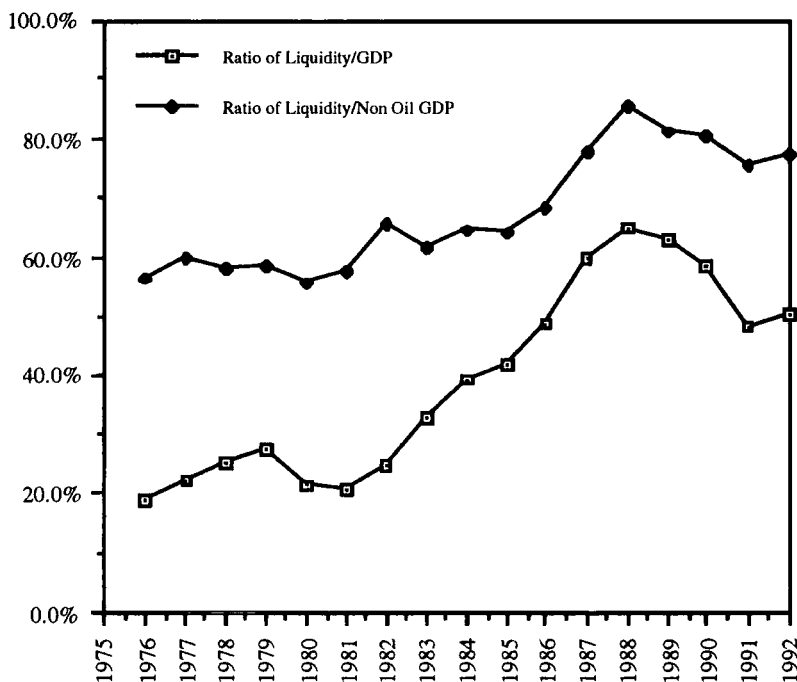
Saudi Arabia has experienced a rapid rate of growth in the past, and a development level that far exceeds that of many of its poorer Arab neighbours. However, this accomplishment had its difficulties and set backs. Problems such as inflation that occurred due to the bottlenecks experienced in the infrastructure, also problems with the availability of enough labour to take over the ever growing number of production processes and to produce the necessary goods and services desired. Today, Saudi Arabia is in the middle income category according to the World Bank Atlas. What is apparent is that wealth is lower than might be expected, given current income levels. It is important to distinguish the stock of wealth from the flow of income. Wealth can only be attained

by enhancing infrastructure and through developing health and education facilities and ensuring that the nation takes full advantage of the available support that the government offers. Saudi Arabia realises that it still has a long way to go before it can become a truly developed nation.

Gillis et. al. explain that to calculate financial deepening and ultimately economic development one needs to look at the expansion in the portion of liquid assets to GDP and if it has grown then it would imply that a policy of financial deepening is being adopted, (see chapter two for more detail). Figure 5.6 shows the ratio of liquidity to GDP and also to non-oil GDP. It is clear that both these ratios show an upward trend, however, it is obvious that they vary with the country's economic climate. They both peaked in 1988 but then started to decline, however, they showed a very slight recovery in 1992, this is probably due to Saudi Arabia's increase in the production of oil.

Oil has not been the only determinant of the government's expenditure programme. There have been other factors that have dramatically influenced the government's decision to accelerate or curtail its expenditure programme. Those factors can be divided into three

Figure 5.6: Ratio of liquidity to Oil and Non-Oil GDPs in Saudi Arabia



Source: SAMA's Annual Reports.

major headings.

Firstly, the government tried to maintain price stability in order to reduce the uncertainty that might harm business performance. One of Saudi Arabia's main objectives has been to dampen inflation, especially, after the turmoil of the mid 1970's and the dramatic results experienced in the real estate and the housing sectors. In recent years inflation has posed less of a threat since capacity has been increased, thus, enabling it to deal with large expenditure without worrying about similar inflationary effects. Also due to the improvement in port facilities, imports are no longer a bottleneck, which also means less inflationary pressure.

Secondly, the Saudi Arabian economy strives to achieve its ultimate objective of upholding and strengthening the religious and moral values of Islam. This task has occasionally come into immediate conflict with the increase in the number of expatriates who bring with them values and traditions that are often be in direct conflict with the Saudi Arabian way of life.

The final objective of the Saudi Arabian economy, which has in recent years been emphasised, is the aim of the government to reduce the amount of imported labour and to improve by training the technical know-how of Saudi nationals. If the government continued to accelerate its economic growth and simultaneously reduce the amount of imported labour it may be faced with an increase in the rate of inflation.

The Saudi Arabian budget has fluctuated from surplus to deficit depending on the boom or slump experienced by the oil market. During the 1960's and the beginning of the 1970's Saudi Arabia was experiencing a budget deficit, this however, transformed into a surplus in 1974 reflecting the increase in oil prices. Nevertheless, this surplus began to dwindle. In 1979, however, there was a substantial increase in oil prices that resulted in budget surpluses. Around 1985 the government's budget began steadily to fall into deficit. This was partly because the government felt it necessary to continue spending at high levels even though revenue from oil was declining. However, in 1982 and 1983 the budget surplus was SR 117,703 million and SR 102,748 million respectively, while in 1985 it became a deficit of SR 23,767 million, which continued to increase through the 1980's and 1990's - see table 5.2.

Table 5.2: Saudi Arabian Budget (1971 - 1993); SR.M

| Year | Revenues | Expenditure | Surplus (Deficit) |
|------|----------|-------------|-------------------|
| 1971 | 5741 | 6028 | -287 |
| 1972 | 7954 | 6293 | 1661 |
| 1973 | 11116 | 813 | 2986 |
| 1974 | 15326 | 10158 | 5168 |
| 1975 | 40579 | 18595 | 21984 |
| 1976 | 100103 | 35039 | 65064 |
| 1977 | 103384 | 81784 | 21600 |
| 1978 | 135957 | 106737 | 29220 |
| 1979 | 132241 | 137110 | -4869 |
| 1980 | 131505 | 146306 | -14801 |
| 1981 | 211196 | 185724 | 25472 |
| 1982 | 348119 | 230416 | 117703 |
| 1983 | 386006 | 283258 | 102748 |
| 1984 | 246182 | 244912 | 1270 |
| 1985 | 206419 | 230186 | -23767 |
| 1986 | 171509 | 216363 | -44854 |
| 1987 | 131736 | 184004 | -52268 |
| 1988 | 76498 | 137422 | -60924 |
| 1989 | 103811 | 173526 | -69715 |
| 1990 | 84600 | 134850 | -50250 |
| 1991 | 114600 | 149500 | -34900 |
| 1992 | 154721 | 210430 | -55709 |
| 1993 | 161879 | 266370 | -104491 |

Source: SAMA's annual reports, several years

In 1993 the government has tried to apply restraints to its fiscal policy. Hence, the budgeted figures submitted for that year were just under the 1992 estimates. The reduction was mainly possible because the government decreased its budgeted project spending figures. In 1994 the government put forward a budget that was 19 percent lower than that of the previous year. These cuts were to be achieved by the fact that spending will only be undertaken to complete projects that were in progress. The budget of the water and municipal authorities were decreased by 25 percent. However, lending to the private sector, including agricultural projects, new industries and real estates was to continue. Saudi Arabia's Sixth development plan (1995-2000) has made it clear that the government objectives are to sell part of its enterprises, and to encourage the private sector to become more involved in the management of basic industry and public utilities.⁹

Government spending has decreased dramatically in recent years, to levels that enables it to maintain the economy. Large projects have been halted and very few new ones are approved. There has also been a decline in the expenditure that is allocated to the health and education sectors. Those people employed by the government sector have

experienced little if any increases in their remuneration package. Much of the government expenditure has been directed to the defence infrastructure since the government has always been concerned with both its internal and external security. The Gulf War has resulted in increases in defence expenditure. This, Saudi Arabia was forced to participate in, and as a result it had to use much of its already depleted foreign assets to finance it.

Saudi Arabia's objective today is to return to reasonable growth rates that will be achieved not only through oil revenues but also through its new diverse economic activities that would interact with the GCC countries and would employ Saudi nationals in the long run. In the past, and prior to the Iraq-Kuwait War, the government had been able to manage the deficit figure by drawing from its overseas asset holdings and by the issuing of government bonds to commercial banks, after it found that its foreign assets have depleted and it is, therefore, unable to draw on them. The only alternative is for it to rely on commercial bank financing through bonds and treasury bills, and through the privatisation of its domestic manufacturing holdings (as mentioned in the previous chapter).

5.5 Private and Government Consumption

The large amounts of funds absorbed by consumption expenditure are apparent when looking at those used by both government and private consumption. However, until 1985 Saudi Arabia's total sum of consumption expenditure represented a low figure in relation to total income. Due to this, Saudi Arabia saved, yet financed a high rate of capital formation. For the period from 1970 to 1980 Saudi Arabia's private consumption increased at a steady 28 percent per year in comparison to 37 percent per year for GDP growth.¹⁰ Private consumption had alternated at lower rates than GDP. Its proportion of GDP varied from a low of 9.9 percent to a high of 28 percent during the 1970-80 period. The lowest figure occurred in 1973 straight after the surge in oil prices which resulted in the increase in revenues. The 1978 share was equal to 24.4 percent, almost the same as that experienced in 1971. Thus, it is apparent that private consumption had not increased at the same rate as GDP during the 1970's. However, government consumption expenditure had surpassed the rise in GDP, with its average rate of yearly increase equal to 39 percent.¹¹ The government consumption expenditure had mainly been on the social

services and also on improving and developing the existing administrative infrastructure. This had enabled it to cope with the fast growth in the economy that had taken place in the past.

In fact, until 1983/84 government fixed capital formation continued to be greater than the private sector's share. However, for the period 1985 to 1989 the situation changed, as the private sector began to make good use of the investment opportunities available. Private consumption made up the largest promotion of the expenditure figures, with an average rate of 45-50 percent of GDP, although during the Gulf War in 1990-91 government investment exceeded that of the private sector. However, this expenditure was attributed to the circumstances of the war, and has declined since.¹² What is apparent is that the government had been reducing its spending on infrastructure since 1983, reaching very low levels in 1992 - see figure 5.2. The effect of this policy on the economy will only be felt in the future.

Saudi Arabia has reached a stage where it can no longer spend as much as it would like to on development, because of the reduced income from oil and the depletion of its foreign assets. It is now time for it to step back and allow the private sector to play an active role. The government has, in fact, been trying to encourage the private sector to participate, but this has not been very successful.

5.6 Investment (Gross Capital formation)

In the 1970's due to the large revenues from oil Saudi Arabia could invest as large a sum as it desired as long as the country was able to absorb it. The government could redirect the country to the type of economic activities it envisaged itself involved with, as long as those activities were in line with the government's political and social objectives. With the huge amount of revenue Saudi Arabia had to choose the best possible investments and in its process of making this decision it must not pass blindly an opportunity available to it, especially, when the stakes were so high. Far from large expenditure implying waste, responsibility and caution have been emphasised.

A country's speed in accumulating capital - where capital is defined as buildings, machinery, assets, human resources...etc. - depends on its "absorptive capacity". If the

country had not yet developed a physical and social infrastructure capable of handling new large investments, then it must prepare itself to face major problems. This Saudi Arabia experienced in the mid 1970's with bottlenecks in the infrastructure that consequently led to a high rate of inflation. However, by the 1980's Saudi Arabia had overcome those obstacles and was ready to invest at an accelerated rate. El-Mallakh attempted to calculate Saudi Arabia's absorptive capacity and found that it had been developing to its full capabilities in the 1970's.¹³

As the Second Development Plan was drawing to an end, Saudi Arabia decided that it had sufficiently developed its infrastructure and the problems encountered during the decade 1970-1980 had completely disappeared. Hence, the main objective of the Third Development Plan was to invest in diversified industries, with a particular emphasis on import substitution. Those investments were developed at considerable speed despite the difficult physical environment. This involved the problems of heat, dust, and humidity that often damaged the equipment and encouraged workers to demand greater wages in order to tolerate conditions.

When choosing an investment opportunity the Saudi Arabian government and Saudi Arabian investors tend to have a long term horizon. This is often done because Saudi Arabian's realise that labour and other necessary inputs, with the exception of capital, are the real scarce resources. It is, therefore, inevitable to use investments that would maximise output rather than profits. Saudi Arabians tend to invest in capital intensive plants, since the government acknowledges that with time it will accumulate capital stock, but due to the small size of its population it would not have a sufficient number of people to run those investments. The unavailability of workers in Saudi Arabia is one of the main reasons why investors choose capital intensive industries. In recent years Saudi Arabia had been decreasing the amount of imported labour and has invested in educating its nationals in technical know-how. On observation one will find that all investments embarked on by the government have been capital intensive.

One can appreciate the government's drive and determination to achieve its objective of encouraging the development of capital intensive projects by simply observing the financial support offered to the private investor intending to purchase highly capital

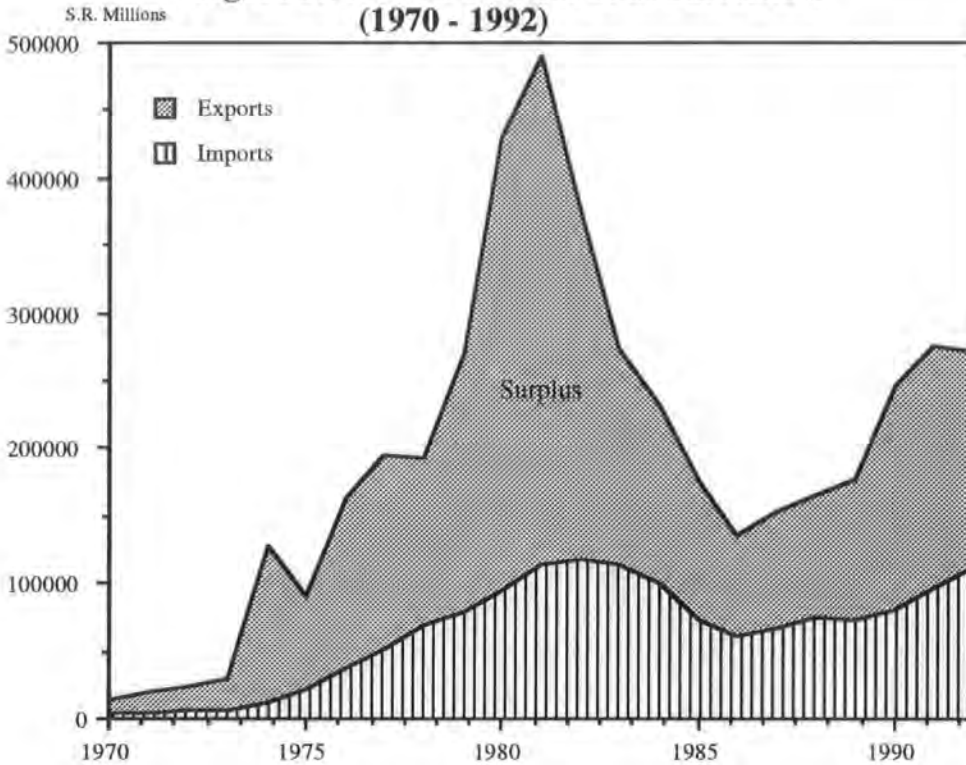
intensive machinery. Moreover, the SIDF, which is the body responsible for arranging loans to private investors, had made it apparent that it prefers capital intensive projects to others. The objective of the Saudi Arabian planners was to develop a modern industrial economy in as short a span as humanly possible. By doing so they hoped that they would be able to decrease the Kingdom's dependency on commerce and subsistence farming.

5.7 The Balance of Payment

Saudi Arabia enjoyed a balance of payment surplus even before OPEC's price increase of 1973-74. However, following this event Saudi Arabia experienced an abnormally large surplus on its current account, balanced mainly by a huge accumulation of foreign exchange. This surplus prevailed throughout the 1970's with a second surge in 1979. Nevertheless, due to the decline in oil prices in the early 1980's and Saudi Arabia's decision to decrease its production of crude oil, the balance of payment experienced a heavy reduction in its surplus. Exports have proved to be quite volatile, rising and falling depending on the trends in the oil market. However, imports have continued to increase at a rapid rate since the mid 1970's reflecting, first, the increase in population and expatriates. Secondly, due to the increase in incomes, demand for imported consumer goods increased. Thirdly, tastes changed due to the influence of expatriates or travel, thus the requirement of specific imported products. Fourthly, the difficulty of providing certain products, within Saudi Arabia due to the lack of technology, labour and even infrastructure. Fifthly, the capital stock imported by the government for the general and specific projects necessary for the overall development of the Kingdom. Finally, the increase in military goods, especially during both Gulf Wars.

Due to the growth in oil exports in 1980 the balance of trade experienced a surplus. The balance of trade surplus doubled in 1980 due to the growth in oil exports. However, in 1981, the growth in imports nearly offset that experienced in exports, and by 1982 the surplus was reduced to half its existing value due to the decline in oil prices and the increase in imports. From this period onwards export earnings declined substantially, although they rose again from 1987 reflecting increasing oil production levels. (see figure 5.7). Saudi Arabia continued to experience a trading surplus for the past ten years,

**Figure 5.7: Trade Balance of Saudi Arabia
(1970 - 1992)**



Source: Kingdom of Saudi Arabia: Achievements of the Development Plans (1970-1989), p.238, and (1970-1992), p.249.

especially in 1990 and 1991. This was in spite of the fact that the import bill remained substantial, as although imports were curtailed in the late 1980's, they rose again in the early 1990's with the Gulf War.

During the period 1974-1981 more than a third of the accumulated surplus was transferred abroad through increases in investments overseas, including foreign asset acquisitions of the commercial banks, oil sector transactions and private capital movements. In fact, the total amount of declared foreign assets increased by roughly US\$ 118 billion for this period.¹⁴ Almost half of this increase occurred in 1980-81, as the Saudi Arabian economy was not able to absorb the enormous surge in its income from oil. However, foreign assets were on the decline in 1983 since the government had to draw on them to meet its expenses i.e. increased imports and aid commitments. In 1986 SAMA recorded foreign assets of SR 361.22 billion¹⁵ showing a decrease of around SR 137 billion since 1982. While in 1987 SAMA showed foreign assets of SR 342.6 billion, a decline of 5.2 percent. In 1989 SAMA revealed foreign assets of SR 304.6 billion, a large decline of 11 percent. The figure of foreign assets in 1990 according to SAMA's statistics

was recorded at SR 292.4 billion, another decline of 4 percent.¹⁶

Oil represents Saudi Arabia's main export and its price has been erratic over the years, while imports accelerated drastically between 1975 and 1985. Then they experienced a slight decline during the recessionary period in the mid 1980's. However, they soon increased again in 1988. The Saudi Arabian government attempted to reduce the increase by encouraging import substitution and imposing high tariffs on imported goods. Despite the increase in imports the balance of payments has continued to show a surplus. Even though Saudi Arabia continued its aid - an instrument of foreign policy - towards Arab states, however, this has showed a clear decrease due to the deteriorating external financial situation and the new foreign policy of the Kingdom. Today aid is focused on the Islamic World more generally, rather than the Arab World in particular.

A contributory factor to the balance of payments deterioration was the fall in the dollar interest rates and the consumption of a large portion of the overseas holdings which has caused the kingdom's returns from invested income to decline. Saudi Arabia's balance of payment situation can only be improved if oil prices increase once more, or if it is able to export petrochemicals at greater levels. Both scenarios are highly unlikely in the near future. By definition it is unlikely that the import substitution industries will contribute greatly to exports, but they may be able to replace the imported goods, thus reducing the import levels. However, they still need to import the raw materials for manufacturing. Another issue that Saudi Arabia has to decide is whether or not to continue its aid policy.

5.8 Conclusion

The underlying objective to Saudi Arabia's limited fiscal policy is to achieve its goal of shifting the reliance from oil to manufacturing and service industries. However, in order for this goal to be reached, the government realised the need for a strong founded infrastructure to cope with the new developments. All of Saudi Arabia's expenditure policy have been towards achieving its development plans, which have sometimes resulted in inflation, but this the government was willing to live with as long as it was reaching its goals. The drop in oil prices and the Iraq-Kuwait war has forced the Saudi government to commence its objectives ahead of time. During all this, SAMA, as the government bank,

has played an important role in managing the government finance, but it did not take the advantage of the full extent of monetary policy. The government has chosen instead to control its finance through expenditure variation. Nevertheless, SAMA has come a long way. Its role in the financial system is discussed in the next chapter.

Notes:

- (1) Moliver, Donald M. and Abbondante, Paul J. The Economy of Saudi Arabia USA: Praeger, 1980, pp. 100-101.
- (2) Presley, John R. A Guide to the Saudi Arabian Economy Hong Kong: Macmillan, 1984, pp. 41-44.
- (3) Ibid., p. 43.
- (4) Moliver and Abbondante, op. cit., p. 105.
- (5) Ministry of Planning, "Fifth Development Plan (1990-1995)." p. 45.
- (6) Ibid., p. 47.
- (7) Ibid., pp. 47-51.
- (8) Middle East Economic Digest, Vol. 36, No. 45, 13th November, 1992.
- (9) The Arab Economies: Structure and Outlook. Arab Banking Corporation. ABC's Economic Publication, 1994, pp. 115-116.
- (10) Johany, Ali D. Berne, Michel and J. Wilson, Mixon Jr. The Saudi Arabian Economy London: Croom Helm, 1986. p. 20.
- (11) Ibid., p. 23.
- (12) The Arab Economies: Structure and Outlook, op. cit., p. 113.
- (13) El Mallakh, Ragaei. Saudi Arabia Rush to Development. London: Croom Helm, 1982, p. 435 - 51.
- (14) Middle East Research Institute, University of Pennsylvania. Meri Report: Saudi Arabia: London: Croom Helm, 1985, p. 3.
- (15) The Economist Intelligence Unit. "Country Report: Saudi Arabia." UK: EIU, 1987, p. 17.
- (16) SAMA Annual Reports, 1988 and 1991.

Chapter Six

The Functions of the Saudi Arabian Monetary Agency in the Kingdom's Financial System

Having looked at the Saudi Arabian economy and the budgetary and fiscal position, we are better placed to consider monetary issues, and in particular the position of SAMA, which was established in 1952. Its main responsibility was to follow policies that would moderate fluctuations in the value of the riyal. Since its formation, its duties and power have continued to evolve. Today, it performs most of the functions that are traditionally associated with a nation's Central Bank.

Until the 1950's the only type of money available was in the form of coins, and the government's income was not subject to any formal accounting policies or controls. The Saudi Arabian financial system fundamentally emerged from Jeddah, which was, and still is, the centre of the annual "Hajj" traffic and Saudi Arabia's main business link to the outside world.¹ The system flourished in line with, and in order to satisfy, the varied needs of the merchant community and therefore, did not accommodate the needs of other sectors within the rapidly developing Saudi economy.²

Today, SAMA is in charge of all progress and growth in Saudi Arabia's financial sector. Its charter has been modified and its responsibilities have been increased on several occasions. In its capacity as a Central Bank, it has made a valuable contribution towards enhancing commercial banking facilities and has boosted the agricultural and industrial development within the economy. Abdeen et al. argue that SAMA has followed a policy of "non-intervention", and demand for credit is directly determined by market forces of supply and demand. They show that SAMA, along with the Ministry of Finance and National Economy, has strived to direct commercial banks so as to secure a methodical development of the banking system. They stress that in more recent years, SAMA has also begun to exercise control over Saudi Arabia's foreign investments.³ Moliver and Abbondante stress that SAMA's functions are to operate as an inter-bank clearing house, to prescribe statutory reserve requirements, liquidity quotas and margins for the establishment of letters of credit.⁴ Hence the role of SAMA as explained by Moliver and Abbondante contradicts the "non-intervention" description of SAMA by Abdeen. What is apparent is that as a result of its control policy SAMA is intentionally or unintentionally curtailing the commercial bank lending, which could be described as financial repression.

Prior to the establishment of SAMA, there was no efficient mechanism to monitor the proper utilisation of the financial resources which influence the nation's standard of living. Hence, the establishment of SAMA was a major breakthrough. The inspiration of SAMA has also fostered systematic economic growth, helped maintain a stable currency unity and improved the nation's balance of international trade.⁵

6.1 The Birth of SAMA

The 1950's brought with it an increase of oil revenue that prompted the Saudi Arabian government to take appropriate action to enhance the overall growth and development of the economy. King Abdul-Aziz felt it necessary to establish a Central Bank in order to stabilise the riyal in both the national and international markets and also to monitor government expenditure.⁶

Assistance was sought from the United States of America which sent a financial team headed by Dr. Arthur Young, a monetary and banking specialist. Young realised that the Saudi Arabian financial system was not sufficiently advanced to cope with the country's fluctuating balance of payments. He felt that the present financial system was overloaded since the revenue from oil had increased substantially in the previous three years, thus a budget of \$7 million had now become a budget of more than \$140 million. This in turn created a foreign exchange dilemma since over 80 percent of the country's earnings were in foreign currency. It was also apparent that there were inadequate facilities for introducing the new gold coin or even to handle the circulation of existing coins. It was also evident that there was insufficient, if any, control over the banks and the money changers.⁷

Young felt that the establishment of a system whereby the government generates credit by issuing circulating notes and by loans to itself, was prone to considerable abuse even in the strongest of economies, and could, therefore, not be applied in Saudi Arabia. This view had the full backing of experts in Washington, who also emphasised the necessity of preserving the institution's autonomy from the government.⁸

Young also recommended that a suitably qualified expatriate be appointed as governor, until an equally qualified local person was available. Young's suggestion was to

appoint George Bloomers who had been at the helm of Central Banks in Liberia and Ethiopia and who had also worked with the International Monetary Fund. This nomination was approved by Washington.⁹

Young suggested the formation of a "Saudi Arabian National Bank" which would be funded by the government. He outlined the bank's role in a report submitted to the Saudi Financial Minister, Abdullah Suliman. Then in April 1952 the charter of SAMA was endorsed by Royal Decree. The King wanted to ensure that the institution would not either charge interest or receive it. This Young felt could be done by using the commission from the government's exchange transactions - instead of interest - to cover SAMA's operating expenses. He was also sceptical about the word "Bank" in the title, hence the institution was named SAMA.¹⁰

Young and Bloomers had further discussed the issue with Crown Prince Saud, and the following points were agreed upon; that the head office was to be based in Riyadh.¹¹ SAMA would receive all government income and would control all its expenditure, in turn it would keep the government fully advised of its operations. The government was to be presented with monthly reports, and it was Young's responsibility to monitor the preparation of these reports. The institution should not pay interest and should obey Islamic Law in all respects. Finally, the procedures used and the personnel employed should be authorised by the head office in Riyadh.¹²

The agency's functions were setup as follows. First, to regulate and preserve both the external and internal value of the riyal. Secondly, to control and manage the government's financial reserves as separate funds which were to be used for monetary purposes only. Thirdly, to trade in gold and silver coins and bullion on behalf of the government. Fourthly, to guide the government on new coinage and to supervise the manufacture, shipment and issue of all coins. Thus, coins would only be supplied through and at the requisition of the agency. Fifthly, to monitor and control commercial banks, exchange dealers and money changers.¹³

These functions were contrived in order to assist the agency in stabilising the foreign exchange value of the riyal; to facilitate the launch of a newly coined gold sovereign; to pave the way for the inter-convertibility of the various coins and to enhance the monetary

and banking system.¹⁴

The Ministry of Finance recognised the necessity of improved budgetary control, which required the centralisation of all receipts and payments from different government divisions. Hence, the agency would retain all the government's operating funds along with the monetary and fiscal reserves. Young felt the agency could prove to be vital to the government, since as the representative of the government, the agency could take charge of the government's contractual responsibilities. His report stated that the creation of a system which would receive government revenue and then be responsible for making prompt payment of government costs would enhance the efficiency of government procedures and also facilitate the administrative practices for the Finance Ministry.¹⁵

Since the majority of the oil revenue was, and still is denominated in foreign currency, mainly U.S. Dollars, the agency could play an important role in advising the government on the most efficient use this revenue could be put to. It was apparent that part of this revenue would be used to meet Saudi Arabia's own foreign obligations whilst another part could be sold for local outlay. The agency would be taking over these operations from local branches of foreign banks which would entail savings that would make the agency cost effective. However, it was stressed that the agency should not excessively reduce tasks that locally created banks and money changers have grown accustomed to performing. The agency could ask the Kaki/Mahfouz firm - i.e. the NCB - to act as its agent in some areas where it is not recommended for the agency to set up its own branch. Thereby, the agency would be able to avail itself of the advantages of the firm's experience and organisational structure.¹⁶

6.2 The Development of SAMA's Responsibilities

It was argued that the agency should have a specific research department to enable it to collect and evaluate data that would subsequently be used in developing monetary and economic policy. However, the agency was prevented from engaging in the following operations; paying or receiving interest, receiving private deposits, lending to the government or otherwise, getting involved in trade, commerce, industry or agriculture, buying or holding fixed property, unless the agency needs it to conduct its affairs and

issuing currency notes. The Young report emphasised the point that the agency was designed to be a service institute rather than a mere profit making organisation. Its objectives were to develop and improve Saudi Arabia's monetary system and its management of national finances.¹⁷

The agency would not come in contact with the public except to the degree necessary to carry out its overall monetary policy. The prevailing commercial banks in the country were able to supply the necessary services needed by the general public, notably the NCB. The agency's success would depend, to a great extent, on co-operation from these commercial banks. Therefore, the agency's functions were not to rival the functions of the commercial banks, such as receiving deposits, making loans and buying and selling foreign exchange. Under normal circumstances, the agency was to deal solely with the banks and the banks would deal with the general public whose credit worthiness could be easily assessed by the banks. The agency should endeavour to attain the confidence of the commercial banks and assist these banks when necessary.¹⁸

The agency was prohibited from generating credit by circulating currency notes. The Kingdom was accustomed to using coins and it was advisable to continue with this rather than issuing paper money. SAMA was also banned from making loans to the government as this would entail the utilisation of the agency's surplus funds. Following the same reasoning it was also not permitted to make loans to private parties. The agency's only source of revenue was government deposits and therefore it would not retain any funds for the purpose of lending, except for the earnings from public revenue. This revenue was to be utilised for the government's own use. The agency was also banned from partaking in trade. The rationale behind this ban was to ensure that the agency had no liquidity problems that would ensue if capital was tied up in any commercial, industrial or agricultural enterprise or if the agency invested in fixed assets in addition to those needed for its operations.¹⁹

Over the years the restrictions imposed on the agency curtailed its efficient operations. This fact was acknowledged and some of the restrictions were lifted. In December 1959, the Charter was extended to permit SAMA to issue paper money²⁰ which was backed by gold and convertible currency. SAMA has been unable to fully take

on the traditional role of a Central Bank in acting as bankers to the government, since lending to the government was prohibited according to the 1952 Charter. However, in 1955 SAMA was forced to break this rule and lent to the government when it acquired an extremely large budget deficit. Lending was not permitted to SAMA because oil revenues had made fiduciary issues, such as government bonds, unnecessary.²¹

At its inception SAMA was very inhibited in its regulation of the banking system. This was due somewhat to the ambiguity of the 1952 Charter especially concerning the powers of SAMA and the role of banks in Saudi Arabia as a whole. Although in the 1950's SAMA was in a position to avail itself of foreign financial expertise, banking facilities and skills were limited. Banks were predominately controlled from overseas. However, from 1952 all commercial banks had to register with SAMA and SAMA had to sanction the opening up of new branches of commercial banks.²²

SAMA's role was also hindered by the fact that in the 1950's the fiscal controls were not very tight and the government was almost insolvent at times. (Chapter seven provides an example of the NCB experience with the Minister of Finance on this issue). In the 1960's, however, the monetary system was reorganised and SAMA's role was broadened to cater for a higher degree of fiscal control in order to avert the re-occurrence of the 1950's circumstances. The main instruments used were to help constitute and preserve the adequate asset base and lending limits and oversee general commercial bank operations, in particular transaction charges.²³

The governor and Board of Directors of SAMA, were charged with the task of monitoring the daily proceedings and the overall management of the agency. The power of choosing and electing both the governor and Board of Directors, was left with the Minister of Finance and National Economy and with the Council of Ministers. The agency also has to report on a monthly basis to the government, via the Ministry of Finance. SAMA was also subject to a statutory audit by external auditors who were chosen by the government.²⁴

SAMA's main currency responsibility was to ensure that the internal and external value of the riyal remains stable. This value had varied since 1973 due to the rise in oil price. In order to overcome this volatile climate SAMA pegged the value of the riyal,

which is currently at the rate of SR 3.75 per U.S. Dollar, and has been at the same rate for a long time.

When SAMA was formed, the degree of its administrative responsibility over the commercial banks was not explicit. As a result, Article 16 of the Banking Control Law (1966) was passed which clarified SAMA's duties as regards commercial banks to be as follows: first, setting an upper limit to the amount of loans that a commercial bank can give. Secondly, banning or confining certain classes of loans and other transactions. Thirdly, laying out the boundaries and prerequisites which banks should take into account when performing specific types of undertakings for their clients. Fourthly, specify the collateral required by banks for various categories of transactions. Fifthly, specifying the ratio to be maintained between loans and collateral, for each type of loan; and finally, determining the assets to be held by each bank within the Kingdom. The asset base should not be reduced to below a specified percentage of the bank's liabilities, a percentage which would be charged by SAMA when necessary.²⁵ It is very clear that SAMA was not only aiming at monitoring the performance of the commercial banks, but to restrict lending opportunities. It also acquired some potential commercial banking business itself. The agency was licensed to receive and deposit all revenues including receipts from concessionaire companies, customs and Hajj. SAMA kept deposit accounts on behalf of the different government departments and other nominated organisations under the auspices of the Minister of Finance and National Economy. The agency was also the paying agent for the government and could make payments for purposes that were authorised by the government through the Minister of Finance and National Economy.²⁶

Hence, SAMA's authority was gradually widened, to enable it to control a large portion of the government's financial assets. It was felt that the agency should adopt a cautious approach.²⁷ In the early 1980's, most of the foreign currency managed by SAMA were invested in short term foreign government securities and other very liquid financial vehicles. This ensured that funds were easily obtainable, virtually on demand. SAMA's investment policy was based on the principle of "risk limitation", and hence only limited funds were invested in blue chip U.S. Companies such as IBM, AT&T and Dow Chemicals. Portfolio diversification was kept to an absolute minimum with some medium and long term bond placements in Japan.²⁸

The Kingdom's banking system has been a mirror image of a cautious social atmosphere, with SAMA implementing a multitude of guidelines and procedures needed for effective management. SAMA's contribution was, therefore, vital to the success of the overall operating rules. The Banking Control Law of 1966 formulated by SAMA, made up the fundamental structure for the progress of the banking sector. Developments in the Saudi Arabian economy made it necessary for modifications to be made to the Banking Control Law in order to fit in with the general environment. One of the controls where SAMA can exercise greatest influence is that over credit availability. Article 7 of the Banking Control Law required banks to deposit 15 percent of their capital and reserves, interest free, with SAMA, thereby, restricting bank credit. SAMA could alter the amount of its statutory reserve according to what it believed to be the best interest of the monetary system. However, these deposit requirements could only be changed if the Minister of Finance and National Economy agreed.²⁹

Another deterrent in Article 7, on the liquid reserves, grants SAMA retaliative control over the assets of the banks: "Every bank shall maintain with the agency, at all times a statutory deposit of a sum not less than 15 percent of its liabilities....." The percentage dictated here is between two to three times as much as the percentage set on banks in Western countries. This 15 percent statutory reserve will have to be lifted if financial liberalisation is to take place. Hence, for the banks to lend more funds to investors - foreign or local, the government must allow both to be involved in the liberalisation of the economy. If the government allows non-Saudi investors to set up business in Saudi Arabia this will increase competition in the market which has become lethargic and set in its ways.

Articles 6 and 8 of the Banking Control Law also needs serious consideration. Article 6 demands that if the deposit liabilities of a bank is over fifteen times its reserves and paid up capital, then the bank has to either build up its capital and reserves to the dictated level, as advocated by SAMA, or deposit 50 percent of the surplus deposits with SAMA without receiving any interest. Concerns arise over this piece of legislation as bankers feel that it is excessively restrictive and that they are being punished for attracting more deposits. In an attempt to circumvent this law, banks are transferring excess deposits offshore, mainly to Bahrain, where no such legislation exists.³⁰ These funds

could be used to lend to local firms for development purposes instead of being placed outside the country.

Article 8 bans the granting of loans to any individual or organisation that were in excess of 25 percent of the bank's reserves and paid up capital. SAMA could, however, increase this percentage up to 50 percent subject to any conditions it thought necessary to impose. This requirement applied to customer loans, letters of credit and guarantees. This legislation again deters economic growth and development, especially in capital intensive projects where usually substantial funds are required. Often contracts which individually amount to several million riyals could not be covered in the country since the amount of the guarantee will be greater than 25 percent of the bank's capital and reserves. This put the banks in a very restricted position and drove them to deal with the guarantees offshore.³¹

SAMA's control laws also prevent banks from making loans to foreign individuals. However, loans to sanctioned foreign corporations are permitted. Additionally, banks must retain 25 percent of their net profits and transfer this amount to reserves as per Article 13. This special reserve is gradually built up until it at least equals the bank's paid up capital, thus giving banks the necessary ways to boost their equity base. SAMA has been hesitant in allowing the build up of paid capital. SAMA charges a 45 percent tax on interest and dividends paid to shareholders of foreign banks. This corresponds to the withholding tax levied in developed countries.³²

All these restrictions on commercial banks tightened the flow of funds and hampered the banks' ability to lend to investors; especially those with large investments. In order to allow the financial system to be liberalised SAMA must give the commercial banks more freedom and access to their funds and allow them to lend to the investors with the best potential regardless of the amount of fund it may require, especially, with the present economic climate. The government can no longer finance heavy investments and the private sector is beginning to play a more permanent role in economic development. But private investors need the support in the form of funds, services, technical advice from the commercial banks, otherwise they may not be able to survive.

6.3 Issues of Notes and Coins

The issuing of notes and coins is the most essential function of a Central Bank. It is particularly so in Saudi Arabia where cash plays a crucial role. Currency in circulation stood at SR 35,680.8 million in 1982, SR 36,464.8 million in 1985 and SR 41,523.5 million in 1987. In 1987 circulating notes and coins made up over 47 percent of the M1 money supply which constitutes currency plus money deposits. In 1989 currency in circulation was SR 35,170.5 million while in 1991 it stood at SR 45,777.2 million making up 36 percent of the M1.³³ Paradoxically, it is the soundness of the riyal which accounts for its value, and not its monetary backing. Most hard currencies are only supported by the stability of the monetary systems that issue them.

It is interesting to note the difference in the degree to which the riyal was backed in 1982 and 1988 respectively. In 1982 SAMA had riyal notes valued at just over SR 38 billion while in 1988 it had riyal notes valued at just under SR 52 billion, while in 1991 riyal notes were equal to SR 58.7 billion. These were backed by gold of about SR 0.75 billion in 1982, 1988 and 1991. The convertible foreign currencies were equal to SR 37.5 billion in 1982 and SR 51.3 billion in 1988 and SR 59.2 billion in 1991. However, SAMA also had SR 93.8 billion in 1982 and SR 45.7 billion in 1988 while it had SR 51.9 billion in 1991 on deposit in foreign banks. It also had another SR 346 billion in 1982, SR 171.2 billion in 1988 and only SR 102.6 billion in 1991 in foreign securities.³⁴ This meant that in 1982 the riyal was backed twelve times over, while in 1988 it was only backed five times over, and in 1991 it was backed 3.6 times over. The major reason for this decrease in the amount backing the riyal is the government's drawing on its foreign reserve to finance its expenditure deficit. It is not disastrous that the riyal is only backed by 3.6 times over, but what is worrying is the fact that these reserves are depleting at a very fast rate to finance current government expenditure rather than investment. SAMA must be more active in the running of the government's financial policy, stressing the position that the country is putting itself in. SAMA must also encourage the private sector to take over investments completely, and the government must now play the expected role as a regulator and facilitator and not a business conglomerate.

6.4 Banker to the Government

SAMA is not permitted to lend to the government. However, it does give other banking facilities. The significance of these services has increased proportionately with the size of the government's income and expenditure.³⁵

In contrast to other Arab nations, SAMA has in the main left its resources in the form of bank deposits, treasury bills and bonds. (see table 6.1). Unfortunately, the analysis of each category of investment is not released by the Monetary Agency. However, bankers are of the opinion that the majority of the bonds are held in short term U.S. Dollars Treasury Bills, with some investments in Yen and Deutsche mark bonds. The deposits are retained by different banks, all of which are approved by SAMA. SAMA does not make public the names of the banks which it finds adequate, nevertheless, some speculation has been made by spectators of the Saudi banking environment. A record of this was printed in the special "Arab Banking and Finance of London" bulletin in August 1983. This publication disclosed that only 58 organisations were authorised to receive deposits. The appointed bodies included Bank of Tokyo, Sumitomo Bank, the four main Swiss Banks, Banque de Paris, Commerzbank, etc. The more substantial deposits are kept in the London branches of the big American Banks such as Morgan Guarantee Trust, Citibank, Chase Manhattan and Bank of America.³⁶

SAMA gathers and issues names of banks which are believed to be recognised by the different government ministries for supplying performance bonds, advance payment

| Year | 1984 | 1987 | 1990 |
|------------------------------|---------|---------|---------|
| Gold | 756 | 756 | 756 |
| Convertibles into Cash | 40,652 | 51,337 | 59,230 |
| Cash on hand | 5,349 | 9,149 | 12,948 |
| Deposits with banks abroad | 56,918 | 45,690 | 51,932 |
| Investments in foreign bonds | 258,025 | 171,248 | 102,659 |
| Other | 21,415 | 14,608 | 45,377 |

Source: Calculated using SAMA's Annual Reports.

guarantees and bid bonds. This publication has proven to be of great value to foreign banks and contractors. If a bank's name appears on SAMA list, it enables the bank to provide bonds and guarantees for the ministry that is signing the contract. The overseas bank does not necessarily have to have the bonds authenticated by a Saudi commercial bank, thus saving the contractors time and money. This regulation, which was established in 1978, encouraged competition between foreign banks and Saudi banks. The contractors benefitted from a considerable reduction in the fees that they paid to banks and also from the lower level of collateral required by the banks. The benefit which accrued to the contractors resulted in decreased profitability for the banks concerned.³⁷

Jean-Francois Seznec, in his book "The Financial Markets of the Arabian Gulf" explains that "On average the reduction in banking costs amounted to 1.5 percent per annum with 15 percent cash collateral interest-free deposits in 1978 to 0.5 percent per annum bonding fees with 0 to 5 percent interest-bearing cash collateral in 1984."³⁸ He then shows that on a US \$10 million bond facility, the banks gain decreased from approximately \$440,000 per annum to \$64,000 per annum. He then argues that due to this reduction in banking fees the contractors were able to compete more realistically, thus resulting in better prices for the Saudi government.³⁹

6.5 SAMA and Monetary Policy

Implementation of monetary policy in Saudi Arabia is very different from that in Western countries. The differences arise due to the fact that SAMA tries to focus its attention on the supply of money and on its particular expectations concerning attainability of credit. SAMA is in a position to manipulate the reserve ratio and therefore it is hoped that it can influence the quantity of money that local banks are able to generate within the scope of the monetary base.⁴⁰

SAMA is not independent, it is an integrated part of the government. Hence, one must consider whether or not Saudi Arabia has an effective monetary policy. During the development heyday, Saudi Arabia's money supply was primarily created by net government spending. However, the amount spent was determined by the government's overall development policy, nevertheless when and how payments were made varied in

order to cater for monetary policy. Keran and Al-Malik argue that "control of government deposits represents the only fine tuning technique for controlling the currency issue of SAMA."⁴¹

Johany et al. (1986) argue that, government expenditure had an unsettling effect on the country's financial system as a whole. This may attribute to the fact that all government contracts were accounted for in riyals whereas the actual payments for the contractors were mainly in foreign currencies. The liquidity crisis of 1979 was a result of delay in government payments and an anticipated change in the value of the riyal, which forced contractors to get involved in foreign exchange hedging strategies. Most contractors were involved in "future contracts" where they would sell to the financial institutions future riyals i.e. those they would receive on completion, *vis-a-vis* their own currency. The institutions would then purchase dollars from the agency to offset their foreign exchange risks and undertake riyal liabilities to equal the future riyal returns. In consequence, the balance of payment went into deficit. In late 1979, in order to prevent a recurrence of such an event, the Ministry of Finance introduced a policy dictating that all government contracts in excess of SR 300 million were to be paid for in foreign currency, namely, dollars. This policy, decreased the amount of circulating riyals which had presented a continuous risk to the growth in money supply.⁴²

It is apparent that the government has the power to influence the timing of government expenditure in an attempt to effect desired changes in the monetary base. Johany et al. (1986) argue that the government could, for the same purpose, exercise some control on the private sector balance of payments deficit. They explain that this could be done by varying the exchange rate through ways that would influence the size of foreign investments by Saudi nationals.⁴³ These policy instruments alone with similar restraints were also examined by Keran and Al-Malik.⁴⁴ Therefore, as can be seen, Saudi Arabia's implementation of monetary policy is different to that of many Western countries. The monetary policy of Saudi Arabia goes hand in hand with its financial policy. (As discussed in a chapter five). Unlike some Western central banks SAMA can not operate as an independent monetary agency. However, the Saudi Arabian government possess a wide range of policy measures that helps to control the overall growth in the money supply.

Although SAMA was given the responsibility of controlling inflation, one could question the ability of the agency in controlling it. An attempt was made to find out the extent to which prices were determined by money supply growth, or real GDP growth using regression analysis, the independent variables being money supply in its narrow form (M1) and the GDP (deflated), with the cost of living the dependent variable. It was hoped to find out from this test whether it is within SAMA's power to manipulate the money supply and hence control inflation. The equation of this simple model was as follows:

$$P = f(M1, GDP)$$

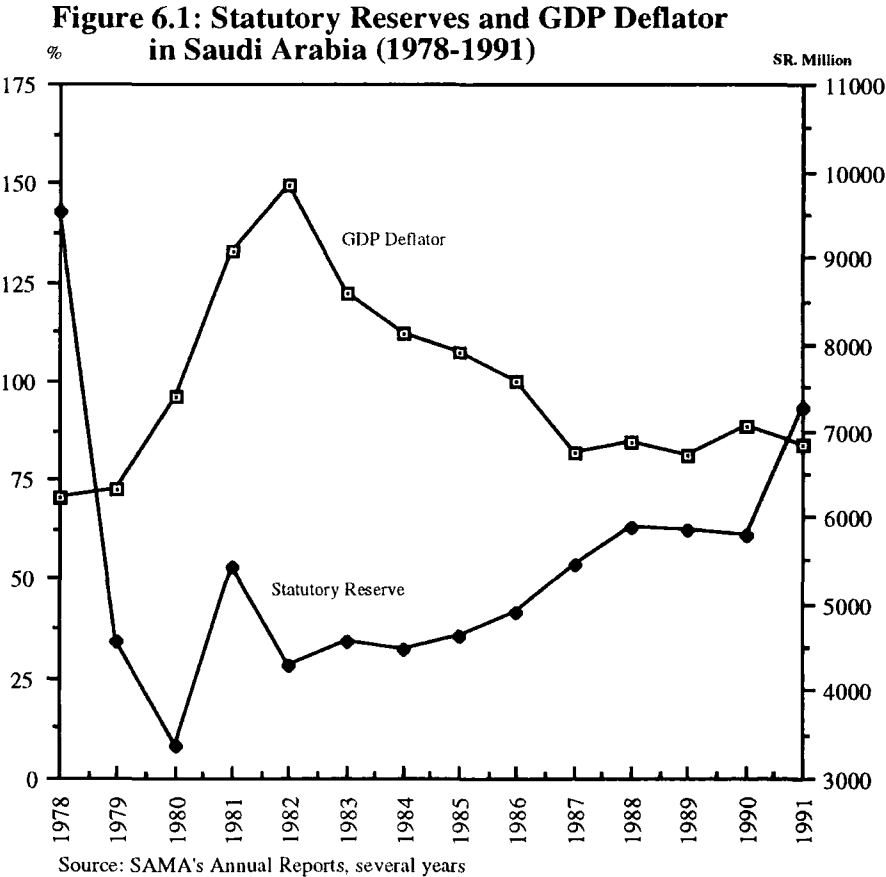
where P is cost of living in Saudi Arabia, M1 is the money supply, and GDP is the gross domestic product at constant prices.

Data used for this test were compiled from SAMA's statistical reports on the variables involved. The data covers the period between 1978 and 1991, and was yearly based. The figures of the GDP were deflated using the cost of living index from the IMF report 1992.

The result of the test indicates that in Saudi Arabia there is a very weak relationship between price index and money supply, as R^2 was equal to 0.118 while adjusted R^2 tended to change to an inverse relationship by recording a negative sign of -0.42. The coefficient of money supply was even negative and equal to -3.422. However, at such levels of correlation there was a high degree of autocorrelation between the residuals, as the D.W. test indicated a very low score 0.452. This implied that controlling the money supply would have little effect on the cost of living. To take matters further, money supply was lagged one year and two years in two separate tests. There was little sign of improvement in the relationship between the regressed variables, as R^2 with a one year lag was recorded at 0.347 percent, and 0.411 percent with a two year lag. Adjusted R^2 also showed higher values when money supply was lagged, but not to a significant level, that would indicate a clear direction of the relationship between the regressed variable. It was also very clear that money supply maintained its negative coefficient value, which meant that it would always go in an opposite direction to the cost of living. Therefore, it can be concluded that SAMA can do little to apply such a mechanism as a policy instrument.

Figure 6.1 confirms the above results, but through the direction of the relationship between the aggregate commercial banks' statutory reserve imposed by SAMA and inflation. The figures indicate clearly the inverse relationship between these two variables as when reserves increase, inflation decreases. This is indicating that SAMA might have been exercising its power through controlling the statutory reserve to curb the level of inflation.

An examination of domestic liquidity to see the performance over a period of 15 years, see figure 6.2, indicated that the majority of funds in Saudi Arabia were still held as cash or demand deposits and were still on the increase. However, time and saving deposits were also rising and hence, quasi money. The behaviour of these variables was interesting during the war period, as quasi money has exceeded the time and saving deposits levels which indicate a switch in preference. What was also interesting was that, the increase in quasi money was in the main attributed to foreign currencies, reflecting bank clients

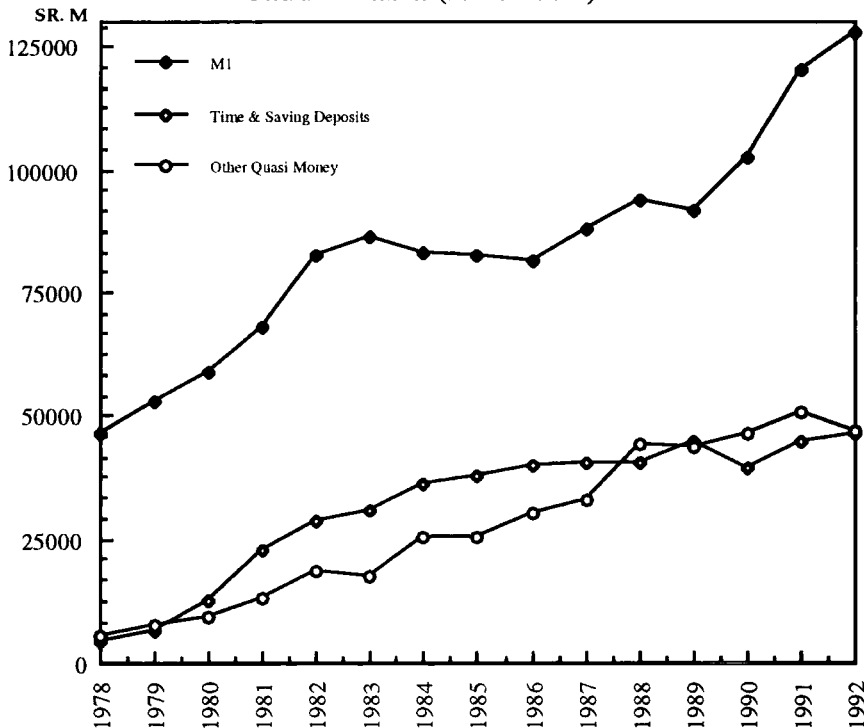


apprehension of the war.

Another aspect of Saudi Arabian monetary policy was that SAMA prohibited banks from lending riyals to non-Saudi businesses and individuals. The aim was to prevent the riyal from becoming too "international". Therefore, the circulation of funds was restricted between Saudi individuals, banks, corporations and Bahrain based institutions. As a result, the value of the riyal was held steady since it was sold at its "spot rate" and riyals were purchased back by either banks attempting to cover their positions, or by the agency whose earnings were mainly in dollars; hence it could afford to buy back its own currency. This meant that the only fluctuations that occurred were in interest rates.⁴⁵

Due to the slump in oil prices in 1986, (as mentioned in chapter three), the Saudi riyal faced a great deal of pressure and speculation existed as to a possible devaluation of the riyal *vis-a-vis* the U.S. Dollar. Therefore, banks borrowed riyals, and converted them into U.S. Dollars at the prevailing spot rate. This ensured that they would eventually settle their riyal debt with riyals that were purchased at a much cheaper exchange rate.

Figure 6.2 Domestic Liquidity in Saudi Arabia (1978-1992)



Source: Kingdom of Saudi Arabia: Annual Report 1412/1413 H. (1992)
M1 = Notes, Coins and Demand Deposits

This resulted in an increase in interest rates.⁴⁶

Similar to most central banks, SAMA backs its home currency and attempts to discourage speculation. SAMA has been reasonably effective in this area. The fact that it holds large deposits in all major financial organisations gives it a lot of clout. Additionally, the riyal is not an international currency, making it easy for SAMA to soak up all the outstanding riyals in the market proving the point that the eventual value of the Saudi currency is in the hands of SAMA.

As mentioned earlier in this section, foreign companies and individuals are not permitted to borrow riyals. This has been the main reason for the creation of the "offshore banking" system. This is organised by means of syndicates. These syndicates were organised by foreign banks and had at least one Saudi bank as a participating member. The role performed by the Saudi bank could be categorised by the following points. First, the Saudi bank would be the local agent of the syndicate in Saudi Arabia. Having a Saudi bank as an agent would enable the syndicate to gain preferential treatment under Saudi law. Secondly, the local Saudi bank would issue the advance payment guarantees and performance bonds. The list of banks authorised to issue such financial instruments is restricted by SAMA. Finally, the Saudi bank has to provide the necessary Saudi riyals for the syndicate. These could only be borrowed by Saudi banks.⁴⁷

Much of the money borrowed in riyals was used to fund non-Saudi businesses i.e. the bank could borrow riyals, earn profits from this amount in foreign currency and then pay back the borrowed riyals. In fact between early 1977 to mid 1978 five banks issued bonds equalling a total sum of SR 360 million, which was all used for foreign contractors.⁴⁸ The agency then made it quite clear that it did not want to see such a situation repeated. This statement was sufficient to discourage foreign organisations from using such methods of financing. In 1983 legislation was passed that Saudi banks must acquire prior approval before negotiating dollar value transactions within the syndicate. This legislation was designed to prevent an exit of dollars from Saudi Arabia without enforcing foreign exchange controls. This legislation curtailed the demand for riyals by foreign companies and ensured that Saudi banks only lend to Saudi companies.⁴⁹

The extent of the growth of offshore banking in Saudi Arabia was depicted by the

fact that 65 percent of all commercial deposits in 1981 had been placed by Saudi banks in foreign banks, the majority of which were in Bahrain. Both the agency and the government must have been alarmed to see such a large figure. The Monetary Agency's legislation of 1983 on foreign bank lending in Saudi Arabia naturally had the desired effect. Since Saudi banks were unable to lend to foreign companies it made sense to lend their cash to Saudi firms instead, in order for them to make some profits. Thus, the government had designed incentives so that Saudi banks would lend predominantly in Saudi Arabia. By 1984 the total riyal figure deposited abroad continued to depict a rise in absolute terms. However, as a percentage of deposits from Saudi companies and individuals, foreign assets and total overseas investments decreased from 65 percent in 1981 to 57 percent in 1984.⁵⁰

To further discourage off-shore banking, in February 1984, SAMA also began to sell non-negotiable certificates of deposits which the banks could either exchange between themselves or sell back to the agency if they required funds urgently.⁵¹ The first bills issued were for a period of 90 days. These certificates were not considered to be very attractive by banks since they could take advantage of more competitive rates offered by short term deposits in Bahrain. However, this did not have a major influence on the liquidity position of the Saudi riyal in Bahrain.⁵²

The actual introduction of certificates of deposits posed a few difficulties. In Saudi Arabia it was viewed as bypassing the policy of prohibiting interest payments by the government. This problem was averted by restricting the buyers to commercial banks only, and by selling the instruments at a concessionary rate so that the actual amount of the interest paid would not show on the certificate itself. This latter tactic has been denied by SAMA. The sale of these certificates disturbed foreign banks dealing in Saudi riyals, most of which were based in Bahrain, since, prior to the issue of these papers, Saudi commercial banks had no way of investing on a short term basis except in these foreign banks. Nevertheless, the volume of certificates of deposits and the attached rate was not enough to completely halt the outflow of riyals to Bahrain. However, it now could be somewhat manipulated.⁵³

The certificates of deposits also provided SAMA with an additional tool to manage

the money supply. In May 1984, *Arab Banking and Finance* quoted a Saudi banker who believed the remaining amount of certificates to be not greater than SR 5.2 billion. This represented 5 percent of total bank deposits.⁵⁴ Within that period, the foreign banking community in Saudi Arabia was concerned about the rumoured imposition of a 10 percent withholding tax on the Saudi based business profits of all foreign banks. The levying of withholding tax on interest would pose problems because under Islamic Law the receipt or payment of interest is forbidden, since interest is not recognised by law. Imposition of withholding tax would be based on non-existent earnings and hence was not plausible.⁵⁵

The issue was discussed, and as far as all authorities on the subject were concerned, the tax was never imposed. Auditors and accountants advised their clients to adopt a prudent approach and make provisions in their accounts for a withholding tax liability on foreign loans which could crystallise eventually. Banks also sought legal counsel. Counsel's opinion was that loan agreements with Saudi customers must include a clause stating that a withholding tax could be levied and the burden could be passed on to the borrower. This additional clause discouraged borrowing from foreign banks. The prospective introduction of the withholding tax also inhibited certain foreign banks from lending in Saudi Arabia and thus helped to decrease the exodus of riyals from Saudi banks.⁵⁶

However, despite all this, the sum of riyals kept in foreign banks continued to be high at SR 67.6 billion, and SAMA's attempts were not enough to reduce this amount. Seznec (1987) argues that there were two reasons for this; first, although SAMA wanted to keep a tight reign over its currency, the Saudi Arabian government and nationals were, and still are, against foreign exchange controls and constrains over the circulation of capital. Secondly, the Bahrain financial market was dependant on Saudi riyal deposits. This was crucial to the economy of Bahrain. The Saudi government could not permit an essential sector of the economy of Bahrain to deteriorate for both political and cultural reasons.⁵⁷

Offshore Banking Units (OBUs) were created for the purpose of taking advantage of the Saudi market by evading SAMA's legislations. The offshore banking units would operate with very little restraint, they were subject to lower tax rates, and did not have to

confront exchange controls or reserve requirements. The assets of the OBU's had increased substantially over the years. In 1975 their assets amounted to \$1.5 billion and by 1978 the amount had increased to \$23.4 billion. With the surge in oil prices in the late 1970's and the rise in development expenditure, assets keep on the increase, and in mid 1982 they were at an all time high of \$61.6 billion. However, since then there had been a continued reduction in total assets.⁵⁸

These OBU's offered several services which were normally similar to those offered by local commercial banks. The deposits held by these banks were in the main short term. However, loans were longer term. Certain clients were able to get loans for more than a year. Saudi banks, suffice to say, offered long term loans only on a renewal basis. The OBU's had also financially contributed to development projects despite the fact that this was not their major purpose. They sold bonds to contractors who were not entitled to obtain bonds from domestic commercial banks in line with SAMA legislation. Often Saudi banks would organise the bond service for their customers, the bank in turn earned an agent's fee. This all happened with the bank not having to literally put up the financing itself.⁵⁹

OBU's were feasible because they permitted a free flow amid currencies. This basically entailed speculation and rendered the Saudi riyal the status of an international currency. This was the cause of conflict within SAMA, which did not wish for the riyal to be an international currency. The OBU's control were thereby undermining SAMA's authority. Consequently, SAMA engaged itself in corrective steps, despite the fact that it has no legal control over the OBU's. These steps were implemented by SAMA, using the powers at its disposal. Since SAMA controlled the government's investment portfolio, it was able to transfer funds both in and out of Bahrain for the sake of implementing its policies. It was also able to vary the value of the riyal which in turn would cause variations in the value of the OBU's assets. SAMA's course of action was taken in 1980, when it revalued the riyal upwards, and as a result the OBU's were \$30 million short in riyals. Hence, it can be seen that although the system of OBU's provided many advantages to Saudi Arabia, it also caused problems for SAMA.⁶⁰

Another reason for the growth of offshore banking in Bahrain was the fact that

Saudi banks could not pay interest on deposit accounts, due to Islamic doctrine. The more affluent and sophisticated members of Saudi society transferred their money abroad in order to earn an internationally competitive rate of interest. Also, Saudi banks still lacked the ability to be able to administer large deposits and were somewhat slower in recognising promising loan opportunities. In addition, foreign banks in Saudi Arabia were prohibited from expanding their capital base and, therefore, were unable to increase the size of their deposits or loans. Both these factors, coupled with the fact that there was sufficient local demand for credit, had accelerated the growth of offshore banking, particularly that of the offshore riyal market in Bahrain.⁶¹

By 1980 an estimated 50 percent of the Saudi money supply was placed abroad and SAMA was making a valiant effort to combat this domestic liquidity crisis (84). Foreign exchange controls were ineffective because of the involvement of unmanaged money changers. Furthermore, Saudi Arabia was on the board of the International Monetary Fund which was itself hostile to the imposition of exchange controls. Saudi Arabia at that time also had a large surplus and hence could not justify such controls on capital movements. As an alternative measure, SAMA insisted that all contracts were to be paid for in dollars. Hence, major Western contractors would have to refrain from taking foreign exchange cover in Saudi currency through Bahrain. This reduced the offshore demand for riyals and, therefore, Bahraini banks would have no enticement to pursue riyal deposits. However, this measure was not very effective because a large amount of the riyals on loan from Bahrain were actually obtained by Saudi citizens, as opposed to Western contractors.⁶²

As a final step SAMA decreased the liquid assets ratio for domestic banks to enable them to provide more funds for lending. Hence, the ratio for demand deposits was decreased from 15 percent to 12 percent in 1979 and another decrease was introduced in 1980 which brought the ratio down to 7 percent. The ratio for savings deposits was decreased to 2 percent. The measure gave a brief break from the liquidity shortage. However, it was believed that if the decrease was too large it would be contrary to acceptable banking customs. This would, in turn, adversely affect the monetary stability of the nation.⁶³

When this measure was unsuccessful, the riyal was devalued in March 1986. This meant that those who had bought dollars using riyals in order to take advantage of higher interest rates and also because of the then relative strength of the dollar, made a gain. Nevertheless, this devaluation had only a marginal effect because of pronounced interest rate differentials.⁶⁴ Another reason for devaluating the riyal in 1986 was the slump in oil prices which led the government to devalue in order to deal with its financial problems i.e. by devaluating the riyal the government was able to get more money out of its dollar investments because of exchange rates and was, therefore, able to pay more of its local riyal commitments.

Nowadays, SAMA's exchange rate policy is to keep the riyal stable against its counterpart currencies in the GCC countries, so that the Saudi export industries to these countries do not suffer. There was speculation that the riyal might be devalued in late 1993, so that the government can again deal with its financial problems, but, this soon was quashed by the King's January 1994 budget statement.

6.6 SAMA and the Commercial Banks

With the increase in oil production in the 1950's the Saudi economy was very buoyant. This in turn increased the opportunity for new financial institutions to enter the market. There were obvious deficiencies in the financial system. In fact in its early years SAMA's responsibility extended to controlling the issuance of notes and acting as banker to the very few banks that existed i.e. one local bank NCB and a group of foreign banks which operated under the auspices of trading companies and hence provided few banking services. Against this background, a group of Sheikhs from the Central and Eastern provinces chose to form the "Riyadh Bank", in 1957. This bank, however, was based in Jeddah, since Jeddah was and still is the centre of Saudi Arabia's commercial heartland. Within five years, a number of branches were opened. In hindsight, the growth of the Riyadh Bank had been too quick. The Bank was over zealous in its effort to compete with the NCB and as a result accrued a lot of bad debts. In 1964, this led to the financial community losing confidence in the Bank and there were numerous withdrawals of deposits.⁶⁵

The Riyadh Bank had no other choice but to seek SAMA's assistance. SAMA itself was relatively inexperienced at the time and found it very difficult to raise the relevant funds, but ultimately it managed to do so. For coming to the rescue, SAMA insisted that it participated in policy making decisions of the Riyadh Bank, and consequently it obtained a 38 percent equity share in the Bank's capital. SAMA also demanded that one seat on the Bank's Board of Directors be given to a member of SAMA's staff. This position is normally occupied by the manager of the investment department. This was reflective of SAMA's conservative and careful approach towards new formed commercial banks. If SAMA was to step in as the lender of the last resort, it insisted that it knew everything about the institution it was backing.⁶⁶

The only foreign banks allowed by SAMA to set up branches in Saudi Arabia were the ones whose home countries had a substantial number of nationals working in the Kingdom or if a significant degree of trade existed between the two countries. Wilson (1983) argues that even if a bank was managing large sums of government funds in markets abroad SAMA would not allow this bank to open branches in Saudi Arabia. Furthermore, only one commercial bank from any one country was authorised to function in Saudi Arabia. Only two exceptions were made to this rule, in the cases of Lebanon and Pakistan.⁶⁷

From Lebanon, both "Banque du Liban et d'Outre-Mer" and the "Lebanese Arab Bank" were permitted to operate in Jeddah, with the Lebanese Arab Bank having offices in Dammam and Al-Riyadh in addition. The reason for making Lebanon a special case was probably due to the fact that a number of Palestinians with Lebanese passports patronised these banks and in Saudi Arabia there were a large number of Palestinian and Lebanese employees. Another, and perhaps more relevant reason, was that both these Lebanese Banks had Saudi shareholders. Pakistan was allowed to open more than one bank. However, each bank was only permitted to open one office in Saudi Arabia. Hence, the National Bank of Pakistan opened its office in Jeddah, while the United Bank operated in Dammam.⁶⁸

The Amman based Arab Bank was also heavily patronised by the Palestinian community in Saudi Arabia. This bank belonged to and was operated by Palestinians.

Other banks which operated in Saudi Arabia were Bank Melli of Iran; The Korea Exchange Bank; Banque du Caire (from Egypt); Citibank (from the United States); and the Algemene Bank Nederland (from the Netherlands). Even though Germany and Japan had extensive trade dealings with Saudi Arabia, being the second and third largest exporters respectively, there were no banks from these two countries represented in Saudi Arabia.⁶⁹

Due to the restrictive nature of SAMA's approach towards foreign banks, there were only 14 foreign banks retaining offices in Saudi Arabia in 1976. SAMA's impending attitude was attributed to political reasons as well as reasons of nationalism. Also it was considered inappropriate that the country which housed the Islamic religions most "holy places", should become an international financial centre. Wilson (1983) suggests that although the previously mentioned factors contributed towards SAMA's restrictive attitude, SAMA itself, since its inception, has been a prudent and conservative organisation. SAMA was also concerned about the fact that before 1974, when its own reserve base was expanded, if it had allowed Western banks to enter then there would be a great deal of Western influence in the banking sector which would undermine the agency's own influence since the Western Banks would have more economic clout due to their substantial reserves. Nevertheless, the 14 foreign banks that were licensed, to operate in Saudi Arabia were in a position to overshadow SAMA had it not been for the agency's determination in continuously enforcing its control by not allowing banks to open more than one branch.⁷⁰

In the 1970's two more banks were permitted to have more than one branch in Saudi Arabia. These were British Bank of the Middle East and the Banque de L'Indochine et de Suez, both operating in the Eastern Province, catering mainly to the large expatriate community located there. This was seen as a discriminatory move by the other foreign banks. Citibank, being the only American bank in Saudi Arabia, wanted to establish itself in the Eastern Province where there was a large American expatriate community, particularly the "ARAMCO" staff. Nevertheless, it was only allowed to function in Riyadh and was not permitted to open an office in Jeddah, where there was a competitive environment between foreign banks.⁷¹

The duopolistic market situation created by the NCB and the Riyadh Bank was a cause for concern for SAMA.⁷² It wanted to encourage competition and at the same time prevent an over dominant foreign influence. The only way in which these two conflicting aims could be harmonised was to "Saudise" the existing foreign banks and then allow them to extend their services. The concept of the "Saudisation" is different from that of nationalisation. "Saudisation" involved the holding of a majority stake, 60 percent, by Saudi individuals, the foreign banks were to offer one third of these shares to "founder members". Founder members were prestigious clients of the banks. The choice of these prestigious clients was at the bank's discretion. All shares were to be put on the market at their spot value, which did not include a bank's goodwill or the increased value of the shares which would result once the restrictions were removed. This meant that the purchasers were obtaining shares at particularly favourable terms. The outstanding two thirds of the equity was to be made available to the general public, with each purchaser obtaining shares in proportion to the size of the proposal he or she made. This was contrived to encourage diversified private ownership and to avert the possibility of ownership falling in the hands of a small group, as was the situation with the NCB and the Riyadh Bank.⁷³

The National Bank of Pakistan was the first bank to be Saudised but it did not obtain a favourable response from the public, probably because they were not appreciative of the beneficial terms at which the shares were being offered. Due to the poor response, founder members who had already accepted the offer, were allowed to buy more shares. Hence, in the reorganised bank, Bank Al-Jazira, the holding of founder members amounted to 35 percent, the National Bank of Pakistan kept 35 percent and the general Saudi public holding was 30 percent. As a result, Bank Al-Jazira was the sole bank which was not Saudised in the normal 60:40 ratio.⁷⁴

The general public soon became aware of the rapid increase in value of the shares of the new Bank Al-Jazira. Consequently, when the local Dutch and French banks were to be Saudised in 1977, the public response was tremendous, with the issue being over subscribed almost eleven times. The new Dutch Bank was Saudised on a 60:40 basis (40 percent Dutch ownership) and was called "Al-Bank Al- Saudi Al-Hollandi". The French bank issue was oversubscribed ten times. The new French Bank was called "Al-Bank

Al-Saudi Al- Franse". Citibank, which was very unwilling to be Saudised, felt that other countries might follow Saudi Arabia's example and ask for a local equity stake. After much deliberation they consented to be Saudised since it was apparent that the advantages outweighed the disadvantages.⁷⁵

Therefore, in 1980 the Saudi American Bank was formed. Citibank had attempted to delay negotiations for as long as possible using the influence of one of their most valued customers, a founder member of the Saudi American Bank, Adnan Khashoggi. Khashoggi also owned the premises on which the head office of the new bank was established. The delay in the negotiations proved advantageous for the bank in many respects. They were allowed to keep the Citibank name for an extended period of time, in fact the new headquarters carried the Citibank name in spite the fact that the premises were only used after Saudisation was authorised. The delayed negotiations provided the bank's employees with ample time to plan for the transition, in terms of training as well as extensive investigations into the local banking requirements. Research allowed the bank to target its marketing and advertising efforts towards key customer groups and to provide the required services for each of these groups. For example, they provided segregated banking offices run by women for women.⁷⁶

Separate banking facilities for women in Saudi Arabia are becoming very popular. NCB, Saudi Cairo Bank, Bank Al-Jazira and Saudi American Bank all run special branches for their female clients. This enables the Saudi women to avoid the awkwardness of doing business with male staff members and also provides women confidentiality with regard to any capital which they have inherited.

SAMA did not stop at Saudising banks; it also insisted that the banks take on Saudi Arabians as employees. It is not surprising therefore, to find today that many Saudi Arabians hold chairs on the board and important managerial positions. In fact in some cases SAMA would actually "advise" on who should be appointed.⁷⁷

Foreign investments of the Saudi Commercial Banks totalled 25 billion riyals in 1980 (Table 6.2). Most of these funds were deposited with overseas banks in the major financial capitals of the world, with London being a popular choice. The two Saudi Arabian national banks also began to function outside the Kingdom at this period of time.

These operations mainly included wholesale banking.

The deposits were made up of highly liquid investments which could be withdrawn at any time. The assets were held in Western owned banks and in banks owned by consortia with a combination of both Arab and Western retainerships, such as the Union de Banques Arabes et Francaises (UBAF). The Riyadh Bank had a minority equity stake in this institution while the NCB had shares in the Luxembourg based holding company which owns the European Arab Bank. In 1985 foreign assets were over SR 69 billion and by 1990 they had reached SR 123.5 billion. Although the foreign assets were very liquid, only domestic assets were allowed to be classified as liquid assets under the banking legislation.

The banks were Saudised at the beginning of 1980 charged lending rates that were in excess of 15 percent. SAMA believes that it was necessary for prices to determine the allocation of credit. By maintaining lending charges at high levels, SAMA aspired to deter borrowers from obtaining loans in Saudi Arabia and then transferring these funds abroad for speculative purposes.⁷⁸

Table 62. Growth of Commercial Banking Activity in Saudi Arabia (SR. M)

| Year | 1965 | 1970 | 1975 | 1980 | 1985 | 1990 |
|--|-------|-------|--------|--------|---------|---------|
| Assets: | | | | | | |
| Claims on private sector (loans and investments) | 1,014 | 1,667 | 6,722 | 34,919 | 60,423 | 65,295 |
| Foreign assets | 193 | 535 | 3,617 | 25,241 | 69,228 | 123,467 |
| Liquid assets (cash and deposits with SAMA) | 253 | 321 | 4,845 | 10,483 | 11,311 | 11,636 |
| Unclassified assets | 73 | 406 | 528 | 3,275 | 9,228 | 31,657 |
| Liabilities: | | | | | | |
| Current account deposits | 570 | 868 | 7,427 | 33,295 | 47,564 | 57,488 |
| Time and savings deposits | 116 | 561 | 1,610 | 12,330 | 37,621 | 39,281 |
| Letters of credit | 97 | 113 | 815 | 2,304 | 2,506 | 3,593 |
| Guarantees | 78 | 107 | 984 | 2,392 | 2,364 | 1,634 |
| Foreign liabilities | 185 | 181 | 1,786 | 5,018 | 9,794 | 30,172 |
| Capital and reserves | 143 | 178 | 679 | 4,129 | 12,777 | 17,359 |
| Unspecified liabilities | 271 | 833 | 1,945 | 10,130 | 17,111 | 40,862 |
| Foreign currency | 73 | 88 | 466 | 4,310 | 20,531 | 41,666 |
| Total liabilities = total assets | 1,533 | 2,929 | 15,712 | 73,918 | 150,250 | 232,055 |

Source: Saudi Arabian Monetary Agency. Annual Report, several issues.

Since 1985, SAMA became increasingly involved in the regulation of commercial banks in Saudi Arabia. Commercial banks began facing the problem of bad debts. This was specifically attributable to the recession that had faced the Saudi economy since mid 1985. Another contributory factor was the legal "loophole" that did not punish borrowers who decided not to repay.⁷⁹ In an attempt to ensure that the banks' financial statements, in particular the balance sheet, were reliable, SAMA had published recommendations to the banks to classify their outstanding loans as follows: amounts outstanding for six months; outstanding for one year and finally amounts outstanding for more than one year. SAMA had also designed a central accounting system which permits it to identify how much a customer is owing to the entire market i.e. how much has borrowed in aggregate from different banks.⁸⁰

However, SAMA had relied on the banks' management to decide whether or not to make a provision for a loan or whether to write it off, and also whether the income from such loans was to be accrued. These policies differ from bank to bank and therefore, there was no consistency. Thus, SAMA had to stipulate rules regarding "accruals" so that banks did not continue to show "income receivable" from loans that were never likely to be repaid.⁸¹ In 1986, SAMA began to counsel commercial banks on drafting their loan agreements. The language was more depictive of a contractual agreement.⁸² Also, the Ministry of Commerce "empowered its legal committee to hear disputes between banks and their customers."⁸³ However, the hope of equitable judgements was remote because all borrowers had access to the Sharia Judges who viewed banks as a product of evil and treated them as illegal entities.⁸⁴ By the late 1980 the situation was resolved with either payments made by debtors or written off.

SAMA has continued to supervise and support its twelve commercial banks individually. In 1990 Al-Jazira bank faced losses of SR 33 million due to its bad debt problem. The bank organised a team of specialists to help it emerge from this crisis. However, the bank was put under pressure by the National Bank of Pakistan which held a 35 percent stake and had wanted to sell it off in the late 1980's. SAMA stepped in and stopped NBP from selling.⁸⁵

At the onset of the Iraq-Kuwait war panic amongst Saudi nationals resulted in a run

on deposits; this forced SAMA to step in as lender of the last resort. The rush occurred in the first 14 days of the invasion and continued when one million Yemeni workers were expelled from the Kingdom. The aggregate of withdrawals equalled SR 16 billion and many banks experienced liquidity problems. SAMA resolved this by offering to repurchase the banks' shares of government bonds, however, this was not enough and it had to go even further and offer commercial banks up to \$10 million worth of riyals each.⁸⁶

In 1992 SAMA brought into being the Bank for International Settlement (BIS) more stringent regulations in order to establish guidelines on capital adequacy of 4 percent for tier one and an aggregate of 8 percent. This regulation was easily accepted by the Saudi banks. However, they feared the new regulations that were passed earlier that year which pertained to the eight-year tax deferrals period of the foreign joint venture partner which had ended in 1990. This meant that the foreign partner would have to pay tax on both profits that were transferred to reserve and those taken out of the country. They will also have to pay the full tax on their present profit. Many of the foreign banks resented the fact that they had to pay tax on retained earnings.⁸⁷

SAMA has also favoured technological advancement. It has encouraged the commercial banks to set up automated teller machines (ATM's). It passed regulations forcing them to link up their machines so that, for example, a client of the NCB can use a Saudi American ATM point. This was also extended to include the points of sales (POS) payment systems (this is discussed further in chapter ten).

6.7 SAMA and the Money Changers

Until 1982, money changing companies in Saudi Arabia were in keen competition with commercial banks. In total there were over 250 branches, with 150 placed in Jeddah, Mecca and Madina. Until January 1982, they were legally limited to holding only demand deposits and foreign currencies. Yet, the money changers were providing and operating all commercial banks' services with the exception of buying dollars from SAMA and issuing letters of credit and guarantees. In fact, these exceptions were insignificant since money changers could easily buy dollars from commercial banks at very little expense.

This caused concern to the commercial banks since money changers were in a position to perform banking functions at a much cheaper cost and they were not answerable to any of SAMA's controls. The latter state of affairs had also caused concern to SAMA. SAMA was in no position to monitor the hustle and bustle of the money changers and it could not exercise control over their domestic lending and the transfer of capital abroad. This put SAMA's effectiveness to manage capital flows at risk.⁸⁸ A policy was needed to be formulated in order to bring money changers into line with commercial banks. This was done in case Saudi Arabia's economic environment should suddenly change in a negative manner. Thus, the introduction of authority was more as a safeguard as opposed to being crucial.⁸⁹

One incident that caused SAMA real concern was the case of Abdullah Saleh Rajhi, the money changer who became insolvent in 1981. He had bought gold and silver using his clients' money and made a loss of over \$300 million. All the creditors sought assistance from SAMA in an attempt to recover their money. As SAMA had no authority over the money changers, all it could do was to arrange a systematic liquidation of assets and offer repayment to at least the smaller creditors. This case was partially settled in 1985. Chief creditors have not as yet received settlement of their dues.⁹⁰

This Dharan based Rajhi case prompted SAMA to request the government to place money changers under the jurisdiction of SAMA. The government conceded to SAMA's request in December 1981. In January 1982, SAMA imposed many regulations and controls over the operations of money changers. The money changers now had to be officially licensed. They had to make an application to the agency for a license in order to operate. Once granted, the license was valid for a period of three years only, and was renewable only if SAMA was convinced of the financial standing of the money changers.⁹¹ They would also have to deposit at least SR 2 million with SAMA, interest free plus an extra SR 500,000 per branch. They were not permitted to lend funds, accept deposits, or distribute cheque books. Nevertheless, money changers could register as a commercial bank if they wanted to accept deposits and extended loans. Registration as a commercial bank meant that the money changers were subject to regulations by the agency. Money changers were allowed to undertake transfer services for remittances in payments from foreign exporters providing that they maintained the minimum capital

reserve mentioned earlier.⁹² Hence, by 1985, all activities not related to currency exchangers were no longer performed by money changers.⁹³ In theory, the restrictions should serve as a means of eliminating the "informal" sector of the banking industry which inhibited proper control of the Saudi Arabian financial system. The existence of money changers had resulted in a loss of confidence in the financial system, with adverse repercussions on the commercial banks. The most likely money changer to register as a commercial bank was Suleiman Al-Rajhi, the largest of all. This he did which made the firm the third largest commercial bank in Saudi Arabia, after NCB and the Riyadh Bank.⁹⁴

6.8 SAMA and Islamic Banking

After much reluctance, SAMA authorised two private groups to operate as Islamic Banks in Saudi Arabia. These were the Al-Rajhi Company for Currency and Exchange in Riyadh and the Al Rajhi Islamic Investment Banking Company in Jeddah, which has just been mentioned. Both these groups were operating large money changing organisations and were concerned when SAMA tried to control their business. This led them to convert themselves into publicly owned Islamic banks. The two institutions finally received authorisation to operate as Islamic banks. They needed a Royal Decree to enable them to organise a public issue of their shares in which was pending for several years, but was eventually finalised in 1990.

The above mentioned two groups are the biggest and most well recognised money changers in the Kingdom. Consequently, the delay in obtaining a decree was definitely not attributable to lack of management ability or lack of capital. Al-Rajhi Company for Currency and Exchange was not allowed to get the status of an Islamic bank but was given a Royal Decree to allow it to operate as a commercial bank in 1987. To circumvent the inability to operate as an Islamic bank they registered themselves as the Al-Rajhi Islamic Investment Company Limited of London on the 28th of December 1989.

The Saudi government was concerned about the fact that Islamic banks, under the facade of religion, could become a very powerful force in the financial system and usurp SAMA's power. SAMA's own employees are trained under Western banking conventions. SAMA's major investments are all made in interest bearing securities. Hence, SAMA

may be convinced that it is not able to manipulate a financial institution, exhibiting the name of religion, in an orthodox country such as Saudi Arabia. Therefore, SAMA was initially reluctant to accept the concept of Islamic Banking.⁹⁵

In late 1992 there was much speculation that Faisal Islamic Bank of Bahrain and Al-Baraka Investment Development Company of Jeddah would be given licenses to operate in the Kingdom. The reason for this expectation was because SAMA had employed two Islamic bank specialists in its banking control department, simultaneously it was encouraging its corporate banking department to expand their understanding of Islamic banking services.⁹⁶ In 1993, it was reported that the King had issued a verbal approval of these Islamic banks. Nevertheless, SAMA was still reluctant to license Islamic banks even though it does not mind banks offering Islamic banking products.

6.9 SAMA and the Capital Market

6.9.1 Government Instruments

In 1988 SAMA started the issuing of five year development bonds on behalf of the Ministry of Finance and National Economy. The bonds are sold at a discount and the yield is slightly over that of the US treasury notes. At first, the bonds were only offered to commercial banks and government agencies. However, nowadays banks are allowed to resell them to investors, hence creating a secondary market. Banks can also resell the bonds if they need liquidity, however, speculative sales are not allowed by SAMA.

In late 1989, SAMA started proceedings to officially formulate a secondary market to deal with its bonds. This was to be done through elected banks who were to represent SAMA as "market-makers" for such instruments. In June 1990 banks were encouraged to sell these bonds to offshore banks in Bahrain and other GCC states.⁹⁷

6.9.2 Treasury Bills

In late 1991, SAMA introduced a new treasury bill system to replace the previous programme to help the government with its cash flow. After the Gulf war the government had found itself in continuous need of financing, in fact, in 1991 it had taken up two large

loans of around \$ 7 billion from both local and foreign institutions.⁹⁸ Bills with maturity of 13 or 26 weeks were offered on a weekly basis, while one year bills were offered monthly. SAMA has also created repurchase facilities enabling banks with excess overnight liquidity to purchase bills with the intention of reselling. However, SAMA has full control over the quantity of bills in circulation.

6.9.3 The Stock Market

This too operates under the close supervision of SAMA. In the 1991-92 period, the Saudi Arabian Stock market experienced a major transformation from a market dominated by a handful of traders to hundreds who have left their trading positions abroad to pursue profits at home. As a result the stock market prices had increased drastically and at an accelerated rate, which has worried SAMA, as there is a large demand for shares, but not enough supply. One of the main reasons of this increase in demand is that return on investment is greater here compared to that which could be gained from declining international interest rates. SAMA has revised regulations of flotation, in fact, when Riyadh Bank was put on offer, SAMA limited the age of purchasers to those over 15 years and the submission of applications was decreased to two weeks, while each family member had to make a separate application. Nevertheless, the share offer drew 688,000 applications for 26 million shares worth SR 12,500 million and shares which had been sold at SR 475 were soon trading at SR 1,300.⁹⁹ Since then there has been offerings of shares in the Saudi Industrial Development Co., Al-Baha Investment and Development Co., Saudi Pharmaceutical Industries and the Medical Appliances Corporation. By late 1993, there were over 77 listed joint stock companies with an aggregate paid up capital of SR 21,200 million of these, only 66 are publicly traded.¹⁰⁰

Although originally in 1985 SAMA had issued a decree requiring all share trading to be carried out by banks, by late 1990 SAMA introduced an electronic trading system, ESIS, to run along side the old system with the objective of it developing into a full screen based market similar to those operating in the developed countries. However, SAMA does not allow the independent share brokers, although, they are active in the Saudi market.¹⁰¹

6.10 Conclusion

The government ultimately was able to control all the financial institutions through the Ministry of Finance which had control over SAMA. This is illustrated by facts, such as the Saudisation of foreign banks, the reluctance to permit the expansion of Islamic Banking and the relatively high level of independence still allowed to money changers. Foreign banks in Saudi Arabia are still operating under stringent restrictions and their activities are curbed to a great extent.

Political instability in the Middle East has had financial implications, particularly for the stock market. This has given SAMA the opportunity to delay any liberalisation of the market for shares in Saudi Arabia. This works to SAMA's advantage because the share market would be very difficult for SAMA to control. SAMA is reluctant to permit the development of a flourishing stock market in the Kingdom because this would lead to the stock exchange becoming an independent source of capital, over which the government would have little control.

SAMA has been unable to handle the "promotion of a modernised commercial code" and the development of an efficient legal system. Many Saudi borrowers turn to the Sharia Law in an attempt to avoid repayment of loans from commercial banks. This has caused foreign commercial banks to become very restrictive in their lending, in an effort to protect their own interests. Even Saudi banks are hesitant to lend to the private sector. This has hindered the nation's economic development.

Banks have a high liquidity level as they involve themselves only in short term lending. They also tend to place their riyals in other banks or with SAMA, and they lend to government controlled companies, such as SABIC, Petroleum and Saudia, in an attempt to provide themselves more security. The absence of a formalised and efficient legal system in the country has hampered industrialisation and financial development. Any change in the present system would make the conservative elements of Saudi society very unhappy.

Another fact that has retarded economic development in Saudi Arabia is that the policy making is highly centralised. The private sector finds it very difficult to contribute

towards development because if their policy is not consistent with that of the government's, the private companies would be denied benefits such as cheap land on industrial estates, subsidised state loans and they would find it very difficult to obtain the required licences.

The Saudi Arabian government should make an effort to encourage small scale industries and venture capital projects. Both of these would give an added impetus to the industrialisation of the nation.

However, in spite of the above mentioned factors, the government, under the auspices of SAMA has had a certain stabilising effect on the Saudi Arabian financial system. It has encouraged the public to have confidence in the banks. It is to these commercial banks that one now turns, examining in particular their role in the Kingdom's economy.

Notes :

- (1) Knauerhause, R. The Saudi Arabian Economy New York: Praeger Publishing, Inc., 1975, p. 238; Sayigh, Yusif A. The Economies of the Arab World London: Croom Helm, 1978. p. 127-130.
- (2) Abdeen , Adnan M. and Shook, Dale N. The Saudi Financial System London: John Wiley & Sons Ltd., 1984, p.35.
- (3) Ibid., p.35.
- (4) Moliver, Donald M. and Abdondante, Paul J. The Economy of Saudi Arabia USA: Praeger, 1980. , p.79-82.
- (5) Abdeen and Shook, op. cit., p.35
- (6) Young, Arthur N. Saudi Arabia: The Making of a Financial Giant. New York: Longman, 1983, p. 55.
- (7) Ibid., p. 57.
- (8) Ibid., p. 57-58.
- (9) Ibid., p. 57.
- (10) Ibid., p. 61.
- (11) Although the head office was to be in Riyadh, the main functions were to be carried out from Jeddah.
- (12) Young, op. cit., p. 62.
- (13) Ibid., p. 67.
- (14) Ibid., p. 67.
- (15) Ibid., p. 67.
- (16) Ibid., p. 68.
- (17) Ibid, p. 68-69.
- (18) Ibid., p. 69.
- (19) Ibid., p. 69-70.
- (20) Royal Decree No. 6, 1959.
- (21) Presley, J .R. A Guide to the Saudi Arabian Economy London: Macmillan, 1984, p. 104.
- (22) Ibid., p. 104.
- (23) Knauerhause, op. cit., p. 239.
- (24) Abdeen and Shook, op. cit., p. 36.
- (25) Banking Control Law promulgated by Royal Decree No. M/5 of 22/2/1386 AH , also see Knauberhase, op. cit., p. 240.

- (26) Abdeen and Shook, op. cit., p. 37.
- (27) Ibid., p. 38.
- (28) "SAMA's Cautious Approach", Banker, December, 1980, p. 127,131.
- (29) Abdeen and Shook, op. cit., p. 38.
- (30) Ibid., p. 39.
- (31) Ibid., p. 39.
- (32) Ibid., p. 39.
- (33) SAMA Annual Report, 1992, p. 134 and 143.
- (34) SAMA Annual Reports, 1984, 1988, and 1992, p.144-145, p.168-169 and p.134 and 143 respectively.
- (35) Johany, Ali D. Berne, M. and Wilson, M. Jr. The Saudi Arabian Economy London: Croom Helm, 1986, p. 159.
- (36) Seznec, Jean-Francois. The Financial Markets of the Arabian Gulf London: Croom Helm, 1987, p. 22-23.
- (37) Ibid., p. 23.
- (38) Ibid., pp. 23-24.
- (39) Ibid., p. 24.
- (40) Johany et al., op. cit. , p. 169.
- (41) Keran, Michael W. and Al-Malik, Ahmed Abdullah. "Monetary Sources of inflation in Saudi Arabia." Federal Reserve of San Francisco Economic Review, Winter 1979, supplement, p. 139.
- (42) Johany et al., op. cit. , p. 170.
- (43) Ibid., p. 170-171.
- (44) Keran, et al., op. cit., p. 141.
- (45) Seznec, op. cit., p. 47.
- (46) Ibid., p. 47.
- (47) Ibid., p. 18.
- (48) Mehran Nakhjavani. "Arab Banks & the International Financial Markets." MEPEP Report, Nicosia, 1983, p. 67.
- (49) Seznec, op. cit., p. 18.
- (50) Ibid., p. 19.
- (51) These certificates are often named "repos" for redepositing, but in a wider contexts they are often referred to as treasury bills.
- (52) Seznec, op. cit., p. 19-20.

- (53) Ibid., p. 20.
- (54) Arab Banking & Finance, London, May 1984, p. 21.
- (55) Sez nec, op. cit., p. 20.
- (56) Ibid., p. 20.
- (57) Ibid., p. 21.
- (58) International Herald Tribune. "Bahrain: Offshore Markets for Short Money." May 1979, p. 215, and Abdeen and Shook, op. cit., p. 110.
- (59) Abdeen and Shook, op. cit., p. 111.
- (60) Johany et al., op. cit., p. 163.
- (61) Wilson, Rodney. Banking and Finance in the Middle East London: Macmillan Publishers Ltd., 1983, p. 90.
- (62) Ibid., p. 91-92.
- (63) Ibid., p. 92.
- (64) Ibid., p. 92.
- (65) Niblock, Tim. State, Society and Economy in Saudi Arabia Kent: Croom Helm Ltd., 1983, p. 281-282.
- (66) Ibid., p. 282.
- (67) Ibid., p. 282.
- (68) Ibid., p. 282-283.
- (69) Ibid., p. 283.
- (70) Ibid., p. 283-284.
- (71) Ibid., p. 284.
- (72) The NCB and the Riyadh bank were the only banks with branches across the Kingdom. Even after Saudisation they controlled 70 percent of bank branches in Saudi Arabia in 1980.
- (73) Niblock, op. cit., p. 286-287.
- (74) Ibid., p. 287.
- (75) Ibid., p. 287.
- (76) Ibid., p. 287-288.
- (77) Sez nec, op. cit., p. 22.
- (78) Niblock, op. cit., p. 291.
- (79) This is discussed extensively in Sez nec, op. cit., pp.114-125.
- (80) Sez nec, op. cit., p. 24.

- (81) Ibid., p. 30-31.
- (82) Middle East Economic Digest Vol. 29, No. 14, 7th. April, 1985.
- (83) Arab Banking & Finance, London, March 1983.
- (84) Seznec, op. cit., p. 24.
- (85) "Special Report: Saudi Arabia." Middle East Economic Digest, Vol. 36, No. 21, 20th March, 1992, p. 15
- (86) "Special Report: Saudi Arabia." Middle East Economic Digest, Vol. 35, No. 21, 20th March, 1991, p. XI.
- (87) Special Report: Saudi Arabia." Middle East Economic Digest, Vol. 36, No. 21, 20th March, 1992, p. 15.
- (88) Presley, op. cit., p. 108.
- (89) Wilson, ,op. cit., p. 171.
- (90) Seznec, op. cit., p. 22.
- (91) Ibid., p. 91.
- (92) Wilson, op. cit., p. 171.
- (93) Presley, op. cit., p. 108.
- (94) Wilson, op. cit., p. 172.
- (95) Seznec, op. cit., p. 81.
- (96) "Special Report: Saudi Arabia." Middle East Economic Digest, Vol. 36, No. 46, 20th November, 1992, p. 54.
- (97) "Special Report: Banking." Middle East Economic Digest, Vol. 34, No. 4, 23rd February, 1990, p. 11.
- (98) "Special Report: Banking." Middle East Economic Digest, Vol. 36, No. 16, 14th February, 1992, p.9.
- (99) "Special Report: Banking." Middle East Economic Digest, Vol. 36, No. 21, 20th. March, 1992, p. 16.
- (100) "Special Report: Saudi Banking." Middle East Economic Digest, Vol. 38, No.19, 13th May, 1994, p. 18.
- (101) Ibid., p. 18.

Chapter Seven
**The Origin of Banking
in Saudi Arabia**

The Saudi Arabian financial system emerged long before the existence of modern day banking. With the barter economy giving way to a pecuniary one, it became necessary to develop some sort of financial intermediation. It is virtually impossible to expect all transactions to take place simultaneously, therefore, many individuals and merchants ended up with some sort of monetary value in their possession. They could hoard their earnings but this meant taking considerable risks, i.e. loss, theft...etc. Thus, if cheap, safe facilities were provided, this would minimise the risk. Another reason for the emergence of a financial body was the deferment that occurred between the time of payment and receipts, which meant that financing was needed to cover this gap in time. A third reason for the need of financial intermediation was the existence of different monetary standards, which ranged from minted metals to those in jewelry form. Thus, the money changer had to have a skillful knowledge of the different qualities of the metals. However, the money changer's activity extended to money lending as this had better returns. The money-lender would lend out a portion of the money entrusted to him to a merchant, who was about to embark on a profitable venture. When the project was completed and the returns were realised, the merchant would pass on part of the profits to the money-lender.¹

The cities of Hijaz have always been renowned as trade centres. The Hijaz merchants for centuries travelled on the traditional trade routes, which carried them as far west as the Roman Empire and as far east as China. One can, therefore, deduce that certain monetary standards would be acceptable to a greater extent than others, and it was up to the money-changer to provide them. Hence, the reliance on gold and silver as they were durable and easy to carry. In addition they could be melted down and changed to any shape necessary, but most importantly they were considered as an accepted monetary standard worldwide.²

Until the early decades of this century the money changers remained the sole financial institutions in Saudi Arabia. Their role continued to be similar to that played by the Italian merchant families during the European Renaissance. The Hijaz money changers provided an exchange service for the pilgrims who brought with them their national currency to maintain their daily expenses in Saudi riyals. As the levels of income

increased in Muslim countries, so did the number of pilgrims. Their average stay ranged from one to two months and consequently, they brought with them large sums of money to sustain themselves. This in turn ultimately meant greater profits for the money changers.

Moneychanging in Saudi Arabia historically developed to meet the needs of the growing pilgrim population who visited the holy cities of Mecca and Madina. It has subsequently continued to play a significant role in the Saudi Arabian financial system. Money changers have traditionally served a wide cross-section of society, as opposed to the banks which catered more for the needs of the middle and upper classes. As long as cash continued to be the dominant method of conducting business, traditional moneychanging continued to flourish. The main successful moneychanging families were and still are predominantly of Hadrami origin. Hadramout has for centuries been famous for producing lucrative merchants and businessmen. It is, therefore, not surprising to find families such as the, Bin Mahfouz, al-Amoudis, Balahwals and others, all of Hadrami origin, prospering in Saudi Arabia.

The first banks established in Saudi Arabia were those already set up in other parts of the colonial empires. In 1925 the Algemene Bank of the Netherlands opened its first office in Jeddah.³ This was to cater for the Muslim pilgrims from the Dutch East Indies (Indonesia).⁴ The bank's main function was to operate as a bureau de change and a transfer service. Many pilgrims were robbed on route to Mecca, therefore it was safer to transfer the money through the bank. It did not give loans or take deposits, thus the interest taboo did not occur.⁵ King Saud did not allow other European financial institutions to enter Saudi Arabia and the government itself depended on the money-lenders and money changers to provide the necessary facilities for government and public alike.⁶ In this way the money changer aided the King and his council of ministers in the management of the Kingdom, in a financial capacity only. However, the expatriates, who lived in Saudi Arabia, missed the conveniences provided by commercial banks. As a result they tended to depend on trading companies such as Gellatly Hankey, which was in fact a shipping company.⁷ Nevertheless, it provided the foreign residents of Jeddah with certain banking facilities. This service was extended to Saudi Arabians without interest.

In 1936 Egypt's Bank Misr applied for permission to open a branch in Saudi Arabia, but this soon proved unsuccessful.⁸ However, in 1952, the first locally owned bank was granted permission to operate within the Kingdom.⁹ It was the NCB, which was owned by two former moneychanging families, the Bin Mahfouz and Kakis. It took much lobbying within the Royal Family to convince the King to sign the decree. This particular decree opened the way for modern day banking in Saudi Arabia. However, it will still be a long time before Saudi nationals completely grasp the advantages of chequing and other facilities which are provided by banks, which the West takes so much for granted.

The NCB opened its first branch in Jeddah. In its early days it operated only on a limited scale due to the primitive state of the Saudi economy. However, with the increase in oil revenues and the abundance of wealth that Saudis experienced, the NCB was able to expand dramatically. Initially, its main involvement was in trade finance, which served the requirements of Jeddah's merchant society. This entailed checking the merchants' credit worthiness, then opening letters of credit on their behalf. If required, the bank would organise a short term loan for the merchants, which in turn would be paid back, once the imported goods were sold. The bank also offered deposit-taking services. Foreign exchange facilities were available, but not greatly used, since many people continued to depend on the money changers in the souks. To overcome the problem of interest, they used the term "fee" instead - this was calculated as a percentage of the loan. Nevertheless, most depositors tended to keep their money in current accounts, which meant greater profits for the NCB. As time passed, the merchants formed strong ties with the bank. Often loans would be secured, using the merchants's own property. However, the situation never came to foreclosure on a property.¹⁰

During the following decade, the National Bank grew, but at a somewhat conservative rate, which fitted well with the country's general '*modus operandi*'.

In the early 1950's the Banque de l'Indochine opened its office and soon after the British Bank of the Middle East followed suit. The National Handels Bank mainly catered to the needs of the pilgrims who flocked from the Muslim populated colonies. The French and British banks, on the other hand, tended to mainly service the European expatriates in Saudi Arabia.¹¹ These were Western people who had come to Saudi Arabia to work in the

oil fields and industry. In 1957 the second local bank was founded in Jeddah, called the Riyadh Bank. It was established by the Sharbatly family, along with some wealthy merchants. However, the Riyadh bank faced many difficulties in its infancy and was confronted with bankruptcy in the mid 1960's. It was only due to the timely intervention of the SAMA which took over 38 percent of the bank's equity and reorganised its management, that it survived.¹²

Saudi Arabia's unwillingness to encourage banking has restrained and somewhat hampered the overall financial and monetary progress of the country. Until the late 1970's, the NCB and the Riyadh Bank enjoyed complete control of the market, with the NCB controlling 60 percent of deposits and the Riyadh Bank 20 percent¹³ This duopoly meant that there was virtually no competition and therefore both banks developed at a slow pace. The actual facilities provided by the banks were fairly primitive, and since foreign banks were not permitted to increase their branch networks, the NCB and the Riyadh Bank accounted for over 70 percent of all branches operating in Saudi Arabia.¹⁴ However, in the mid 1970's, the Saudi Arabian authorities had to take action due to the general public grievance over high bank charges and bad service.¹⁵ Such a feudal domestic banking system did not boost Saudi Arabia's prestige among foreign nations, especially as it was the only Third World Country to have a seat on the International Monetary Fund's Board of Governors. Due to internal pressures, the Saudi Arabian authorities were reluctant to allow foreign banks the freedom to operate within the Kingdom. This problem was overcome by the Saudisation of the foreign banks and then, guaranteeing them the freedom of expansion. This resulted in the creation of a more competitive banking atmosphere.¹⁶

7.1 The Founder of the NCB¹⁷

Sheikh Salem Bin Ahmed Bin Mahfouz, the founder of the NCB, came from a humble background and had no formal education. In his formative years he had to resort to many menial jobs in order to secure his livelihood. He gradually worked his way to becoming a money changer.

At his father's suggestion, Sheikh Salem left with his brother Abdullah for Mecca

from his birth place, a cluster of villages known as al-Higreen, in the province of Hadramout, Yemen. He was only six at the time. Their father was unable to provide for them and encouraged them to seek their own livelihood elsewhere. Sheikh Salem worked as a household help in Mecca for six months. During this period he changed his employment six times, due to his restlessness and inability to settle down. His family lost hope and sent him back to al-Higreen in 1914.¹⁸ Soon after his arrival in Hadramout, his father died, followed by his mother, two and a half years later. Times were difficult and due to the commencement of the First World War, all news and financial aid, sent by his elder brother, in Mecca, was cut off. In 1916 his family felt it necessary to send Salem and his brother Sultan to Mecca to help the family financially. However, they could not afford to pay for the travelling expenses. Fortunately, some of their relations decided to go to Mecca to seek their fortunes, so Salem's family begged that the boys be taken with them. On arrival in Mukkala, the chaperoning family changed their travelling plans and decided to immigrate to Africa instead. The two boys, in desperation, and knowing their family's financial difficulties, begged that they too be taken, but the relations refused, the children cried as they were desolate and unhappy. They did not have money to pay their way home. As they wept over their predicament, a passer-by, who had recognised them and remembered their father's kindness to him, stopped to speak to them. The boys explained their situation while the man listened sympathetically. He offered to pay their fare home or, if they wished, he could find them work in Mukkala. Sultan, the youngest of the two, chose the former, while Salem the latter.

Salem continued to live in Mukkala for a further two years. He offered his services to a sweetmaker who in return provided him with clothing and sustenance. He then returned to al-Higreen and stayed with his brothers for six months. During this time, Abdullah, the eldest brother, entrusted a friend with 86 Rupees to pay for his brothers' passage to Mecca, as Salem, the elder of the two, was only ten years of age. When it was time to leave Al-Higreen, the trustees came to collect the boys. Unfortunately, the caravan leaving for Mukkala was not escorted by tribesmen, which left them vulnerable to attacks from rival tribes. Consequently, the boys delayed their travelling arrangement for the next caravan to Mukkala. It was agreed, however, that they would meet their guardian there. On arrival in Mukkala, they discovered, to their distress, that their guardian had

departed to Djibouti - on the African Coast - by boat, without them.

By chance, the very same man who had helped the boys two years earlier, found them in tears in exactly the same street as he had before. He asked what was wrong, and they recounted their story. Once again he said he would try his best to help them out. He took them to acquaintances of his, the Bazaras, who used to own sailing boats. He told the family that the boys were descendants of the Prophet Mohammed - peace be upon him - which was not really the case, but this meant that they would be taken in free of charge and cared for. To make this convincing, Sultan had to change his name to that of Hussain, since the Prophet's descendants did not tend to call their children 'Sultan'. However, the name of Salem was acceptable. The Bazaras welcomed the 'noble' guests and were happy to offer them a safe passage to Djibouti in order to catch up with their guardian. They were put on a boat that sailed from Mukkala to Aden, where they stayed in the Bazara's house. They were treated well until a boat was available to sail them to Djibouti. On arrival in Djibouti, the head of the Bazara household invited them to stay at his house. They declined the offer as they wanted to join their guardian, who had been awaiting their arrival. The Bazara host allowed this request provided that they would visit him daily to receive a Maria Theresa franc each. They remained in Djibouti for twenty days, receiving a franc daily upon their visit to the Bazara house.

They left Djibouti to Mussawa, Ethiopia, where the Bazara family were kind and generous to both their guardian and to them. From there they took a boat to Jeddah, where they stayed until the end of 1918. The First World War had extended to Iraq and Syria. Salem then went to Mecca where he stayed until the beginning of 1921. During his stay in Mecca, Salem worked in different establishments, with jobs varying from breakfast making to dish-washing, and selling perishable foods. He then went home where he spent the rest of the year. He returned to Mecca at the commencement of the following year. Much hardship was encountered during this trip, especially as Salem and his companion were only thirteen at the time of the journey, which took six months and was mostly on foot.

Salem reached Mecca in 1922, the year in which the Sheriff Hussain went to Akaba, and was made The Lord of The Arabian Peninsula. He ruled until 1923; then the Saudis

came and won the title through war. In Mecca, Salem worked for his brother, Abdullah for two months, as his assistant in a small shop. Abdullah was then approached by one of Suliman al-Kaki's employees, who was asked to find a young person to help in the household chores at al-Kaki's home. Abdullah agreed to send Salem for the job, this was to be Salem's first encounter with the Kaki family. Suliman al-Kaki was a distant relative of Abdul-Aziz, who later was to become Salem's lifetime partner. On arrival at the al-Kaki's residence, Sheikh Suliman asked that Salem be taken to the main house and be given a summary of what his work entailed. Salem refused to go, and said he wanted to work in the buying and selling business, and not as a mere household help. Suliman al-Kaki was amazed at the young, thin and puny boy's attitude. Salem was adamant and was not tempted by Suliman's offer of a daily bag of sweets. Hence, Suliman decided to give the young lad a chance, and asked that he be taken to the shop instead.

Salem's first lesson was to understand the value of money. He was given a gold sovereign, and asked to take it to the market and obtain a certain number of Saudi Halalas instead. Salem did so, but came back with an extra Halala. They continued to give him different currencies and would tell him the expected rate; and he in turn, continued to bring back over and above the figures required. Nevertheless, he was never given more than 20 gold sovereigns in a day. He soon developed his skills, and would approach one money changer to ask his requirements; and would then approach another and obtain an offer, thus acting as the middleman. His profits from this ranged from 4 to 5 riyals, and would be gained, on average, twice monthly.

During his first year's employment, he was paid 4 gold sovereigns. He worked for Suliman al-Kaki from 1923 to 1926, and the maximum pay he received was 7 gold sovereigns. This was nothing when compared to the returns he had brought Suliman al-Kaki, since he never made less than 2 gold sovereigns per month. In fact, in 1924 and on his own initiative, - that is, whilst acting as a middleman, - he reaped a profit of 22 gold sovereigns in one deal. The deal was made through Abdullah al-Fadli, a money changer used by the King's financial representative Abdullah Suliman, who later became the Minister of Finance. Abdullah al-Fadli recommended Salem to Abdullah Suliman, describing him as the best money changer in Mecca, a reference that helped to enhance

Salem's already good reputation amongst Suliman al-Kaki's clients. Therefore, it was not surprising that at a later date Abdullah Suliman approached Salem and asked him to manage the King's army's expenses, which then equalled 2,000 Maria Theresa francs per month, and were considered to amount to the highest expenditure in the Kingdom. These were primarily financed by the returns from Al-Quaseem and Al-Ahsa.

Hence, in the early summer of 1926, Salem's brother Abdullah decided to return to al-Higreen and asked Salem to look after his part of the stall. Salem, therefore, told Suliman al-Kaki that he would have to leave his employment. Owing to a deal organised by Salem, however, Abdullah Suliman owned Suliman al-Kaki 95 gold sovereigns. Suliman al-Kaki insisted that Salem should organise the return of the money owed before he left his employment. Salem explained to Suliman al-Kaki that the business with Abdullah Suliman had substantial returns and he should, therefore, keep him as a client. But Suliman al-Kaki did not want to continue to serve Abdullah Suliman, since he knew that without Salem he would not be able to provide the expected standard of service. Therefore, he declined the offer. In consequence, Abdullah Suliman instructed Abdullah al-Fadli to pay Suliman al-Kaki the money owed to him.

Salem took over his brother's stall and worked there for five to six months. His brother had a partner named Bahammdan, who knew that Salem had work experience as a money changer, and was an enthusiastic and active dealer in this type of business; moreover, during the previous four years he had built up a substantial number of contracts. Therefore, Bahammdan offered Salem a partnership. He would himself put forward the capital of 200 gold sovereigns: - then, this was considered to be a substantial sum; - and Salem would run the business, receiving for his services 50 percent of the profit. However, Bahammdan only put forward 100 gold sovereigns, which he only gave after the Haj season, - the most important business period for the money changer. Nevertheless, in the following six months, Salem made a profit of 85 gold sovereigns, of which he received 42.5 gold sovereigns, an amount that equalled seven times his highest earned annual pay. Hence, a year later, they closed the stall.

Soon after this, Salem was approached by Saeed, Suliman and Saleh Mosa al-Kaki, who wanted to employ him for their nephew Abdul-Aziz. Salem was reluctant to accept,

having enjoyed the experience of managing his own business. Nevertheless, he was too shy to turn the others down. Thus, he suggested that Abdul-Aziz pay him 40 gold sovereigns per annum, thinking that they would refuse the offer, since the highest paid money changer at that time earned only 15 gold sovereigns, and such people were educated and spoke both Arabic and English. Nevertheless, much to Salem's surprise they accepted his offer, but he asked that he be given 15 days to try to find a partner for his shop. This he was able to do promptly, and for the following three years Salem worked for Abdul-Aziz al-Kaki, passing on his 40 gold sovereigns at the end of each year to his partner in the stall. Consequently, when Salem decided to return to al-Higreen, he took one of Abdul-Aziz's accountants to his stall in order to calculate the profits his partner had made in the last three years and to collect what was now due to him. To his horror, he found that his partner had lost all 120 gold sovereigns, and it was apparent that no profit had been made during the past three years. Salem, therefore, had to go back to Abdul-Aziz al-Kaki and work for him at the same rate for a further two years.

In 1934 Salem left for al-Higreen in order to marry. However, in 1935, he decided to return to Mecca, but was in debt of 160 Maria Theresa francs. Therefore, he approached his lenders, and begged their permission to leave, promising to send their money upon his arrival in Jeddah. They all accepted, except for one, who insisted on receiving his 32 Maria Theresa francs there and then, thus, forcing Salem to sell his prize dagger in order to pay the debt. Upon his arrival in Jeddah he asked Abdul-Aziz's agent to lend him 10 gold sovereigns in order to repay the 160 Maria Theresa francs, which he instantly transferred by telegram to Hadramout. He then worked for Abdul-Aziz al-Kaki for a further two years.

Between 1937 and 1938 and much to Salem's astonishment, the Kakis decided to make him a partner. He would be given 2,000 gold sovereign to manage. Salem accepted, on condition that a contract be agreed between them, since he was uncertain of the sincerity of some of the family members. The main condition of the agreement was that the Kakis would not buy or sell in Jeddah, Riyadh or anywhere outside the Kingdom. However, about seven months later the Al-Kaki family broke the agreement by trading in Riyadh. Sheikh Salem was disappointed, and his reaction was to complain to the head of

the Kaki family - namely, Sadaka al-Kaki, - who was respected and whose wishes were obeyed by all the family members. He declared that if they were not able to stand by their word, then the company should be dissolved. Hence, the original sum put up as capital was returned to its rightful owners and the profits divided four ways, between Abdul-Aziz al-Kaki, Sadaka al-Kaki, Salem Mosa al-Kaki and his brother Abdullah and Salem bin Mahfouz.

7.2 The Origins of the NCB

Sheikh Salem was then approached by Abdul-Aziz al-Kaki for whom he had worked in Mecca. Soon after he had started to work for him, however, Sheikh Salem suggested to Abdul-Aziz that it would be to the business's advantage if they were to set up an office in Jeddah. Sheikh Salem pointed out to Abdul-Aziz al-Kaki that many of the business people were moving to this city, and he felt that Jeddah would inevitably become Saudi Arabia's new business centre. At first Abdul-Aziz hesitated, but finally he agreed, and authorised Salem to set up an office in Jeddah under his supervision, - namely, Sheikh Salem's. This arrangement lasted from 1938 to 1940. During this period, Sheikh Salem conceived the idea of establishing a Saudi national bank. The wealthy city merchants expressed to him their need of a national bank. Unfortunately, Sheikh Salem knew that he did not have the facilities, nor the financial support required to undertake such a responsibility. Nevertheless, he was determined to attain this ultimate goal. Then, in 1941, Abdul-Aziz Mohammed al-Kaki, Salem and his brother, Abdullah Mosa al-Kaki suggested that they would give Sheikh Salem a capital sum of 2,000 gold sovereigns, which he would manage for them; and all profits made would be divided amongst the partners; that is to say, a third would go to Saleh and to Abdullah Mosa al-Kaki, another third to Abdul-Aziz al-Kaki; and the final share would be for Sheikh Salem himself. Sheikh Salem was reluctant to agree, even though his partners would accept any conditions set by him. However, after much discussion, he approved their offer. The newly found partnership lasted for eight years, until 1948. It continued to operate as a moneychanging institute, expanding its facilities to include some banking. During those eight years, Sheikh Salem endeavoured to establish the foundations of a bank. One of the steps taken by Sheikh Salem was to send, unofficially Egyptian and non-Egyptian

currencies, for example, the Indian Rupee, the German Mark, Japanese Yen and the Russian Rouble, to Bahai and al-Masri, - two big merchants in Egypt who would sell the currencies in Cairo for him. This had to be done unofficially, since the Saudi government declared that only the Royal family was allowed to take out foreign currencies from the country, which made it impossible to import goods, since only official funds could be used for this purpose. Sheikh Salem realised that this was a deterrent that he would have to overcome. Therefore, he wrote to the Midland Bank in England, the Union Bank in Switzerland, and their counterparts in India and Pakistan, asking whether it would be possible for him to send the currencies to them, and they would then open letters of credit in the normal manner. He knew that they would probably disagree; but it was an effort, nevertheless, that was worth making, he thought. Thus, opening letters of credit was a service that Sheikh Salem's company could not offer to its business people, a benefit that was monopolised by the foreign banks, which operated under company names. They were able to provide this service, as they were already part of an extended network of branches operating worldwide. Hence, whilst facilitating and giving all the necessary support required to provide this sought after service. Sheikh Salem also anticipated his need for staff that were proficient in both English and Arabic as the country's trade with the Western nations began to increase, causing an inevitable interaction.

The company had acquired, through Sheikh Salem's honest and charismatic character, the trust of many prominent tradesmen and government officials; therefore, it was not surprising to discover that they held their accounts with the company. The company also held the Ministry of Finance's accounts, including that of all revenues received from the sale of oil through ARAMCO. The contract for this was signed, in 1942, between the then Minister of Finance, Abdullah Suliman and Sheikh Salem bin Mahfouz. This contract also stated that the company would supply dollars to the Gulf States, especially to the Bahrain and Kuwaiti markets, in exchange for other world currencies, such as: the Sterling Pound, the Indian Rupee and the silver Saudi riyal. The company was also given the responsibility of distributing the wages of government employees. The government also authorised the company to receive the pilgrims' fees on its behalf, and this was equal to SR 480 per pilgrim. Soon after this, the company was given the responsibility of purchasing goods on behalf of the government, and also of

distributing government aid, which consisted mainly of staple foods such as corn and oil to the needy members of the population, from a list composed by the government itself. This was, however, altered in 1953 to a monetary subsidy, which the company, and later on, the Bank, continued to distribute. In fact, this was carried out in both the Reign of King Abdul-Aziz and King Saud. And so, Sheikh Salem realised that by developing the banking idea, the company would be able to expand its market share within existing and future financial businesses. Also, Saudi Arabia did not have a central bank as yet - SAMA was only founded in 1952 - and therefore, Sheikh Salem envisaged himself as the banker to the rulers of the Kingdom. Both those goals were attained, and as a result the company made large profits.

Early in 1949, the company was dissolved, having made a total profit of SR 8 million i.e. 400 thousand gold sovereigns since its inauguration from a capital of 2,000 gold sovereigns, and a new agreement was signed, whereby Sheikh Salem would be paid a salary together with his share of the profits. He would have absolute control to do as he saw fit to ensure the success of the company without having to answer to any of the shareholders, a condition that was suggested by the partners, thus emphasising Sheikh Salem's integrity and respectability amongst his peers. The newly formed company was registered at the Company's Registry Office and the Ministry of Finance under the title: "Saleh and Abdullah Mosa al-Kaki, Abdul-Aziz Mohammed al-Kaki and Salem Ahmed bin Mahfouz". As time passed, the Kakis' relationship with Sheikh Salem became stronger, and they gradually appreciated him more. The company developed and expanded; and in 1951, the Kakis suggested that Sheikh Salem should receive half of the profits earned in addition to some regular remuneration. Sheikh Salem accepted the increase in his share of the profits, but refused to accept a salary. The company proceeded to operate for a further four years since its registration, during which period it continued to offer some banking services and its profit reached 1.6 million gold sovereigns i.e. around SR 32 million.

Even though the company was the only Saudi moneychanging company that offered some banking facilities in Saudi Arabia, its rate of branch growth was very slow, especially since, as a company, it could not freely offer all banking services. Hence, it

was not until the late 1940's that it started its operations outside the Hijaz.¹⁹ It is possible to attribute this slow rate of expansions to four phenomena. Firstly, the partnership's limitations as a company as opposed to a bank. Secondly, Sheikh Salem's conservative and very carefully calculated policy, especially when he realised that he was a pioneer in a field that Saudi Arabia had never experienced, - that is to say, banking. Thirdly, perhaps to a lesser degree, the stagnation due to the Second World War.²⁰ Finally, the traditional, moneychanging families created a strong competitive business environment.²¹ The prevailing atmosphere meant that the company did not enjoy a truly monopolistic position. In fact, in the Eastern Provinces which prospered due to new found oil, it was the moneychanging families that carried out much of the financial intermediation, especially the al-Rajhis, a rich, land-owning family which competed with the newly-formed company. They had their customers' confidence, which was earned through hard work and over a period of time, and many oil workers used this family for the transfer of remittances.

7.3 The Birth of the NCB

In the early 1950's, Sheikh Salem began to consider the possibility of becoming a banker. During this period, the only banks existing were the Bank of Holland, the French Banque de l'Indochine and the Gallatly Hankey, and even those operated under the banner of a trading company, since banks were synonymous with usury, or interest, which is banned in Islam. Sheikh Salem Bin Mahfouz approached Abdullah Suliman - Minister of Finance - with the potential idea of developing a national bank. This was appreciated and responded to by Abdullah Suliman, who suggested that he should put it forward to King Abdul-Aziz.

So Sheikh Salem went to Riyadh to seek an audience with the King, the objective being to get permission to become a banker. Sheikh Salem stated to the ageing monarch that for the Kingdom to be truly independent, it was necessary for the country to be economically self-sufficient first. The King was well known to be disinclined towards the banking profession owing to their practice of charging interest, which was contradictory to Islam. He stated that as a Muslim country he could not allow the use of the word 'bank'. Hence, Sheikh Salem declared that his objective was to look after the religion, and stated

that his insistence on using the word 'bank' was not for business reasons, but rather to prove the company's existence as a banking service to the rest of the world. The King then turned to his Minister of Finance, Abdullah Suliman, and asked his opinion. Abdullah Suliman simply validated Sheikh Salem's argument.²²

Consequently, and after much lobbying by the Bin Mahfouz family together with their partners, the al-Kakis, within the Royal family, and to everyone's surprise, King Abdul-Aziz agreed, and a decree was made through his financial minister to issue the necessary permits. It stated that "the moneychanging company known as Saleh and Abdullah Mosa al-Kaki, Abdul-Aziz Mohammed al-Kaki and Salem Ahmed Bin Mahfouz be changed to a bank, and operate under the name of the NCB". This was then passed to the Ministry of Finance for ratification.

The King may have agreed because he perceived banking to be inevitable, and thought it better to have local devout Muslims involved in such activities rather than infidels, or even other Arabs from outside the Arabian peninsula. He also saw in this an extension of the development of his political policies. In 1952, the NCB was formed²³ - with the Mahfouz's owning the majority of 51.5 percent of the capital and the al-Kakis the remainder²⁴ - and started conducting its business in Jeddah. The bank's initial capital amounted to about SR 30 million.²⁵ Owing to Sheikh Salem's good reputation, and the trust the people had in him, large numbers of customers flocked to the bank to open accounts including many prominent merchants, businessmen and princes. The most prominent account holder at the NCB, was King Saud Bin Abdul-Aziz himself. It is also worth noting that the NCB was the third wholly indigenous bank set up in the whole of the Arab world - Arab Bank of Abdul-Hammed Shoman and Bank Misr of Egypt being the other two.²⁶

7.4 The Bank and the Government

On a national level, the NCB performed leading tasks in the financial development of the economy, especially as SAMA had not been established. It only came into operation in 1952 as already indicated, and had faced some teething problems in its early years. The government had depended on Sheikh Salem's and al-Kaki's moneychanging company for

most loans and continued to do so when it became the NCB. This led to some friction. When, for example, Prince Faisal, already heir to the throne and Minister of Foreign Affairs, was made Minister of Finance to the Kingdom, he had decided to set some control on government spending, since, in the previous periods, spending had tended to exceed revenues, thus forcing the government to borrow in order to fund the deficit from the banks - mainly from the NCB. Thus, in 1956, when the new Minister of Finance, Prince Faisal, approached Sheikh Salem Bin Mahfouz for a loan of SR 50 million to cover the deficit over the next few weeks (the government had not paid its employees for the previous eight months and SAMA had only SR 4 thousand in its vaults).²⁷ Sheikh Salem partly turned the Prince down. The main reason for this was that Saud had already defaulted on several large loans from the NCB and the bank was already over committed.²⁸ In fact, Sheikh Salem had offered to raise half the required loan, - SR 25 million. Sheikh Salem did not have this sum available at the bank, but knew that he would be able to collect it from different people using his trust as collateral, - but Prince Faisal declared: "All or Nothing".²⁹

Prince Faisal was angry, and retaliated by withdrawing his own account from the NCB and ordering the other members of the Saud family to do the same. He then sent messages to the foreign consulates, notifying them that all pilgrim travellers should be informed that no cheques drawn on the NCB would be honoured by the Saudi Arabian government. Prince Faisal also posted an official notice in all government quarters, banning any form of dealings with the NCB. Sheikh Salem's reaction to all this was to ask his large and important clients to withdraw their money since he feared foreclosure.³⁰ Sheikh Salem was surprised to find, however, that many of his clients, from rich to poor, offered their financial support, thus, emphasising the trust and loyalty he had acquired over the years. Sheikh Salem did not surrender to this fate, and continually visited Prince Faisal, begging and pleading that the Prince should revoke his order, emphasising the effect that this situation would have on the Saudi Arabian economy as a whole if it were allowed to prevail much longer. After a period of one month, Prince Faisal acknowledged publicly that, because of this rejection he was forced to try harder to reduce the government's spending levels. In order to show his appreciation and trust, he handed all his money back to Salem Bin Mahfouz, and gave him Power of Attorney to control all his

personal affairs in the Kingdom and abroad.

Sheikh Salem then decided to see how much damage this had caused to the NCB's reputation. Consequently, for the following six months, he toured around the world, visiting Swiss, Canadian, Australian, Arabian, Far Eastern and many other national banks. Sheikh Salem found that they all approved of his stand, and offered him their financial support. So, if anything, this incident had only served to enhance the status of the NCB, and had strengthened Sheikh Salem's credibility and esteem amongst his fellow bankers.

7.5 Expansion and Competition

Due to the expansion of oil production in the 1950's, Saudi Arabia experienced an increase in its revenues. This increase resulted in a dynamic overall development of the economy, which was reflected in the growth of income, and in turn, the encouragement of imports. At this stage, it was apparent that Saudi Arabia needed more financial institutions that would handle letters of credit and trade-related activities, especially when SAMA was only responsible for the issuance of notes and the supervision of banks, namely, the NCB, Bank of Iran and the Middle East - later known as the British Bank of the Middle East, the Dutch Bank and Bank de l'Indochine et de Suez. This potential opportunity was soon recognised by a group of people from the Central and Eastern areas, who resolved to establish a financial institution that would help them to capture the desired market segment.³¹ Thus, the Riyadh Bank was founded in Saudi Arabia's commercial centre - Jeddah. This was followed by the swift opening of several branches.

The Riyadh Bank was so over-zealous in its expansion policy that it did not adequately and fully screen its new customers. Therefore, it was not surprising that in the early 1960's it faced a large number of bad debts. Soon rumours started to unfold as to the confidence attributed to the bank's performance, and this in turn drove many to the withdrawal of their deposits. The Bank had no alternative but to turn to SAMA for help.³² SAMA at the time was a rather young institution, and had not had adequate experience. Nevertheless, it was able to help by acquiring 38 percent of the bank's shares, and then it placed one of its managers on the board of directors.³³ Consequently, SAMA became more cautious about allowing new banks to enter the Kingdom's financial markets. It

acknowledged that if it was to face a similar situation at another date, it at least expected to be fully informed and aware of the situation in order to offer the necessary assistance.³⁴

It is apparent that, during the initial period, owing to the boom in the economy as the production of oil increased, the NCB accumulated large profits. In fact, its balance sheet grew from SR 111 million in 1954 to SR 1,661 million in 1970; and to SR 3,629 million in 1973.³⁵ On each letter of credit opened, the bank would often earn up to 1 percent per quarter; and it would also make a profit from the exchange rate transaction.³⁶ The average cost of financing in Jeddah in 1974 was 2.5 percent and the majority of loans were given at an interest rate of 6-7 percent.³⁷ The bank made substantial profits from exchange rate activities. It was imperative that this service was provided to the merchants so that they could pay the importers the necessary amounts in the appropriate currency. In this, the banks were faced with heavy competition from the money changers.³⁸

It is also worth noting that in its early development stage, Saudi Arabia faced many infrastructural difficulties - as mentioned in Chapter Five. The bank suffered a great deal from the lack of communication systems, both when dealing with the outside world and their locally scattered branches.³⁹ Only 31,600 telephone lines existed in 1973, that is to say, 1.2 lines for every 100 people; telexes were few and far between, and air communication left much to be desired.⁴⁰ Thus, the NCB, like other banks, found it necessary to allow its branch managers to operate with a considerable degree of autonomy and reach the necessary decisions themselves on matters such as to whom loans should be given, at what rate, how much, for how long, for example. This autonomy also suited Sheikh Salem's policy of management as he felt it was necessary to allow management to operate independently showing his complete trust in them and their judgement. Perhaps what encouraged him to do so was the fact that most of his employees were effectively and efficiently trained. For, since 1955 many of the senior managers were sent abroad to Europe and the United States for specialised training, and in 1957 the NCB established a training centre in Jeddah to cover all necessary areas of bank training, thus, producing employees of high calibre. The bank also hastened to establish contracts with the Saudi Arabian Universities.⁴¹ Another policy of the bank which was established in 1955 was to instigate annual general meetings for all important bank employees, in which discussions

of the bank's performance would take place, and then the agenda and budget would be proposed for the following year. Here, the bank's employees would also be encouraged to air their views, make constructive criticism, and suggest ideas that might serve to enhance the bank's future performance. The actual growth in the number of branches was from nine branches in 1954 to 90 branches in 1979, ⁴² emphasising the increasing demand for banks, due to the boom in oil prices and hence, the economy.

7.6 Service to Society

The NCB did not perceive itself just as a financial institute. Its founder felt that it was his duty to give the country back some of the wealth that he had acquired. Therefore, he embarked upon several economically useful plans. In 1955 the NCB set up a department responsible for choosing and developing buildings for the housing of low-income families. This programme was carried out during the housing crises in the 1950's through to the 1970's. Properties were rented out at below the market rate. The bank's profit was very low; in fact, had the money been invested in world markets, the profit would have been far greater; moreover, 113 of the flats were given free to impoverished citizens.

Another charitable and economically useful service that Sheikh Salem accomplished was to take on the responsibility of developing water irrigation systems to serve people in agricultural areas such as Tahama. This idea was developed by his elder son Mohammed and reaped success for the farmers. In fact, to date the number of irrigation systems established by the NCB in Tahama equalled 400 and had cost a total of some SR 40 million.

Sheikh Salem also participated financially in the establishment of hospitals and health-orientated centres all over the Kingdom. He also helped to build several mosques in different parts of the country. The NCB has also given aid to several Third World countries, which totals, to date SR 500 million, and was either in the form of finance or essential amenities.

Sheikh Salem had nurtured and developed ideas that had resulted in success in every possible way; he had continued to preach to his employees, whom he had always made

sure had been satisfied both financially and mentally, that they were not just a financial support, but a friend to the client, advising and supporting when necessary, and always coming to their aid when problems arose, so long as the ultimate goal was the general welfare of the state and of society. This objective is perhaps not surprising when we know that the founder himself came from a humble background, - a background that had remained entrenched in his memory and his daily life, the fact, for example, that he never learned to read or write. The NCB was a dream that became reality through hard work and perseverance. It accomplished success in spite of the many obstacles placed in its path. It played an important role in the Saudi Arabian economy, operating as a central bank, commercial bank and friend to the kings, princes and general public.

Notes:

- (1) Wilson, Rodney. Banking and finance in the Middle East London: Macmillan Publishers Ltd., 1983, p. 1.
- (2) Ibid., p. 2.
- (3) Ibid., p. 87.
- (4) Wilson, Rodney. "The Evolution of the Saudi Banking System and its Relationship with Bahrain." Paper presented to the University of Exeter Centre of Arab Gulf Studies Conference on Saudi Arabia, July 1980, p. 4.
- (5) Wilson, (1983), op. cit., p. 87.
- (6) Ibid., p. 87.
- (7) Ibid., p. 87.
- (8) Ibid., p. 87.
- (9) Interview with Sheikh Salem Bin Ahmed Bin Mahfouz in May, 1990.
- (10) Wilson, (1983), op. cit., p. 87-8.
- (11) Ibid., p. 88.
- (12) Ibid., p. 88.
- (13) Ibid., p. 89.
- (14) Ibid., p. 89.
- (15) Ibid., p. 89.
- (16) Ibid., p. 89.
- (17) All information in this section and the subsequent sections of this chapter, if not otherwise footnoted, were obtained from interviews with Sheikh Salem Bin Ahmed Bin Mahfouz during the summer of 1989 and in May 1990.
- (18) Dates from this point onwards in this chapter, were converted from the Hijree Year to an Anno Domini using Appendix: 7.1.
- (19) Niblock, Tim. State, Society and Economy in Saudi Arabia Kent: Croom Helm Ltd., 1983, p. 280.
- (20) Ibid., p. 280.
- (21) Ibid., p. 281.
- (22) Information obtained from the NCB's Department of Research.

- (23) This date was obtained from Sheikh Mohammed Bin Salem Bin Mahfouz and was confirmed by his father.
- (24) Niblock, op. cit., p. 280.
- (25) Information obtained from the NCB's Department of Research.
- (26) Niblock, op. cit., p. 280.
- (27) Information obtained from the NCB's Department of Research.
- (28) Lacey, Robert. The Kingdom Great Britain: Fontana Paperbacks, 1982, p. 323.
- (29) Information obtained from the NCB's Department of Research.
- (30) Lacey, op. cit., p. 323-4.
- (31) Niblock, op. cit., p. 281.
- (32) Ibid., p. 282.
- (33) Ibid., p. 282.
- (34) Ibid., p. 282.
- (35) Al-Sakaf, M.A. "The NCB, Half a Century of Saudi Arabian Banking." Research Department - The NCB, Jeddah, p. 4.
- (36) Sez nec, Jean-Francois. The Financial Markets of the Arabian Gulf London: Croom Helm Ltd., 1986, p. 3.
- (37) Ibid., p. 3.
- (38) Ibid., p. 3-4.
- (39) Ibid., p. 4.
- (40) Middle East Economic Digest, Vol. 16, 28th September, 1972.
- (41) Al-Sakaf, op. cit., p. 7.
- (42) Ibid., p. 6.

APPENDIX. 7.1: CONVERSION FROM HIJREE YEARS TO ANNO/DOMINI

| HIJREE | ANNO DOMINI | HIJREE | ANNO DOMINI | HIJREE | ANNO DOMINI |
|--------|-------------|--------|-------------|--------|-------------|
| 1329 | 1909 | 1353 | 1933 | 1377 | 1957 |
| 1330 | 1910 | 1354 | 1934 | 1378 | 1958 |
| 1331 | 1911 | 1355 | 1935 | 1379 | 1959 |
| 1332 | 1912 | 1356 | 1936 | 1380 | 1960 |
| 1333 | 1913 | 1357 | 1937 | 1381 | 1961 |
| 1334 | 1914 | 1358 | 1938 | 1382 | 1962 |
| 1335 | 1915 | 1359 | 1939 | 1383 | 1963 |
| 1336 | 1916 | 1360 | 1940 | 1384 | 1964 |
| 1337 | 1917 | 1361 | 1941 | 1385 | 1965 |
| 1338 | 1918 | 1362 | 1942 | 1386 | 1966 |
| 1339 | 1919 | 1363 | 1943 | 1387 | 1967 |
| 1340 | 1920 | 1364 | 1944 | 1388 | 1968 |
| 1341 | 1921 | 1365 | 1945 | 1389 | 1969 |
| 1342 | 1922 | 1366 | 1946 | 1390 | 1370 |
| 1343 | 1923 | 1367 | 1947 | 1391 | 1971 |
| 1344 | 1924 | 1368 | 1948 | 1392 | 1972 |
| 1345 | 1925 | 1369 | 1949 | 1393 | 1973 |
| 1346 | 1926 | 1370 | 1950 | 1394 | 1974 |
| 1347 | 1927 | 1371 | 1951 | 1395 | 1975 |
| 1348 | 1928 | 1372 | 1952 | 1396 | 1976 |
| 1349 | 1929 | 1373 | 1953 | 1397 | 1977 |
| 1350 | 1930 | 1374 | 1954 | 1398 | 1978 |
| 1351 | 1931 | 1375 | 1955 | 1399 | 1979 |
| 1352 | 1932 | 1376 | 1956 | 1400 | 1980 |

Chapter Eight

The National Commercial Bank's Financial Position

In this chapter I will analyse the NCB's overall performance based on actual data and in relation to the economic climate. It is worth noting at this point that the bank has always been and continues to be under private ownership. The bank's performance will be discussed within four main categories, firstly, its deposit growth activities, secondly its asset growth activities, such as liquidity growth, growth of loans and advances, growth in investments, and growth in capital and reserves, thirdly, its revenue sources i.e. income from investments and real estate, income from money exchange and foreign trade activities, and finally its profit/loss growth.

The Saudi Arabian economy has long experienced the transition from a barter economy to a monetised one. However, whether or not the Saudi economy has evolved from its monetised state to an economy fully dependent on financial intermediation and whether or not the Saudi Arabian nationals perceptions of banks has shifted i.e. from the reliance on money for their transactions to the dependency on checking accounts will be discussed in the context of the NCB. Furthermore, consideration is given to what influences the NCB's clients' choice of the type of account that is held and why do they borrow and how does this effect the economy? Those issues are tackled in broad terms, since it is difficult to obtain the actual figures for business borrowing, trade credit, and borrowing for consumption.

The period from 1955 to 1973 is discussed in broad terms while the years 1974 to 1989 are dealt with in detail. This is due to the unavailability of published information emanating from Saudi Arabia during the earlier period. Therefore, there are few explanations available to support the figures for this period. Similarly, it was also difficult to obtain the GDP deflators for the earlier period as the International Financial Statistics Yearbook only goes back to 1968 with reference to Saudi Arabia. Thus, only the figures for the period 1974 to 1989 were deflated to give a true and more accurate reading.

8.1 An Overview: 1955 to 1973

The bank's operations in its early years were on a very small scale and the fluctuations from year to year were not major. This has to be viewed in context of the environment in which the bank was operating. The environment was characterised by a general aversion towards banking activities, which encouraged and effectively promoted a cash oriented

society.

The NCB's deposits increased from SR 783 million in 1967 (the earliest figures available) to SR 1,766.61 million in 1973 (see table 8.1). The main contributor to this rise was customer's deposits with an 18 percent increase from 1970 to 1971 and a 36 percent increase from 1971 to 1972 and finally a 24 percent increase from 1972 to 1973. This is not unexpected, with the economy prospering it is inevitable that some of the wealth would be passed back to the banking system. Another reason for this rise could be attributed to expatriates opening accounts. The NCB had branches in several different areas of the Kingdom and in the early 1970's many infrastructural and development projects were in progress and therefore, many expatriates were needed.

Another apparent increase was in the total assets of the NCB. During this period they ranged from SR 376.10 million in 1955 to SR 3,629.04 million in 1973, as shown in table 8.1, with a noticeable increase of 34 percent from 1971 to 1972. The main cause for this was the increase in the NCB's deposits abroad and with other banks, which was a result of its policy to participate with a group of Arab and European banks in establishing a worldwide commercial banking network, the Arab European Bank with branches in Frankfurt and Brussels and with its headquarters in Luxembourg. The NCB also contributed in the development of an investment banking company in Luxembourg and Paris. The bank's main objective behind these investments was to establish a direct link with European and Arab banks to ensure the smooth running of Saudi business abroad and to have access to new foreign clients. The bank was also able to tap into investment opportunities that were not available to it in Saudi Arabia.

Another obvious rise in the total assets figure occurred from 1972 to 1973 and equalled 45 percent. This escalation was due to firstly, an increase in the cash fund, namely in the cash deposited with SAMA, and secondly, an increase of about 20 percent in the loans and advances to the private sector, which was not surprising since the Saudi Arabian government encouraged the diversification into non-oil sources of income. In fact, the growth of non-oil GDP between the early and mid 1970's was at an average rate of 11.6 percent. The final notable change to total assets was in the total capital and revenue reserve figure. This increased from SR 48 million in 1955 to SR 100 million in 1973 (see table 8.1) with a 33 percent rise from 1972 to 1973.

Table No. 8.1: National Commercial Bank's Financial Performance 1955 - 1973

| Assets | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 |
|--|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Cash | 45 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 97 | 106 | 99 | 112 | 150 | 118 | 175 |
| Cash Fund | 45 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 195 | 199 | 188 | 190 | 287 | 287 | 619 |
| Deposits with Banks Abroad | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 82 | 81 | 71 | 180 | 194 | 510 | 420 |
| Deposits with Banks | 38 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 84 | 86 | 72 | 183 | 198 | 512 | 426 |
| Investment Abroad | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 | 25 |
| Investment | 14 | 0 | 16 | 16 | 17 | 19 | 20 | 20 | 21 | 21 | 22 | 23 | 15 | 17 | 19 | 20 | 22 | 44 | 70 |
| Loans & Advances to the Private sector | 160 | 191 | 199 | 226 | 215 | 219 | 228 | 255 | 284 | 392 | 436 | 543 | 495 | 530 | 508 | 490 | 524 | 474 | 567 |
| Loans & Advances etc. | 163 | 196 | 204 | 233 | 225 | 227 | 229 | 258 | 292 | 397 | 443 | 552 | 499 | 533 | 544 | 526 | 563 | 591 | 706 |
| Fixed Assets | 26 | 0 | 35 | 44 | 47 | 57 | 57 | 58 | 58 | 55 | 58 | 56 | 35 | 35 | 36 | 44 | 43 | 40 | 43 |
| Total Assets | 376 | 548 | 584 | 538 | 512 | 614 | 608 | 725 | 861 | 156 | 1,240 | 1,292 | 1,398 | 1,538 | 1,554 | 1,661 | 1,862 | 2,504 | 3,629 |
| Liabilities and Owners Equities | | | | | | | | | | | | | | | | | | | |
| Statutory Reserve | 18 | 21 | 26 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 | 33 |
| Other Revenue Reserve | 0 | 4 | 4 | 5 | 5 | 5 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 6 | 12 | 37 |
| Total Capital and Reserve | 48 | 56 | 60 | 70 | 68 | 68 | 66 | 66 | 66 | 66 | 66 | 66 | 66 | 66 | 66 | 66 | 69 | 75 | 100 |
| Customers' Deposits | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 610 | 649 | 657 | 728 | 859 | 1,168 | 1,447 |
| Deposits from Banks | 18 | 22 | 13 | 42 | 35 | 16 | 18 | 22 | 30 | 38 | 47 | 65 | 54 | 72 | 6 | 13 | 9 | 37 | 20 |
| Total Deposits | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 783 | 839 | 799 | 863 | 1,004 | 1,390 | 1,767 |
| Profit (Loss) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 6 | 6 | 6 | 6 | 6 | 3 | 0.2 | 8 |

NOTE: Above figures obtained from the National Commercial Bank's balance sheets

This shows the growth of the NCB over the years in line with the economy. In fact prior to the 1970's, there was much less activity in the economy with very restricted oil revenues. The bank's capital base was severely restricted, with no equity market and no secondary market for money market instruments such as commercial papers. All these factors stunted the NCB's growth during this period.

8.2 The NCB's Performance from 1974 to 1989

The NCB's performance has, throughout the period, mirrored the growth of the Saudi economy in general. It is reasonable to expect this to be so, because, the NCB was one of the two 100 percent Saudi owned bank in the Kingdom and nationally owned banks enjoyed privileges over other banks.

The NCB's progress from 1974 onwards is particularly noteworthy, because one has to consider that it started off at a period when the Saudi economy was very impoverished and extremely unsophisticated. The NCB has, over the period, made a positive contribution to the economic and financial growth of Saudi Arabia, as can be seen from the data obtained from 1974 onward.

8.2.1 NCB's Deposit Growth

The structure of the NCB's deposits can be categorised into the following: demand deposits i.e. current, checking, transactional; savings deposits and time deposits. When the NCB accepts money on deposits, it is providing a place for safekeeping for its clients and simultaneously it is also giving them an opportunity to acquire a return on their deposit - at least in the case of saving and time deposits. The main division drawn between the different types of bank accounts is that firstly in the case of demand deposits the client has access to checking facilities and is able to withdraw funds without giving any notice. The second type of deposit account is known as a savings account; here the client earns interest (in the Saudi case commission) on his deposit and is allowed immediate access to his funds but is not given cheque facilities. The final type of account is a time deposit account, here the interest is greater than that procured from a saving account, but if the funds are withdrawn before the maturity date then the client must forfeit all the interest earned for this relevant period.

I had hoped to be able to look at the different types of deposits i.e. current account, savings and investment accounts, but unfortunately the NCB amalgamates all three figures into one on the balance sheet. The breakdown of deposits into current accounts i.e. transaction deposits, and savings and investment deposits would have helped to determine whether or not there was a real spread of the banking habit with customers of the NCB i.e. whether Saudis were using the bank just for depositing their excess money or genuinely using it for day to day spending.

Increased confidence in the NCB was reflected by a 31 percent increase in deposits kept with the bank. The deposits as mentioned above included customers' current, saving and deposit accounts and deposits from banks. The total amount in real terms was SR 8,197.69 million in 1975 compared to SR 6,230.50 million in 1974 (see table 8. 2). This showed that the Saudi financial system was becoming increasingly "monetised" and the banking system in general was expanding. The Saudi population was lending increasing support to the banking system and the bank's customers were becoming more sophisticated. However, the NCB needed to render a more efficient service, since in many cases it was difficult and tedious to draw cash from a NCB branch in Riyadh if the account held was in Jeddah. The cashier would have to literally telephone Jeddah to confirm the balance of the account and see whether or not the cash cheque was acceptable.

Deposits increased by 89 percent from SR 8,197.69 million in 1975 to SR 15,495.02 million in 1976 (see table 8.2). The main contributor to this increase were customer deposits which rose by SR 5,674.62 million in real terms. This reflected the general economic climate which continued to prosper. However, between 1976 and 1977 an increase of only 28 percent occurred in total deposits. This is not surprising since the period between 1976 - 1977 was the period of bank "Saudisation", which commenced in July 1976. The Saudisation programme affected the NCB adversely, because now the foreign banks could operate on an equal and competitive basis with the NCB. For example, previous government deposits could only be placed with the two 100 percent Saudi-owned banks - i.e. the NCB and the Riyadh Bank. Now, other banks competed with the NCB in this particular area. However, in 1977 the Algemene Bank Nederland and Banque de L'Indochine et de Suez was Saudised i.e. 60 percent of their share capital was sold to Saudi individuals, while the British Bank of the Middle East and Banque du

Table No. 8.2: National Commercial Bank's Financial Performance 1974 - 1989

| Assets | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|---------------|---------------|
| Cash | 559 | 772 | 1,090 | 1,112 | 1,532 | 142 | 1,790 | 2,096 | 2,055 | 2,241 | 2,347 | 859 | 731 | 1,208 | 828 | 701 |
| Cash Fund | 2,230 | 4,023 | 5,020 | 11,771 | 15,067 | 10,432 | 5,901 | 4,944 | 7,319 | 6,295 | 5,931 | 4,305 | 5,046 | 5,908 | 4,265 | 4,357 |
| Deposits with Banks Abroad | 1,263 | 1,352 | 5,287 | 3,007 | 3,878 | 5,977 | 6,744 | 10,363 | 14,805 | 16,476 | 23,551 | 23,761 | 29,101 | 31,564 | 31,642 | 27,779 |
| Deposits with Banks | 1,493 | 1,509 | 5,821 | 3,165 | 4,304 | 6,058 | 6,777 | 10,472 | 15,679 | 16,573 | 23,920 | 24,830 | 29,523 | 32,290 | 33,093 | 28,762 |
| Investment Abroad | 142 | 169 | 253 | 441 | 537 | 629 | 494 | 504 | 629 | 996 | 1,475 | 1,952 | 8,700 | 10,293 | 11,873 | 12,117 |
| Investment | 270 | 356 | 476 | 676 | 770 | 866 | 666 | 677 | 845 | 1,336 | 1,850 | 2,364 | 9,207 | 10,794 | 14,823 | 17,046 |
| Loans & Advances to the Private sector | 1,804 | 2,162 | 3,655 | 4,149 | 6,227 | 8,022 | 8,232 | 9,942 | 14,650 | 17,822 | 17,061 | 19,184 | 26,541 | 26,740 | 37,160 | 40,389 |
| Loans & Advances etc. | 2,508 | 2,967 | 5,077 | 5,457 | 7,825 | 9,113 | 9,209 | 10,798 | 16,208 | 18,987 | 18,650 | 20,970 | 29,885 | 30,061 | 39,246 | 42,238 |
| Fixed Assets | 68 | 182 | 169 | 330 | 484 | 381 | 376 | 412 | 932 | 1,298 | 1,542 | 1,682 | 2,613 | 2,561 | 3,065 | 2,872 |
| Total Assets | 12,583 | 16,407 | 32,068 | 37,354 | 46,104 | 46,207 | 37,232 | 41,040 | 66,866 | 74,180 | 84,389 | 85,374 | 111,807 | 133,580 | 97,543 | 98,162 |
| Liabilities and Owners Equities | | | | | | | | | | | | | | | | |
| Statutory Reserve | 73 | 57 | 55 | 47 | 45 | 34 | 25 | 22 | 27 | 29 | 31 | 33 | 40 | 39 | 40 | 37 |
| Other Revenue Reserve | 170 | 327 | 433 | 479 | 768 | 1,085 | 1,081 | 1,240 | 1,851 | 2,380 | 2,848 | 3,059 | 3,740 | 3,630 | 3,771 | 3,466 |
| Total Capital and Reserve | 310 | 573 | 668 | 679 | 962 | 1,233 | 1,187 | 1,338 | 1,966 | 2,506 | 2,980 | 3,200 | 3,912 | 3,797 | 3,945 | 3,626 |
| Customers' Deposits | 5,215 | 6,751 | 12,426 | 15,693 | 20,141 | 19,357 | 16,384 | 15,597 | 30,031 | 33,882 | 41,745 | 43,612 | 56,283 | 59,637 | 71,773 | 72,701 |
| Deposits from Banks | 77 | 416 | 747 | 1,900 | 3,609 | 3,982 | 2,402 | 4,296 | 4,688 | 3,664 | 4,926 | 4,969 | 13,154 | 15,269 | 16,848 | 14,903 |
| Total Deposits | 6,231 | 8,198 | 15,495 | 19,850 | 26,398 | 25,328 | 20,280 | 21,868 | 37,169 | 39,371 | 48,063 | 49,962 | 71,194 | 76,665 | 90,552 | 90,989 |
| Profit (Loss) | 44 | 35 | 255 | 367 | 123 | 87 | 61 | 100 | 145 | 145 | 94 | 100 | 98 | 95 | 99 | 91 |

NOTE: The above figures were obtained from the National Commercial Bank's balance sheets and then deflated using the GDP deflator (1985=100) from the International Financial Statistics Yearbook 1992

Caire were in the final stages of Saudisation.

From 1977 to 1978 deposits grew by 33 percent. This was an improvement on the previous year's growth rate and in line with the overall development of the economy. The Saudisation process continued to take place during 1978 and many of the recently Saudised banks opened new branches, putting the NCB under more competitive pressure. By 1979 the majority of banks had Saudised, and it is interesting to note that the NCB experienced a decrease of 4 percent in its deposits with customers' deposits being the main cause for this decline. Many factors could have caused this drop but it could be mainly attributed to decreased government expenditure, the private sector balance of payment deficit and finally to the NCB's slow pace in keeping up with technological bank developments, thus, causing its market share to decline.

This phenomena continued in 1980 with a major decrease in deposits equalling to 18 percent. However, in this case both customer and bank deposits suffered a decline. This result forced the NCB to take vigorous action in order to attract more clients. Even though total deposits increased by 8 percent from 1980 to 1981 customer deposits for this period declined and the main cause for this slight increase was bank deposits. It is worth noting that 1981 saw the completion of the Saudisation process of foreign banks, putting the NCB under even more pressure to improve its services. The decline of customers deposits, from 1979 to 1981, forced the NCB to recognise the need to update its banking facilities. Thus, by 1981 all branches of the NCB had their own computer access which enabled them to have immediate details of customers and general ledger accounts, but the branches were still not networked with each other. In fact, improvement and efforts by the NCB were being aimed at the eventual bank-wide automation.

In 1982 total deposits had increased by a record 75 percent with customers' deposits making the main contribution. This was a direct result of the bank's active effort of market targeting and customer computer links. With the programme of Saudising banks now complete, aggressive marketing became a major factor in obtaining deposits, and the results show that the NCB had managed to increase its branches from 92 in 1979 to 133 branches by 1982. Another contributor to the increase in the deposit figures for 1982 was the international rates which began to drop and, therefore, more time deposits were being placed in the NCB and other Saudi banks. As the Saudi Arabian economy started to

stabilise during this period, the deposits became long term. An added impetus to deposits growth was provided by new regulations that stipulated that money changers must stop taking deposits.

Deposits continued to grow at a reasonable rate i.e. 6 percent, which was 2 percent lower than the industry's average growth i.e. 8 percent. During 1983 the country experienced diminishing public spending and as a result a sluggish growth in bank credit to the private sector followed. Hence, the low growth rate of deposits. However, in 1984 total deposits grew by 22 percent. One of the main contributors to this increase was a higher bank claim on the private sector, while another reason was the expanding number of the NCB branches.

Total deposits amount to SR 49,961.66 million in 1985 compared to SR 48,062.90 million in 1984. This represented an increase of only 4 percent. This was due to diminishing public spending and a relatively sluggish growth in bank credit to the private sector. However, total deposits grew by an astounding 42 percent from SR 49,961.66 million in 1985 to SR 71,193.81 million in 1986. The increase in the number of branches to 174 i.e. 28 percent of the total number of commercial bank branches in the Kingdom, helped to increase the number of the NCB customers. According to the bank's annual report, term and savings deposits accounted for the bulk of the growth, while demand deposits fell.

At this point I would like to ask what determines a person's choice of the type of account he keeps? Normally money that is deposited in current accounts is held in this way for two purposes; firstly, for settling day to day transactions and the usual cash withdrawals; the second reason is the precautionary measure i.e. for such payments as repairing the television set or washing machine or even the car. In these cases the deposited money in the current account performs the same function as cash, but with the added safety of the bank vaults. Money deposited in savings accounts serves similar purposes as that in the current account but the differences being, firstly, interest is earned and secondly, if the client wants to make payments he must draw the necessary funds in cash. Time deposits normally give the highest return the longer the commitment, their disadvantage is that if they are withdrawn prior to their maturity date then the client stands to lose out all interest earned. In the case of clients of the NCB the choice between a

current account and a savings account is obvious, since most payments in Saudi Arabia are made in cash and since safety is not a problem as crime levels are low due to the severity of the punishment for theft. With the added incentive of interest earned, savings accounts are definitely preferred. Time deposits are also used for saving purposes i.e. money that is kept there is normally used for important purposes. Had there been an increase in demand deposits it would have indicated the spread of the banking habit amongst the NCB's customers. However, as this stands it would appear that the NCB's clients use the bank as a place to put excess liquidity and make some return on it i.e. the NCB's clients have not evolved from the monetised stages of financial development.

During 1986 a very small number of the NCB cash points were available to its customers. This facility encouraged clients to keep transaction balances at the bank, knowing that if necessary they can access cash even during the bank's closing hours. Saudis almost entirely rely on cash when making purchases, credit cards are not used often since the purchaser is expected to pay a surcharge to the shop if an acceptable credit card is used i.e. the commission that is normally paid by the shop to the credit card company is born by the customer. Another contributor to the increase in total deposits was a substantial rise in the cost of deposits acquired by local banks.

Growth in total deposits was equal to 8 percent in 1987 and according to the NCB reports, time and savings deposits accounted for the major portion of this increase. The continued growth of time and savings deposits at the expense of demand deposits had an impact on the NCB's cost of funds. In general terms it is accepted that the main influence on the size of the current accounts is the level of the overall business undertakings in the economy at the time. Hence, if the economy was going through a recovery period and business was booming, then it follows that bank transactions would increase in volume and value, which in turn would result in an increased demand for money on current accounts. Likewise, a decline in the general level of prices would, *ceteris paribus*, decrease the level of transactions and hence reduce the number of current accounts. In the Saudi Arabian case this would apply to the savings accounts. However, in this situation savings deposits were increasing but at the expense of demand deposits which suggests that the bank's clients are merely switching funds between accounts. In times of recession people often try not to forgo any opportunity of making some extra money.

Another point to be made would be that when a person shifts funds from a saving account to a time deposit account he has in a sense decided to give up some of his consumption and as a result this move will eventually influence aggregate levels of output and employment. The only problem that the NCB can experience is if a great number of clients decide to withdraw large sums simultaneously. This can be overcome if the bank keeps high liquidity levels in order to be able to satisfy demand and only lend short-term. However, if the bank feels it can have access to funds if necessary from SAMA or other banks then this problem could be dealt with without keeping high levels of liquidity, which is an unprofitable situation. The NCB can also try to forecast the demand for saving deposits if they are used for transactions and precautionary spending.

The growth in aggregate deposits in 1987 could also be attributed to an increased number of the NCB branches that opened during the year. Another contributing factor could be SAMA's permission for commercial banks to extend the operating times of automated teller machines from 15 to 24 hours a day and to allow them to increase the sum of cash withdrawn per day from SR 4,000 to SR 5,000.

Total deposits amounted to SR 90,552.10 million in 1988 compared to SR 76,664.56 million in 1987, and showed a growth of 18 percent. According to SAMA, unlike previous years a greater portion of this increase is reflected in demand deposits, which was brought about by the reduced rate of return on time savings deposits and also by the general increase in the volume of economic activity.

In 1989 an increase of only 0.5 percent was experienced in the total deposit growth rate of the NCB. Customer deposits increased by 1.3 percent whereas deposits from banks decreased by 11.5 percent. The major components of the growth were customer deposits. However, the decrease in bank deposits was caused by a drop in deposits from banks abroad. This could be attributed to world recession.

A point worth considering here would be the foreign companies deposits and expatriate deposits held in Saudi riyals at the NCB. One issue is whether or not the bank would be able to come up with foreign currencies equal to those deposits if those clients suddenly decided to withdraw all their deposits simultaneously and in their own currencies. The bank naturally is under no obligation to keep enough foreign currencies to cover all its foreign clients. The NCB would have to look to SAMA for help and if we

presume that all the other Saudi commercial banks were experiencing a similar situation they too would turn to the central bank for help. This would put SAMA's foreign holdings under pressure and if the amounts are great enough they would affect the reserve level and hence lead to a balance of payments problem. From the early 1970's to the early 1980's with the development plans in full force the occurrence of such a situation could have been disastrous to the Saudi Arabian financial system. However, in recent years this would not have been so bad an experience, since Saudi Arabia has depended more and more on its own companies and human resources.

The NCB's total deposits increased from SR 6,230.50 million in 1974 to SR 90,989.01 million in 1989, a rise of 1,360 percent. The total customer deposits figure grew from SR 5,214.85 million in 1974 to SR 72,700.62 million in 1989, while deposits from banks rose from SR 76.83 million in 1974 to SR 14,902.90 million in 1989. However, due to the Saudisation of commercial banks in 1976, the NCB was faced with more competition, which forced it to be more aggressive and up to date with its facilities in order to provide a better service to its clients and, hence, successfully compete with the other banks. The NCB's deposit taking was very much influenced by the Saudi Arabian economic climate. When the government increased its spending this would trickle back to its nationals and thus deposits with the NCB would increase. In fact, in recent years the NCB has embarked upon extensive marketing programs to encourage the growth of deposits. As the Saudi Arabian economy started to stabilise the deposits became longer term. Hence, it was possible to surmise from the text available in the financial reports that the NCB's customers kept their money in, mostly, deposit and savings accounts. In fact, demand deposits decreased over the period i.e. the banking habit did not spread amongst the NCB's clients.

8.2.2 The NCB's Asset Growth

In order to determine the performance of the NCB's assets it was necessary to look at four different categories, namely, liquidity growth i.e. cash, loans and advances growth, investment growth and finally capital and revenue reserve growth.

8.2.2.1 Liquidity

The liquidity of the bank is its prompt ability to meet its depositors demand for

withdrawal. This does not mean that the bank must hold liquid assets - by liquid it does not mean only cash, but any asset that can be swiftly changed to cash with very little loss of value - equal to the deposited funds. What determines the bank's level of liquidity is the expected deposit drain that the bank may face. Traditionally, banks have restricted themselves to short term business loans, "the Real Bills Doctrine", in order not to jeopardise their liquidity position. A bank has two sources of liquidity, either through borrowing from other banks or selling its asset holdings. However, how much the bank would depend on its asset holdings would be determined by the availability and cost of borrowing. It is not to the banks advantage to keep very high liquid levels as this means it had to forgo some income that could have been made. Hence, a bank must always balance its wanted income against its necessary liquidity.

The NCB's cash in hand, and with SAMA, local banks and foreign and local correspondence abroad amounted to SR 5,531.66 million in 1975 - excluding marketable securities, compared to SR 3,722.53 million in 1974. This represented a 48 percent growth rate. The bank's liquidity ratio was 67 percent despite expanded loans and advances. In 1976 cash in hand, and with SAMA, local banks and foreign and local correspondence abroad increased by 96 percent, while overall liquidity of the bank increased by 70 percent. This was attributable to increased government expenditure.

In 1977 the NCB's cash in hand and with SAMA, was SR 14,935.90 million compared to SR 10,840.72 million in 1976, a growth rate of 38 percent. The banks liquidity reached an all high of 75 percent which showed that the NCB did not know or was not able to make good use of the funds available, which basically meant either poor management or no available investment opportunities. However, the NCB itself attributed its high liquidity to SAMA's large reserve requirements, i.e. 41 percent of the total funds.

Cash in hand and with SAMA, local banks and foreign and local correspondents was SR 19,370.10 million in 1978 compared to SR 14,935.90 million in 1977. This represented an increase of 30 percent. The percentage increase had dropped from the prior period because of the decrease in statutory deposit requirements on demand and time deposits. However, the bank's liquidity was still high enough at 73 percent for the NCB to act as "lender of last resort" when SAMA's move to Riyadh caused administrative problems with the clearance of cheques and also the temporary weakness of the Dollar

forced companies operating in Saudi Arabia to acquire funds to meet future riyal liabilities earlier. These problems inhibited the velocity of money supply and the NCB honoured most of the cheques drawn on accounts with SAMA.

However, in 1979 the NCB experienced a decrease of 15 percent in its liquidity growth rate. This was due to SAMA's lowering of the statutory deposit requirements. Hence, this growth rate caused a liquidity crises and cash flow problems for the NCB. As a result, the NCB had to borrow riyals offshore where rates were higher than in Saudi Arabia. This involved a high element of risk, but the high profit potential and return on investment made it worth the bank's while. The liquidity growth rate continued to decline in 1980, in fact, it dropped by 23 percent. The main reason for this was SAMA's lowering of commercial bank reserve requirements in response to the pressure on bank deposits.

Cash in hand and with SAMA, local banks and foreign and local correspondents was SR 15,416.37 million in 1981 compared to SR 12,677.63 million in 1980. This represented a 22 percent increase. Through 1981, the money supply was kept within stringent but rational limits to curtail inflation. The cash fund and deposits with banks continued to increase and experienced a rise of 49 percent in 1982. This was mainly due to the increase in the statutory deposits with SAMA. However, the actual liquidity ratio dropped from 70 percent in 1981 to 62 percent in 1982, which meant that the NCB improved its management of available funds.

In 1983 the NCB's cash growth rate was practically zero, it only decreased by SR 131.18 million and simultaneously its liquidity ration dropped to 58 percent. This was due to a lowering of liquidity reserve requirements and a large decrease in deposits with banks in Saudi Arabia from SR 874.53 million in 1982 to SR 96.59 million in 1983. It is apparent from the balance sheet that these funds were used for the most part in investments in shares and securities abroad.

However, in 1984 cash in hand and with SAMA, local banks and foreign and local correspondents, increased by 30 percent while the actual liquidity ratio increased to 62 percent, which reflected poor management of funds, since SAMA statutory liquidity requirements was lower. This category had grown primarily due to substantial increases in deposits with other banks in Saudi Arabia and abroad. Domestic liquidity dropped due to a substantial decline in the domestic cash flow and government expenditure. However,

in 1985 the banks liquidity funds decreased by 2.4 percent. The major drop was in cash in hand and as a result the bank liquidity ratio decreased.

Cash in hand and with SAMA, local banks and foreign and local correspondents, totalled SR 34,569.82 million in 1986 compared to SR 29,134.15 million in 1985. This represented a 19 percent increase. Free and statutory reserve with SAMA increased, so did deposits with banks abroad. SAMA had increased the deposits requirements in order to prevent the growth of foreign assets owned by commercial banks in Saudi Arabia. To implement this plan, SAMA expanded the scope of the Bankers Security Deposit Accounts (BSDA) twice during 1986. It did so by introducing two new issues during the year. In fact, the liquidity ratio dropped yet again and reached 48 percent.

In 1987 liquidity funds increased by 10 percent. The main elements that increased were cash in hand and deposits with Saudi Arabian banks and banks abroad. The liquidity ratio also increased by 2 percent to 50 percent. Cash in hand with SAMA, local banks and foreign and local correspondents amounted to SR 37,357.98 million in 1988 compared to SR 38,197.89 million in 1987. This showed a small decrease of 2.12 percent. This decrease could primarily be attributable to the decline in cash in hand and deposits with banks abroad. However, this decrease was compensated by a slight increase in statutory deposits with SAMA. It increased the offering of Bankers Security Deposits Accounts (BSDA) to soak up the surplus liquidity in the banking sector in general. Also, the liquidity ratio decreased to 41 percent which shows that the NCB was perhaps beginning to understand the importance of making profitable use of available funds. In 1989 the liquidity funds declined by 11 percent to SR 33,119.04 million. The main reason for this drop was a reduction in deposits with banks in the Kingdom and abroad. The actual liquidity ratio continued to decrease and reached 36 percent in 1989.

8.2.2.2 Loans and Advances

The boom in oil prices in the early 1970's helped the Saudi Arabian government to finance extensive development plans with a high rate of acceleration. However, the rate of economic development meant that the government had to expand its financial system in order to cater for the country's development needs. As a result the government set up several financial agencies namely, the Saudi Credit Fund (for the import of heavy equipment), the Real Estate Development Fund (for construction purposes), the Saudi

Industrial Development Fund (for heavy manufacturing), the Saudi Agricultural Fund and finally the Saudi Credit Bank (for small business manufacturing). All these agencies meant that little was left for commercial banks to do apart from their usual role of supplying short-term loans to the private sector and accommodating the traders by opening letters of credit...etc. However, with the fall in oil prices in the 1980's the government was forced to retract its lending and as a result many of the government borrowers turned to commercial banks for loans. In fact even the government was forced to borrow by the late 1980's, this was done through the issuing of bonds to commercial banks.

At this point the question of why do people borrow must be addressed. It is possible to divide society into two main groups, those who's income is greater than their expenditure, the savers, and those who's expenditure is greater than their income, the borrowers. For the savers income is earned by producing goods and services, i.e. their savings are equal to a certain portion of goods and services that they have produced but did not use. In order for the economy to run smoothly these excess goods and services must be consumed by the borrowers in society (i.e. people in general, government, business) who spend beyond their means. However, in order for them to be able to borrow they must have some financial resources, apart from their regular income. There are two ways to borrow either direct (governments do this through the issuing of treasury bills) or indirect through financial intermediaries such as commercial banks. It is worth noting here that when a commercial bank is lending it is taking on two types of risks, a default risk which basically means that the borrower may not be able to pay back the whole or part of the loan on the due date. As a result of this the bank is then faced with the liquidity of the asset that was originally placed as collateral for the loan. This could mean that the bank may have to take on some losses as a result of the sale. However, in the case of Saudi Arabia the banks have even greater risk since the Islamic laws that govern the state forbid the taking of interest and do not allow the banks to repossess the collateral especially if it is something like a persons home. Due to the recession in Saudi Arabia many borrowers were not able or were not willing to pay back the money they owed to the NCB and the other banks. Banks have been reluctant to take those borrowers to court since the Sharia Law would reduce the interest payments already made on the loan and any new interest charged from the original loan. However, SAMA has now set up its own committee to deal with such borrowers.

Another question that needs to be imposed is why do people borrow and what are the economic implications of this? On the one hand we have the neoclassical economic theory that states that the main causal factor determining borrowing is the interest rate. If interest rates are high, people borrow less, but if it is low people borrow more and hence stimulate the economy. This theory may be true of individual borrowing in the case of Saudi Arabia. But with reference to commercial borrowing many argue, especially Keynesians and neo-Keynesians, that business borrowers would borrow no matter what the price of borrowing is since it is not the cost of borrowing that matters but the future economic climate. In the case of the NCB's business borrowers, the second theory could be applied, since loans and advances to the private sector has been on the rise since 1974.

The NCB's loans and advances to the private sector, banks and others and commercial papers bought and discounted amounted to SR 2,967.38 million in 1975, net of bad and doubtful debts, compared to SR 2,507.97 million in 1974. This represented a growth of 18 percent. In 1976 loan and advances rose to SR 5,076.74 million, a growth rate of 71 percent. This pronounced growth was due to the increased bank claims on the private sector. Even though 1976 saw the initiation of the Saudisation process of commercial banks this was not fully implemented until later. Therefore, the NCB had an advantage over the other banks and it continued to control the bulk of the commercial bank loans.

In 1977 loan and advances to the private sector, banks and others and commercial papers bought and discounted amounted to SR 5,457.31 million compared to SR 5,076.74 million in 1976. This represented an increase of only 7 percent. This was due to an increase in the availability of low cost finance from the specialised credit agencies i.e. the Real Estate Development Fund and the Saudi Industrial Development Fund. In fact loans and advances to the private sector increased by 13.5 percent in 1977 compared to the large increase of 69 percent in 1976. However, in 1978 the loans and advances growth rate was 43 percent, and the actual increase experienced by the loans and advances to the private sector equalled 50 percent. This could be attributed to the fact that the overall government credit agency disbursements were reduced since the government's actual expenditure exceeded the budgeted amounts, so borrowers turned again to commercial banks. This was particularly so because of the commercial sector's need to finance its inventory requirements.

Loans and advances to the private sector, banks and others and commercial papers bought and discounted amounted to SR 9,113.23 million in 1979 compared to SR 7,824.56 million in 1978. This represented a growth rate of 16 percent. The main reason for this increase was that loans and advances to the private sector rose by 29 percent. This was lower than the previous year, which reflected the increasing importance awarded to the specialised credit agencies as providers of finance. However, in 1980 loans and advances increased by a mere 1 percent which was a result of a low increase in loans and advances to the private sector equalling 2.6 percent. This reflected the bank's very conservative policy towards lending for that year. However, in 1981 we note an increase of 21 percent in the growth rate of the loans and advances figures, backed by a 17 percent increase in loans and advances to the private sector. This low increase in borrowing from the private sector was due to the Saudi Industrial Development Fund's continued support to the private businesses by giving 50 percent of the plants capital to 35 percent of private ventures.

In 1982 the loans and advances figure increased by 50 percent from SR 10,798.03 millions in 1981 to SR 16,207.61 million in 1982, while loans and advances to the private sector increased by 47 percent. This increase occurred despite the availability of low cost loans from specialised credit agencies and the growing trend for the government to finance the majority of the primary industry sector itself. It is also worth noting that during the year the government reduced its advance payment to contractors of government projects from 20 percent to 10 percent, this forced many contractors to call on commercial banks for interim financing.

Loans and advances to the private sector, banks and others and commercial papers bought and discounted, net of provisions for bad doubtful debts amounted to SR 18,987.16 million in 1983 compared to SR 16,207.61 million in 1982. This represented a growth rate of 17 percent. The decline in the growth rate of loans occurred despite SAMA's regulations that restricted offshore bank loan syndications. These restrictions were established in early 1983 in an attempt to prevent the internationalisation of the riyal which would mean, firstly, that SAMA would lose control of the money supply which could have serious implications for inflation and, secondly, the riyal would be subject to periodic speculative pressure and this could result in further availability crises in the riyal market. The restriction, however, did not cure the basic problem which the NCB and other

Saudi banks were experiencing i.e. competing with offshore banking units for loan business. In 1984 the loans and advances figure declined by 1.7 percent. This was also due to the credit activity of specialised credit institutions, such as, the Saudi Industrial Development Fund, the Saudi Real Estate Development Fund and the Saudi Agricultural Bank, which collectively disbursed SR 658.29 million. For the first time since 1974 the loans and advances to the private sector growth rate declined by 4.3 percent. However, in 1985 it increased by 12 percent while the total loans and advances figure rose by an equal percentage. This increase could be attributed to the fact that loans disbursed by specialised credit institutions dropped. Also, repayments on loans made by the NCB increased during the year.

In 1986 loans and advances to the private sector, banks and other and commercial papers bought and discounted, net of provisions for bad and doubtful debts, amounted to SR 29,884.84 million, while the total was SR 20,969.97 million in 1985. This represented a 42 percent growth rate. In the mean time, loans and advances to the private sector increased by 38 percent. This increase occurred despite reductions in both governmental revenues and contracts, which lead to an average 2.6 percent decline in banking credits to the private sector. The NCB growth rate was primarily due to the bank's ability to attract lenders from both the private sector and other banks. The loans and advances figure remain virtually unchanged for 1987 and so did that for the loans and advances to the private sector. However, in 1988 the loans and advances figure increased by 30 percent, from SR 30,060.94 million in 1987 to SR 39,245.72 million in 1988. However, SR 424.36 million of this amount was paid to withdrawing partners as value for their share which was sold to the remaining partners. This was included in the financial statements as loans and advances until the legal formalities relating to the withdrawal of the partners were completed. It is important to emphasise that since all comparatives are taken from financial statements these have to be included and explained. However, the increase in the loans and advances figure could be attributed to the fact that the NCB transferred profits for the financial period to the provision for loans losses.

Loans, advances, bills and commercial paper bought and discounted, net of provisions for bad and doubtful debts, amounted to SR 42,238.41 million in 1989 compared to SR 39,245.72 million in 1988. This showed an 8 percent increase. As in the previous year, these figures are taken from the financial statements and include amounts

paid by the bank to its withdrawing partners. In 1989, loans to withdrawing partners amounted to SR 390 million. Loans and advances to the private sector increased but at a very low rate of 9 percent compared to the 1987 rate of 39 percent. This was because of a more prudent credit policy adopted by the NCB. The NCB's objective during 1989 was to develop and extend its retail and investment banking services.

8.2.2.3 Investments

For the period between 1974 and 1985 investments grew at an average rate of 24 percent, from SR 270.08 million in 1974 to SR 2,363.75 million in 1985, with the investments abroad making the bulk of the figures in most years. In fact, for this period investments in shares and securities abroad had not seen any significant fluctuations. However, in 1986 investments increased to SR 9,206.60 million, a soaring growth rate of 289 percent, with investments abroad being the sole contributor to this increase since they increased by 345 percent in 1986. The reason for this could only be a new policy taken up by the bank to invest abroad, since this in most cases means higher returns. Investments of the NCB increased from SR 9,206.60 million in 1986 to SR 10,794.29 million in 1987. This represented an increase of 17 percent with investments abroad equalling SR 10,293.49 million for this year, making up almost the entire investment figure and a growth rate of 18 percent.

In 1988 investments rose to SR 14,823.17 million, an increase of 37 percent. This was due to an increase in investments abroad equalling 15 percent and the acquisition of Saudi government bonds worth SR 2,410.30 million by the NCB which helped to contribute to the growth in the investment figure. The Saudi government issued the bonds as an alternative to drawing on reserves to finance budget deficits. In 1989, investments of the NCB rose from SR 14,823.17 million in 1988 to SR 17,045.53 million in 1989, showing a 15 percent increase. During 1989 SAMA continued to issue Government Development Bonds in order not to draw on its reserves to finance a budget deficit. The NCB, therefore, increased its ownership of these bonds and equally it increased both its investment in securities in Saudi Arabia and abroad.

8.2.2.4 Capital and Reserves

Capital and reserve of the NCB have shown continued growth due to the general increase

in the NCB's activities and profits. This is an indication of the bank's ability to provide a substantial financial cushion for the future. The growth of capital and reserves is also a reflection of the NCB's profit growth.

Banking control law required that the status of the bank must be changed from a partner company to a Saudi share company. To implement this change, the NCB had to revalue its investment and real estate properties to current market prices prevailing at the balance sheet date. This resulted in a revaluation surplus of SR 77.90 million which was included as part of the capital reserve (undistributable).

Total capital and reserves amounted to SR 753.37 million in 1975 compared to SR 309.87 million in 1974. This represented an increase of 85 percent. By 1976 capital and reserve amounted to SR 668.34 million, which represented an increase of 16 percent on the previous year. The basic form of equity capital for the NCB has been through the accumulation of statutory reserves imposed by SAMA. This is an undistributable reserve. In 1977 capital and reserves remained virtually unchanged. However, in 1978 capital and reserves increased to SR 962.05 million, a growth rate of 42 percent. The main contribution to this increase came from revenue reserve where a transfer of SR 303.24 million occurred from the profits made for that year. This was done in order to enable the NCB to raise its credit limit for individual customers and to facilitate the bank's underwriting of syndicated facilities abroad.

In 1979 total capital and reserves were SR 1,232.83 million, a growth rate of 28 percent. The main increase was in the revenue reserve caused by increased profitability of the bank. In fact revenue reserve increased by 41 percent. However, capital and reserve declined by 3 percent in 1980 as did profits for the period. This suggests that the bank performance was poor for that year. This could be attributed to increased competition from the recently Saudised banks. In 1981 capital and reserves increased by 13 percent and this was due to the transfer of profits to revenue reserves which increased to SR 1,240.07 million, a growth rate of 15 percent. The NCB's policy has been so far to transfer the majority of profits to its revenue reserves in order to strengthen its balance sheet.

Capital and reserves rose by 47 percent in 1982 to SR 1,966.25 million. Revenue reserve reached SR 1,850.75 million, or a growth of 49 percent over the previous year. In

1983 capital and reserves equalled SR 2,505.82 million and marked a growth rate of 27 percent, again the main reason for this growth was the revenue reserve which also increased by 28 percent. The same phenomenon occurred in 1984 with an increase of 19 percent to capital and reserves due to an increase in the revenue reserve figure of SR 468.60 million. However, it is worth noting that the total capital and reserve growth rate began to decline from 1983 and in 1985 it was only 7.4 percent which suggested that the NCB's performance had begun to deteriorate. In fact, in the actual balance sheet the figure for the capital and reserve remained unchanged from 1985. This was interesting because the capital and reserve of all commercial banks taken as a whole increased by SR 1.1 billion. This was due to a large decrease in profits due to an increase in service charges and other provisions. Due to the small profit figure the bank was unable to retain and capitalise part of the profit from revenue reserves.

In 1986 the total capital and reserve remained the same due to an increase in other provisions, namely bad debts for customers who deliberately refused to pay back. This was the second year that the bank set aside a large amount of the revenue. In fact the bank decided to transfer all the profits to make provision for loan losses. Similar decisions were made in 1987, 1988 and 1989. Hence, capital and reserves remained unchanged throughout this period. By reducing its revenue reserve the NCB is reducing its liquidity and leverage ratios i.e. weakening the overall balance sheet. All profits were transferred to loans losses as already mentioned and will be discussed in the profit/loss growth section in detail.

Total assets increased from SR 12,583.36 million in 1974 to SR 98,162.42 million in 1989. However, in 1987 and 1989 the bank experienced a decline in its total asset figures. During the period 1974 to 1989 the liquidity assets grew at a reasonable rate, the bank was able in the final years to utilise its available funds in secure investment. Loans and advances grew dramatically over this period, and though overshadowed with bad debts, nevertheless, they proved to be extremely important for the bank's success.

From 1986, the NCB began to invest heavily in securities, but mostly abroad. However, it is apparent that if the NCB was offered similar securities in the Kingdom it would take them up immediately. This can be observed from its keenness to invest in Government Development Bonds. Finally, capital and reserves also experienced a

reasonable increase for the stated period.

8.2.3 Sources of Revenue in the NCB

8.2.3.1 Income from Investment in Real Estates

From 1974 to 1979 the NCB showed an amount with the heading profits from sales of real estate and the total of these figures was SR 126.78 million. However, from 1980 this profit was taken completely off the profit and loss account statement. It is apparent that the NCB from this point on decided to gain from its real estate through yearly income as opposed to one off profits from sales.

The net income from investments and real estates were nominal from 1974 to 1981. However, in 1982 the net income from investments in real estate experienced an increase of 330 percent and similarly in 1983 the net income from this item increased to SR 177.86 million. This represented a growth rate of 92 percent. But in 1984 it remained virtually unchanged. In 1985 the net income from investments and real estates reached SR 227.91 million, an increase of 44 percent over the past year. In 1986 it experienced a growth rate of 104 percent to SR 466.17 million, and again the growth rate was high in 1987 i.e. 97 percent. Income from investment and real estate rose again in 1988 to SR 1,342.61 million, a growth rate of 46 percent and in 1989 it reached SR 2,450.16 million an increase of 82 percent.

Despite the different economic trends within the Kingdom, it seems that with careful management of its real estate the NCB was able to make reasonable profits from property.

8.2.3.2 Income from Foreign Exchange Transactions and Other Services

In 1974 petroleum products were the only significant export item for the government and the main imports constituted commercial and consumption products. There was a substantial and sudden increase in oil prices during 1973-1974 and this was the major factor contributing to the increased revenues from oil and petroleum products. The same phenomena created world inflation and a balance of payments deficit in most of the consuming countries. The increased purchasing power in the hands of the Saudi nationals boosted the demand for imported goods. These transactions were denominated primarily in US Dollar and this created a large Riyal-Dollar

Table No. 8.3: National Commercial Bank's Liquidity Position 1974 - 1989

| Assets | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---------------------|-------|-------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Cash Fund | 2,230 | 4,023 | 5,020 | 11,771 | 15,067 | 10,432 | 5,901 | 4,944 | 7,319 | 6,295 | 5,931 | 4,305 | 5,046 | 5,908 | 4,265 | 4,357 |
| Deposits with Banks | 1,493 | 1,509 | 5,821 | 3,165 | 4,304 | 6,058 | 6,777 | 10,472 | 15,679 | 16,573 | 23,920 | 24,830 | 29,523 | 32,290 | 33,093 | 28,762 |
| Liquidity | 3,722 | 5,531 | 10,840 | 14,936 | 19,370 | 16,491 | 12,678 | 15,416 | 22,998 | 22,867 | 29,851 | 29,134 | 34,569 | 38,197 | 37,357 | 33,119 |

NOTE: The above figures were obtained from the National Commercial Bank's balance sheets and then deflated using the GDP deflator (1985=100) from the International Financial Statistics Yearbook 1992

Table No. 8.4: National Commercial Bank's Income 1974 - 1989

| Income | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|------|------|------|------|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Net Income from Foreign Exchange and Other Services | 305 | 366 | 711 | 776 | 908 | 1,198 | 1,538 | 2,208 | 3,428 | 3,264 | 4,177 | 4,673 | 5,119 | 4,617 | 8,506 | 7,643 |
| Net Income from Investments and Real Estates | 17 | 18 | 24 | 17 | 18 | 27 | 20 | 21 | 93 | 178 | 184 | 228 | 466 | 918 | 1,342 | 2,450 |

NOTE: The above figures were obtained from the National Commercial Bank's balance sheets and then deflated using the GDP deflator (1985=100) from the International Financial Statistics Yearbook 1992

exchange market.

Despite the low commission charges on riyal-Dollar transactions, (about a quarter of one percent) the bank still made large revenues, because of the substantial volume of these transactions. Therefore, volume compensated for the low margin. In fact, import financing through commercial banks in the Kingdom was reported to be SR 11,747.67 million at the end of 1974. This was due to the expansion of the economy and also due to the steep increase in the price of imported goods. The increased imports, enabled the bank to earn increased commission from letters of credit. All foreign companies exporting to Saudi Arabia used letters of credit and the bank charged between 1/8 to 1/4 of one percent of the value of the letters of credit. As imports increased the total value of the letters of credit became significant. In fact, in 1974 net income from foreign exchange transactions and other services i.e. letters of credit was SR 304.65 million.

There were some dramatic financial and monetary developments in 1974 and these had their effects on banking operations. The Bretton Wood agreement and Smithsonian agreement were abandoned, as the fixed exchange rate system was replaced by floating exchange rates. This created instability in foreign exchange markets. Despite these unsettling events, the NCB managed to emerge with some success.

Net income from foreign exchange transactions and other services amounted to SR 366.29 million in 1975 compared to SR 304.65 million in the previous year. This represented 20 percent growth rate. The sale of foreign currencies contributed heavily to the increase in net income. This was necessary because of the substantial increase in imports. The volume of imports financed through commercial banks was SR 19,207.69 million, an increase of 39 percent. The increase in imports substantiated the fact that the country was experiencing an economic boom. During 1975 operating expenses increased by 1.53 percent. It must be mentioned here that in 1975 Saudi Arabia and other oil producing countries experienced a significant fall in revenue from oil as demand shrunk. This was attributed to the economic recession in non-oil producing countries. This had an adverse effect on the NCB's revenues but, it was more than offset by the income that the bank received from its foreign exchange transactions, import financial activities and other services. Hence, the overall position of the bank was favourable.

In 1976 income from foreign exchange transactions and other services equalled SR

711.26 million. This represented a growth rate of 94 percent. The major cause was an equally steep rise in import financing activities. However, in 1977 income from foreign exchange transactions and other services only grew by 9 percent, nevertheless, this increase was primarily attributed to increased imports, which are characteristics of any purchasing power due to the boom in the construction business.

In 1978 net income from foreign exchange transactions amounted to SR 907.94 million compared to SR 775.94 million in 1977. It is interesting to note that most of the increase was attributed to increased imports of items for infrastructure development rather than of consumer goods. The three main commodities of imports were structures, aircraft parts and large trucks. Import financing through the NCB was substantial, but not as high as in previous years. This was due to the increased competition from other "Saudised banks". It must be mentioned here that in 1978, the NCB incurred a substantial increase in its expense items relating to personnel costs and service charge due to high international interest rates and an increased number of Saudi Arabian deposit accounts. Other expenses such as office refurbishment and relocation cost were also incurred. Meanwhile employee retirement benefit provisions and provisions for bad and doubtful debts expense increased.

Net income from foreign exchange transactions and other services amounted to SR 1,197.94 million in 1979 compared to SR 907.94 million in 1978, an increased growth rate of 32 percent. This was primarily attributed to the increase in the bank's import financing activities. The increase in imports was caused by increased private consumption of consumer goods reflecting the increased personal income. However, in 1980 the growth rate was lower than the previous years i.e. 28 percent, nevertheless, it was high. Again the main reason for this increase was the increase in the bank's import financing activities. Also, part of the growth was due to increased construction contracts involving foreign companies which created a need for guarantees to ensure proper competition of all contractual obligations. These construction projects were required for the Kingdom's major infrastructural developments.

In 1981 net income from foreign exchange transactions and other services amounted to SR 2,207.79 million representing a growth rate of 43 percent though to some extent this reflected the fact that the riyal was devalued during the year. However, high riyal interest

rates persisted and rose to as high as 20 percent for overnight interbank loans, but by the end of the year rates had dropped to as low as 8 percent. With the development plans in progress, imports continued and hence, the NCB continued with its import financing activities and revenues continued to be earned from foreign exchange transactions. However, the NCB's expenses increased to SR 1,847.10 million in 1981 compared to SR 1,198.84 million in 1980. This represented a 54 percent increase. The major cause for this rise were salaries and other staff expenses, which was due to the opening of over 20 branches.

Net income from foreign exchange transactions and other services amounted to SR 3,428.81 million in 1982. This was represented by a growth of 55 percent. The NCB continued to finance the high level of imports, particularly that of motor vehicles. Saudi Arabian imported goods changed due to a requirement change, as once infrastructure developments were completed less cement and building material were required, and by 1982 it was consumer products which made the bulk of imports. This meant the NCB commissions on letters of credits and other instruments increased. However, in 1983 net income from foreign exchange transactions and other services decreased by 5 percent. This drop was primarily attributed to the decline in income from traditional bank loan functions. Nevertheless, this decline was somewhat compensated for by an increase in contract financing activities. The NCB's need in this area increased because the government reduced the percentage of advance payments from 20 percent to 10 percent or lower (as mentioned earlier) and also there was strict enforcement of retention clauses in contracts. Import financing activities remained an important source of revenue for the NCB, especially when the volume of imports increased. However, the decline in the NCB's revenues can also be attributed to the relative slowdown in economic activity due to the process of economic consolidation, and also to the increased competition from Saudised commercial banks.

In 1984 net income from foreign exchange transactions and other services increased by 28 percent. This was due to the increase in bank revenue from guarantees. It is worth noting that in 1984 the import growth rate declined. However, as mentioned earlier imports of consumer product were still high. Net income from foreign exchange and other services amounted to SR 4,673.63 million in 1985 compared to SR 4,176.86 million in 1984. This represented a growth rate of only 12 percent. The appreciation of the riyal

against all major currencies except the US Dollar caused a decline in the price of the Kingdom's imports. This meant that revenue from import financing dropped considerably.

Total private sector imports, financed by commercial banks, recorded a fall in their growth rate. However, guarantee margins climbed through at a slower rate than the previous year.

Net income from foreign exchange transactions and other services amounted to SR 5,119.68 million in 1986 compared to SR 4,673.63 million in 1985. This represented a 9 percent increase only. This was expected because of the continued downward trend in imports due to lower government expenditure. Government expenditure had fallen by this time as the major infrastructural projects were completed and also due to the decline in oil revenues. Reduced imports lowered the NCB's import financing activities. Income from guarantees remained stable. However, in 1987 net income from foreign exchange transactions and other services amounted to SR 4,617.29 million. This represented a 10 percent decline on the previous year. The contributing factor was the reduction in the volume of imports and hence reduction of import financing activities. This was a direct effect of the government's cost containment and import substitution policy. Income from other sources such as guarantee margins remained stable.

In 1988 net income from foreign exchange transactions and other services amounted to SR 8,506.77 million in 1988 compared to SR 4,617.29 million in 1987. This represented an 84 percent annual growth rate in this area. The main contributory cause for this was increased import financing activities, and also a substantial increase in the export of petrochemical products. Exports realised foreign currency earnings of SR 8 billion during the year. This automatically gave the NCB an increased margin as it dealt with export activities and earned commission. However, income from foreign exchange transactions and other services declined by 10 percent in its growth rate, it dropped to SR 7,643.83 in 1989.

Over the period 1974 to 1989 both income from real estate and foreign exchange transactions increased. The former was influenced by higher management from the NCB, while the later relied heavily on economic trends and government policy. In fact, for the period from the mid to the late 1970's, when the infrastructural work undertaken by the government was under way, the NCB complemented somewhat government lending

sources through its involvement with import financing.

8.2.4 Profitability Growth

In 1975 profits transferred to the NCB's balance sheet were SR 35.12 million compared to SR 44.44 million in 1974. This represented a negative growth rate of 21 percent. However, it is worth noting that a large portion of the profits made for 1975 were transferred to revenue reserve. In 1976 profits increased by 625 percent on the previous year, this being due to a reduction in the figure allocated to revenue reserve. Profits increased to SR 367.26 million in 1977 compared to SR 254.74 million in 1976. This was the peak profit for the study period. It represented a growth rate of 44 percent on the previous year. In 1977 only one third of the actual profits made were transferred to the revenue reserve, therefore, the profits recorded were far greater than in previous years.

In 1978 profits declined as the largest portion of the year's profits were transferred to revenue reserve. Profits continued to decline in 1979 and 1980. However, in 1981 they experienced a slight increase on the previous year. This reoccurred in 1982, but profits remained the same in 1983 i.e. as in 1982. In 1984 profits declined again. The actual profit figures in the profit and loss account, before any transfer to revenue reserve, for the above period reflect the real bank performance. The NCB made very good profits but it followed very strict control, it was mostly concerned with long term effects, therefore by continuously strengthening revenue reserves and forfeiting the shareholders dividends the balance sheet of the bank reflected a strong and well managed institute.

From 1985 through to 1988 profits were kept at a very steady rate, while a large portion of actual profit made for these years was now transferred to provisions for bad and doubtful debts, instead of revenue reserve. Even though provisions reduced the pay outs to shareholders, profits, and the assets of the bank, nevertheless, by increasing the provisions for bad debts the bank is also strengthening its assets especially since the bank had, it seems, a lot of bad debts over hanging. If the bank did not strengthen its provisions it may be quite difficult for it to raise capital when it needs it. The NCB may also experience problems when dealing with other banks through the interbank market, since bad debts means bad credit ratings. This would be a big concern when dealing with the international market.

It is apparent from the NCB's accounts that they have had to deal with a lot of bad debts. Hence, the transfer of the majority of its profit to provisions for bad and doubtful debts. This was done every year since 1985, one could only presume that the bank had a plan to eliminate its bad debts completely. However, it is worth noting that the economic circumstances of Saudi Arabia in the late 1980's were of a country in recession. Oil prices were on the decline from 1984, government expenditure was higher than its income, the property market was suffering and business was sluggish. During this period many businesses were not able to pay back their debts, and as the largest bank in Saudi Arabia the NCB was caught up in the late 1980's with the bad state of the economy compared to the early 1980's. This experience was not exclusive to the NCB, almost all commercial banks in the Kingdom were going through the same trend. Thus, the NCB's decision to allocate the largest amount of its profits to bad debts, in fact in 1989 all profits were allocated to bad debt, was a commendable one. By taking this step the bank has increased its public confidence in it.

Throughout this period the performance of the NCB had mirrored the economic trends of Saudi Arabia. When the economy boomed this was reflected in excellent balance sheet results and when the economy was suffering so did the NCB. However, it made several decisions in order to insure its survival. Some of these came a little late, but were nevertheless still needed. An example of this was when, in 1976 SAMA made a decision to Saudise all commercial banks in the Kingdom. The NCB failed to react by improving its services. In fact it was only when it began to experience the competition that was coming from its rivals that it started to improve its image.

Chapter Nine

The National Commercial Bank's Financial Ratios

When analysing financial ratios it is essential to look at both the denominator and numerator of each one since a ratio can be effected by changing one or both of them in different degrees. It is important to note that the ratios calculated here are based solely on the data available in the NCB's financial statements. A better picture of the bank's financial status, weaknesses and its future prospects could have been provided had their been additional inside information available for the research.

In this chapter eleven ratios are examined in order to obtain an overall view of the NCB's performance over the study period from 1969 to 1989, since financial ratios showing bank developments can be more revealing than the percentage growth figures presented in the previous chapter.

The objective of this chapter is to shed some light into the NCB's performance in relation to the Saudi Arabian economy. Questions are addressed such as how the NCB's profitability was affected by the economic climate? Was the Bank an active element in the development process? Did the Bank gain from oil price fluctuations? How was the Bank's performance affected by the Saudisation process?

9.1 The NCB's Liquidity Ratios

The NCB's liquidity is needed to meet its depositors' and to a lesser extent borrowers' cash requirements on demand. Therefore, the NCB must keep a sufficient amount of liquid assets - assets that can quickly be converted to cash without loosing their value - against its total volume of deposits.

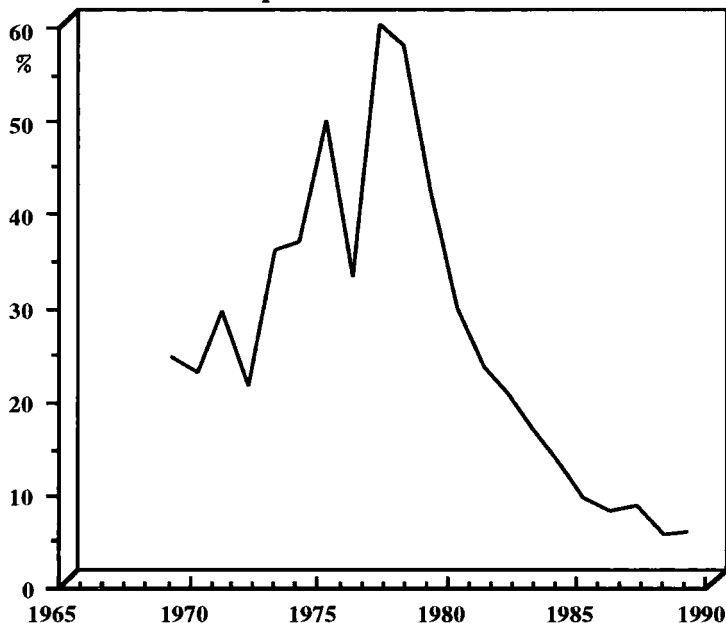
In Saudi Arabia there are no legal requirements dictating the level of a bank's liquidity. SAMA has statutory powers to impose such requirements but it is has not really exercised this power - it has set the levels of statutory reserves, but those have been fixed since 1969. It is, therefore, up to the NCB to determine its liquidity levels. Hence, the larger the amount of the NCB liabilities that would be subject to instant withdrawal, the greater would be the cash held at the bank. Nevertheless, the bank was also faced with a trade off between liquidity and profitability. In general terms, the higher the liquidity of

an asset the lower is its return, and since the bank is in the profit making business it would be interested in obtaining assets that have the highest possible return whilst still capable in maintaining the ability to redeem liabilities on demand. However, the greater the rate of interest to be earned in the money market the higher would be the incentive for the bank to hold the minimum possible non-interest bearing assets, but the greater the risk of sudden cash demands from clients the more essential is the maintenance of cash levels at the bank. Hence it is this immediacy of deposit liabilities, which make the question of liquidity so vital to financial intermediaries. Not only do banks have to meet all depositors' demand for legal tender, they must ensure people's confidence by publicising the fact that they hold a satisfactory liquid asset portfolio. However, it is reasonable to assume that with time and as the banking system becomes more secure people will experience increased confidence in it. It would no longer be necessary to keep excess cash for the sake of clients' sudden panic attacks which may cause them to withdraw large amounts of cash from the bank.

The NCB's cash to total deposits ratio was somewhat erratic from 1969 to 1977, the major increases and decreases for this period were caused by the level of actual cash held and the extra deposits with SAMA - as mentioned earlier, statutory deposits were held at the same amount for the whole period. Nevertheless, the continuous increase in deposits also helped to alter the liquidity ratio. With the increase in oil prices in the early 1970's it is apparent that the NCB did not quite know how to deal with its excess liquidity and hence we see no real bank control over its assets. In fact, the liquidity level was left to reach 59 percent in 1977.

However, from 1978 onward the bank had tried to invest its liquid assets in more profitable ways. This can be observed from figure 9.1. It is worth noting that deposits continued to increase for the period, but the bank continued to reduce its liquid assets bringing the liquid ratio down to 5 percent. Some may argue that this level is too low and could jeopardise the clients' confidence in the bank, presumably the NCB is counting on SAMA to step in as lender of the last resort in case of any problems. But it is worth noting that the NCB gradually reached this level of liquidity; in fact it took the bank 11 years to

Figure No. 9.1: NCB's Cash Fund to Total Deposits 1969 - 1989



Source: National Commercial Bank Reports

reach this standard. At this level of liquidity we should expect the bank to be making greater profit - which is not the case, as discussed later in this chapter.

It is necessary to look at the implications of bank liquidity to the economy. In normal economies where commercial banks play a large role in the money supply, liquidity levels are often set by the central banks. However, in Saudi Arabia from 1969 to 1985 the government has been the main contributor to the increase in the money supply, as the latter depended on its expenditure levels.¹ Nevertheless, we need to look at commercial bank liquidity and how it may effect the economy if SAMA ever decided to use its prerogative and apply monetary policy.

Let us assume that the government has now set up all the country's necessary infrastructure, accomplished its required development objectives and has ceased to lend through its financial agencies such as the Saudi Arabian Development Fund, the Real Estate Bank...etc. With government funding neutralised, the interaction between the Saudi Arabian Monetary Agency and the commercial banking sector which determines this money supply can be considered. As the central bank, SAMA, will establish a minimum level of reserve which all banks must have in order to support their deposits. How would SAMA increase the money supply? By reducing the levels of reserve required of banks,

leaving the banks with more money under their control, and since they do not like to hold substantial cash (as no interest is earned on this) the banks must now use these funds to make profits.

We now need to ask the question of how do banks eliminate these excess funds? This is done through providing loans to the private sector, who in turn keep these funds in the banks or pay them to others who also put them back in banks. Through this mechanism one can observe that by the creation of excess funds in the banking sector which then leads to an increase in loans and deposits and since deposits are part of the money supply, the money supply increases. However, it is worth noting that increases in the money supply tend to cause decreases in the interest rate, since banks are forced to lower their rates in order to encourage borrowing of these excess funds. Also the increase in the money supply results in an increase in the demand for goods and services since the increase in borrowing is done so that it may finance the purchase of goods and services. Thus, the increase in the money supply causes a decrease in the interest rates and an increase in the demand for goods and services, otherwise known as expansionary monetary policy, while decreases are called contractionary.

Taking this further, a balance of payments deficit may result in the central bank raising interest rates to attract compensating capital inflows. In the money markets it may result in the money supply contracting, as the foreign exchange backing of the currency is used up. The government may borrow from the commercial banks by increasing their reserve requirements or offering bonds to commercial banks at attractive returns. Hence, if a commercial bank had kept its liquidity levels at the minimum required levels then such government action would cause its holdings to fall even below the accepted levels, and it would then be forced to re-establish the desired level by making it harder for their clients to borrow. Thus, the balance of payments' drain would immediately affect the amount of commercial bank loans available. However, by holding funds above the required minimum the bank would be able to soak up the decrease in reserves, due to the central bank's increase in the required level of commercial bank reserves, and hence leave their loans to their clients unchanged. Thus, the actual effect on the real economy would be

much less or somewhat deferred.² However, by holding above the required minimum the bank is in effect holding more liquidity, which means there is less for lending. Another point worth noting is that by keeping reserves above the required minimum level it is more difficult for the government to control the banks. Hence, if SAMA attempted to reduce the commercial banks' loans by increasing its reserve requirements, banks who remain above the minimum liquidity requirement would be unaffected, and there would be no impact on their loans. Thus the impact of SAMA policy could be cushioned.

In Saudi Arabia the growth of the money supply has always been caused by increases in government expenditure. Between 1970 and 1980 when the first and second development plans were implemented, the government's objectives were to accomplish the planning objectives at all cost since it was essential to establish the country's infrastructures. The money supply increased dramatically with the accelerated rate of development and hence expenditure. As a result inflation grew.³ However, by improving its port facilities and by increasing housing projects inflation declined slightly, but in order to decrease it further the government had to subsidise the staple foods. Hence, as oil prices increased the Saudi Arabian government's revenue increased which encouraged the government to increase its spending causing the money supply to grow. Thus, increases and decreases in the money supply were a direct result of oil price increases and not government monetary policy. In fact, the authorities did not operate on the basis of any coherent theoretical model of monetary impulses within the economy. Their approach was pragmatic and their measure of control largely ad hoc.

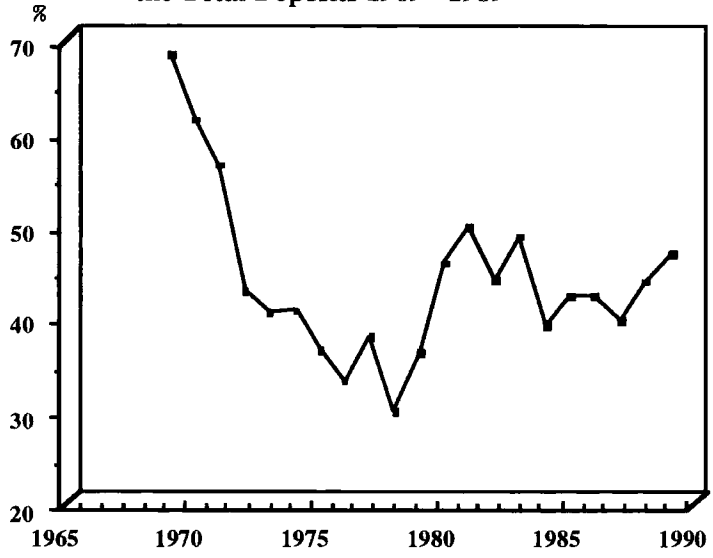
9.2 The NCB's Loans to Deposits Ratio

This ratio shows loans as a percentage of bank deposits, otherwise known as liability management i.e. the banks ability to manage depositors' funds and ensure a good return for itself.⁴ In the case of the NCB it is apparent that it is finding it easier to get deposits as opposed to making loans. One needs to ask how does this ratio get affected by the economic climate? How do the NCB's clients behave in times of recession or tighter credit?

From figure 9.2 it is apparent that for 1974 to 1977 the ratio decreased reaching its lowest levels for the 1969 to 1989 period under review. This reflects the lagged effect of increased oil prices which meant greater revenue returns for the government and ultimately a trickle down of money to bank clients. Hence, deposits increased at a far greater rate than loans. It is also worth noting that the Saudi Arabian people have always been reluctant to borrow from banks as this meant paying interest which is not Islamic practice. However, between 1978 and 1980 the ratio increased reflecting an increase in the level of loaned funds. This was due to the increased borrowing by merchants to finance trade that was becoming buoyant and prosperous, especially when the port problems were remedied which meant the reduction of port handling costs. ⁵

Between 1981 to 1985 the third development plan was implemented. By then all major infrastructure projects were completed and the government objective was to diversify the country's exports. Hence the government set up several financial agencies to lend to business at very cheap financing rates. Thus, industrialists turned to the government for loans as opposed to commercial banks, and as a result we see the ratio reaching its highest level during this period. However, it is also worth noting that the 1980's brought with it economic recession which contributed to a decrease in lending.

Figure No. 9.2: NCB's Loans & Advances to the Total Deposits 1969 - 1989



Source: National Commercial Bank Reports

It is of vital importance to the bank to see how it is utilising its deposits. After all a bank needs to re-invest these deposits so that it can pay its clients adequate interest and also make money to cover its overheads with some profits left. It is apparent from the NCB's loan to deposit ratio that the bank tends to invest a large amount of the deposit funds in foreign assets and to a lesser extent local ones. In analysing the loan to deposit ratio of the bank we are able to determine its lending policy. If the NCB's ratio had indicated that a large amount of its deposit funds were being loaned out there would be cause to be apprehensive, since it would mean that the bank was not very liquid, and in a country like Saudi Arabia often calling up a loan does not mean you can get it easily. It is this phenomena that has probably inhibited the NCB's lending policy.

The actual level of loans to deposits as dictated by SAMA is 65 percent, but the NCB has not come anywhere near this figure. One of the reasons is because it is constantly competing with other Saudised banks and also government agencies. However, it is notable that from 1988 the ratio had begun to increase, again reflecting the private sector reinvolvement in the development of the economy and its general pick-up. Another vital impediment to lending is the bank's inability to use mortgages on borrower's property as security which was dictated in a 1981 Ministry of Justice ruling.⁶ It is also worth noting that banks do not give special mortgage packages for household buyers, a business that secures very high interest returns for the banks in the West.

9.3 The NCB's Provisions for Bad and Doubtful Debts Ratio

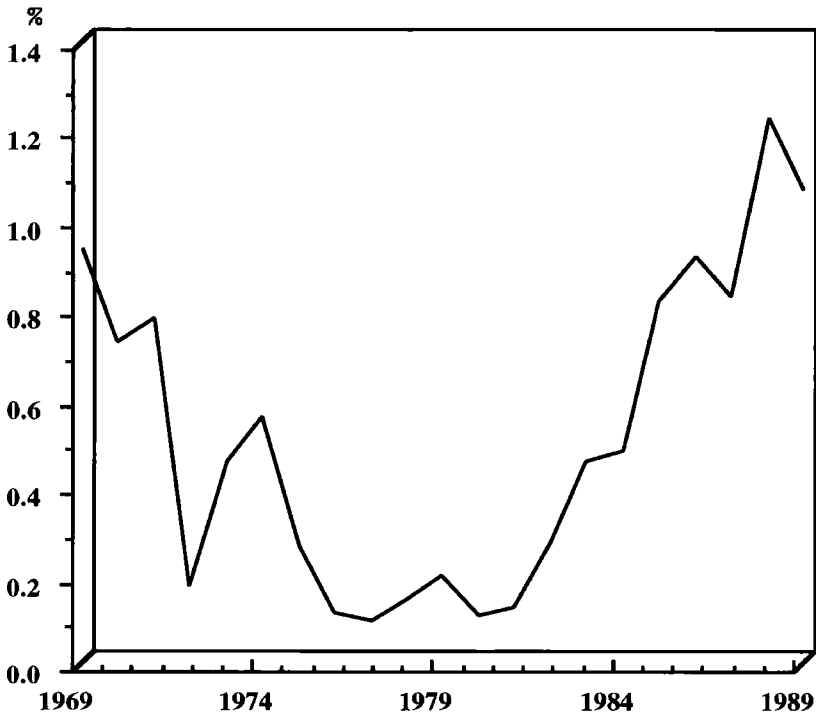
It is apparent from figure 9.3 that the provision to total assets ratio had declined in the early period of our study due to the fact that assets had grown tremendously. The ratio was fairly constant from 1976 to 1981, but this was not surprising since lending was also at its lowest during this period, but from 1982 the provisions for bad and doubtful debts to total assets ratio has been on the rise due to both an increase in assets and the actual provisions figure. The provisions for bad and doubtful debts to loans and advances to private sector tells a similar story as depicted in figure 9.4. In fact from 1981 to 1987 provisions have been on the increase at a greater rate than loans. This was in line with the

NCB's policy to protect itself against bad debt. With the recession in mind it is not surprising that the bank has been very wary of what is to come. In fact the NCB's decision to significantly increase its provisions thereby reducing profits was soon taken up by other competing banks.⁷

With the decline in oil prices in the early 1980's, there was a reduction in government spending which led to a gradual slowdown in the economy. Many businesses suffered, especially those in construction, since during the boom years they would use money from new contracts to finance existing ones and since no contracts were being made they turned to banks for loans and many ended up being bad ones. Many medium to small companies also became insolvent during the recession especially when they kept running their businesses to the point where they had to literally stop trading, hence ending up with bank debt, that they either could not pay back or in some cases refused to repay. Many of these businesses have been running very inefficiently since many are owned by untrained people with no real understanding of financial control, often thinking that they were making good profits while in reality they were experiencing some losses, only to find out later their true financial position. Many of the businesses also invested in real estate both in Saudi Arabia and abroad, and when the bottom fell out of the Saudi real estate market, many found it hard to liquidate their local assets and refused to draw on their investments abroad, often denying their existence.

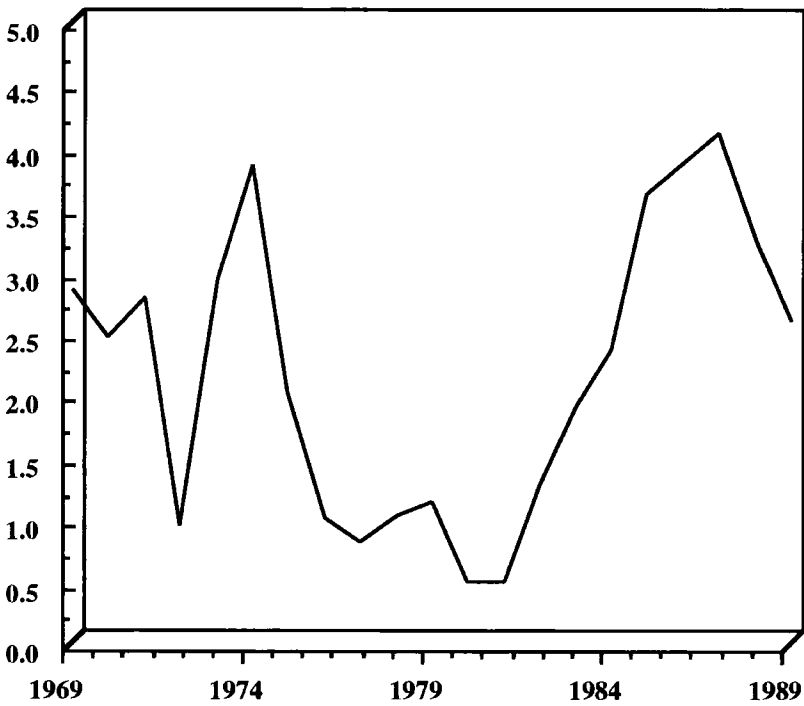
In the mid 1980's many debtors felt that in this time of hardship banks should be willing to let them off since the banks had made good returns from them in the past, or at least they should be let off paying the interest. The NCB, like the other existing banks was reluctant to take the debtors to court since the judges and the Commercial Dispute Committee, which normally arbitrate in such cases, would deduct all interest due or already paid from the initial amount borrowed since interest is classed as usury and, therefore, forbidden in Islam. Banks are not allowed to take securities against loans and guarantees by third parties which are not always reliable and often difficult to organise. The guarantor must be one of the bank's own clients, so that if the borrower defaults on his loan the bank can automatically deduct the amount from the guarantor's account. It is,

Figure No.9.3: NCB's Provision for Bad & Doubtful Debts to Total Assets (1969 - 1989)



Source: National Commercial Bank's Report

Figure No. 9.4: NCB's Provision for Bad & Doubtful Debts to Loans & Advances to Private Sector 1969 - 1989



Source: National Commercial Bank's Report

therefore, not surprising to find that the NCB's loan to deposits ratio was low since the bank has been reluctant to lend and had emphasised the importance of lending to reputable clients, as was the case before the 1970's boom. Such clients, even if they had to reschedule their loans, ultimately pay their debts; especially as they do not want to damage their reputation internationally.

In 1987 the Saudi authorities established a strong government committee who's sole responsibility was to settle loan disputes. The authorities also lifted its ban on mortgage-based lending in an attempt to encourage the domestic borrower to take up bank loans. A committee was set up by SAMA with a royal decree from King Fahd. Its duty and powers extended to the freezing of bank accounts, payment to clients from public-sector agencies, restriction of loans for overseas travel, a check on bank accounts and a ban on government departments from dealing with customers not fulfilling their debt obligations.⁸ However, its main objective was to solve the problem of the two parties without inflicting a judicial-style kind of settlement. This kind of pressure from SAMA made debtors more willing to reach agreements, along with the banks "blacklist" of bad debtors, which was circulated around the banks so that these customers were unable to obtain new credit facilities.⁹

Until 1989 the NCB had not really come to terms with the full extent of its bad debts. In order to avoid its clients' bankruptcy the NCB rolled over their credit. However, eventually it would have to enforce default and if this was done it should be done gradually, since too abrupt a change could cause the public to lose faith in the bank. Nevertheless, it is important to note that if the NCB was to get into difficulty then SAMA would step in and act as lender of the last resort. But what no bank expects is a change in the laws on interest, since this change would go against all the *raison d'etre* of the Saudi Arabia Islamic State.

9.4 The NCB's Investment Abroad to Total Assets Ratio

Until 1972 this ratio was virtually non-existent. This is not surprising since up to that point the NCB had not been affected by oil revenues which was quite stable. However,

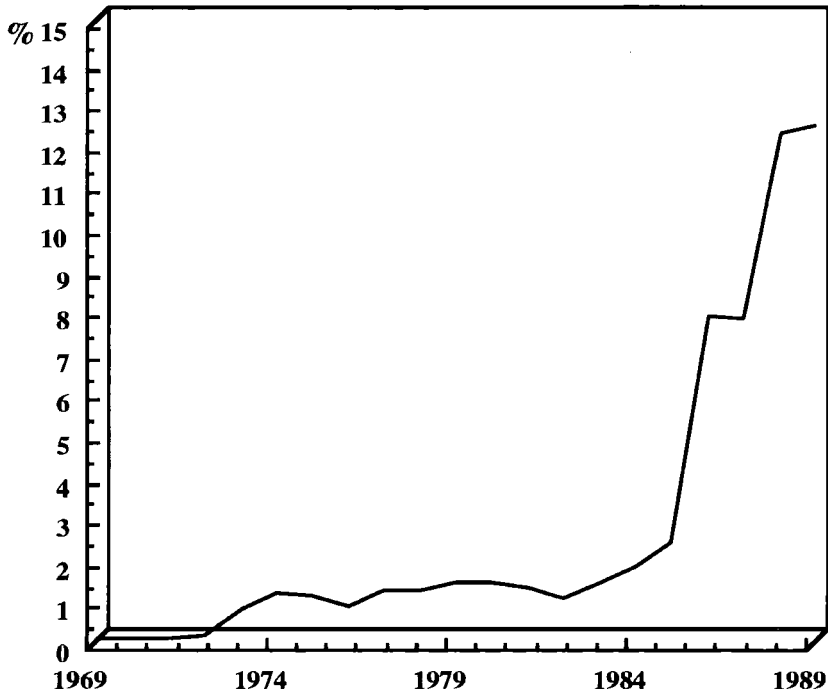
from 1973 with the increase in oil prices it was inevitable that the NCB would be dealing with more liquidity and since the rate of return from foreign investment was high, it was inevitable that the NCB would seek a higher return on its local time deposits, especially since lending locally meant that they may be faced with the Shari'a laws which might result in accepting reductions on late payments due to the prohibition of interest taking. However, the question of what foreign assets should the bank invest in comes to mind? Here it is necessary to look at foreign exchange losses or gain, but perhaps the safest form of assets for the Saudi banks was to invest in dollar related investments since the Saudi riyal was pegged against the dollar. Nevertheless, the bank did not put its eggs in one basket and a portfolio of foreign currency related business would be a better policy to hedge against exchange rate complications.

However, as can be observed from figure 9.5 the real take off of this ratio occurred in 1986. From then on it continued to increase with the rise in customers' deposits. Due to the bad debts element in loans, the bank was reluctant to lend any further than necessary, hence, the increase in investments abroad. It is worth noting here that when SAMA issued new government bonds in the late 1980's, the NCB quickly took advantage of this by purchasing bonds on both occasions.¹⁰ However, the NCB was hesitant to invest large amounts because of maturity dates on these bonds were one to five years and the majority of the banks liabilities were short-term deposits. Another reason was the continuous devaluation of the riyal, but the main offputting cause was the absence of a secondary market. In fact in 1988 the NCB along with four other banks, namely, Riyadh Bank, Saudi American Bank, Saudi British Bank and Saudi French bank began discussing with SAMA the possibility of operating a secondary market in Saudi Arabia.

9.5 The NCB's Customers' Deposits to Total Assets Ratio

Customer deposits have always contributed a significant proportion of total liabilities of the NCB. The growth and utilisation of customers' deposits are important indicators of any bank's financial position and performance. As can be seen from the erratic fluctuations in the ratio shown in figure 9.6, the customers' deposits to total assets ratio is

Figure No.9.5: NCB's Investment Abroad to Total Assets (1969 - 1989)



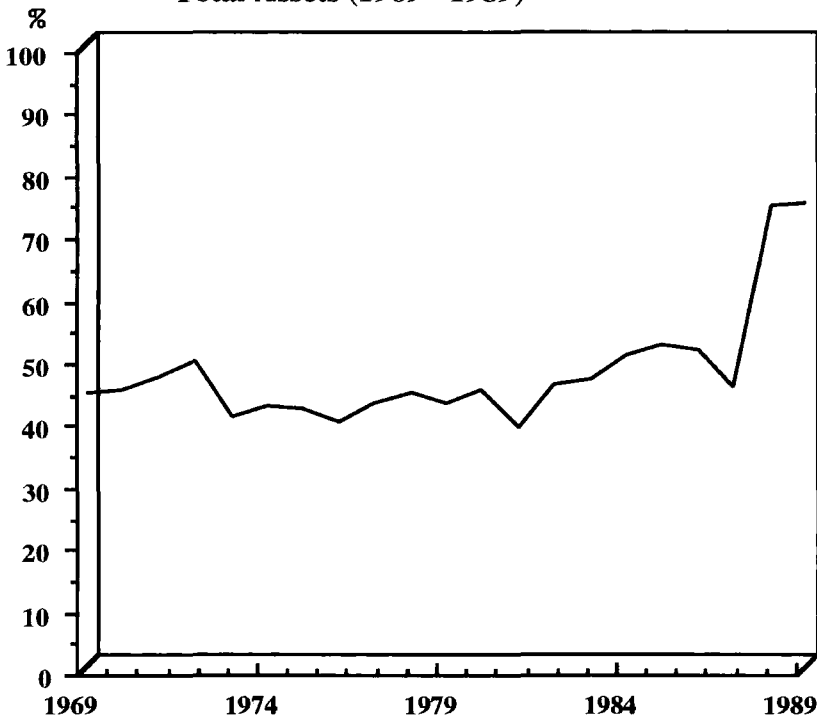
Source: National Commercial Bank's Reports

one of the most changeable and volatile elements of the bank's growth; however, it is worth noting here that one of the main causes of these fluctuations was the extreme increases and decreases in assets causing the main shifting in the ratio.

The NCB's customers' deposits had grown over the period under review, but the ratio of growth was slow and the rate even stabilised in certain years. Total assets, however, grew at a much faster rate. The rate of growth in customers' deposits was in the beginning at a moderate rate. This was due to many factors. The Saudi Arabian nationals relied heavily on cash for their everyday activities and expenses, so many did not see the need to hold a bank account. Also in the early years much of the country's wealth was held in the hands of the royal princes and some well known merchants. However, when the development plans were rapidly implemented many nationals saw an improvement in their incomes. However, much of this wealth was used to satisfy immediate needs. Because of these factors and a general distrust of banks, many did not see the need to hold bank accounts.

Nevertheless, customers' deposits started to increase at a steady rate during the

Figure No. 9.6: NCB's Customer Deposits to Total Assets (1969 - 1989)



Source: National Commercial Bank's Reports

1970's, and despite Saudisation in the late 1970's, the NCB's share of deposits was not significantly altered. This was due to the Saudi nationals lack of interest in the use of banks. However, with the increase in wealth Saudis began to travel abroad and many of the young people obtained better education. They too experienced the outside world and in order to facilitate payments and general expenses it became necessary for them to develop the banking habit; especially if they tried to fit in with the international society. On their return many found that those habits had become a way of life, therefore, they began to open bank accounts and encouraged others to do so. Also as businesses began to flourish it was necessary for them to open bank accounts to deal with their foreign counterparts abroad and the excess liquidity at hand.

In the period between 1981-1985, the growth rate of bank deposits was not as pronounced, as oil prices were lower and could not match imported inflation, which showed that at the time the Saudi banking system was very sensitive to fluctuations in oil revenues. The monetisation trend within the Saudi banking sector made the NCB's customers more aware of international interest rate fluctuations. The more sophisticated customers moved deposits to and from Saudi Arabia to take advantage of the fluctuating interest rates. However, with the recession in the mid 1980's the bank's deposit to assets ratio dropped.

This was due to an increase in assets, namely investments and in particular investment abroad, and a lower rate of customers' deposit increased, due to the recession. It is apparent that many customers had to draw on their savings in order to keep up the level of expenditure they had been accustomed to. Many have had to use their savings to rescue their businesses as many banks were reluctant to lend given the problems of bad debts. Another cause for this decline was the increasingly aggressive marketing strategies followed by the Saudised banks.

In 1988 the NCB experienced a huge surge in its customers' deposits to assets ratio. The main contribution to this increase was a large increase in customer deposits while assets experienced a very low rate of growth. The increase in customer deposits reflects the country's gradual pull out from the recession and the good will prevailing for the coming period. Another reason for the increase in deposits could be that due to the recession many Saudis learnt a lesson and felt it necessary to make a distinction between their private and company money, since when it is one's own money that is lost one tends to suffer much more i.e. on a personal level.

Hence, the NCB was able to survive despite the ups and downs of the economic climate, and its deposits continued to increase despite the recession and competition from the newly Saudised banks. This could be seen as a positive reflection on the calibre of the NCB's management team.

9.6 The NCB's Total Capital and Reserves to Total Assets Ratio

This ratio measures the bank's ability to generate additional capital from its assets base. Total capital and reserves have steadily increased over the period under review as can be seen from figure 9.7 and so had total assets, but total assets had increased at a faster rate. The ratio itself decreased from 1969 to 1974 which was due to a very small increase in the capital and reserve figures which were out weighed by the increase in assets. One could attribute this to a small level of profits due to the government's sole involvement in the expansion policies. However, in 1975 the ratio increased dramatically; this was due to an

increase in profits as with the increased revenue from oil many businesses flourished and trade expanded. All this was reflected in the increased level of bank reserves.

In 1976 and 1977 the ratio declined due to the large increases in assets and the nominal increase in capital and reserves. This again was due to the governments full involvement in the infrastructure process leaving little for the banks to do. However, yet again in 1978 the ratio increased and continued to do so until 1981 reflecting the increase in the bank's profits despite Saudisation. In the late 1970's and early 1980's oil prices increased creating new opportunities for businesses to prosper as a result of increased government spending. In fact, in the 1980 to 1985 development plan much emphasis was placed on medium to small manufacturing businesses and the bulk of loans were obtained through the government's own banks. Hence, not only did the NCB have to compete with the Saudised banks for business, it also had to compete with government agencies, making it more and more difficult for the bank to make large profits.

One of the main reasons for the NCB's continued contribution to increasing its reserves was the Banking Control Law which required all banks to transfer at least 25

Figure No.9.7: NCB's Total Capital & Reserves to Total Assets (1969 - 1989)



Source: National Commercial Bank's Reports

percent of their net profits to a statutory reserve until the amount of the reserve at least equalled the paid up capital. This was mandatory and the NCB was thereby compelled to build up its equity base and provide a financial buffer for the future. This statutory reserve was the primary cause for the expansion of the NCB's equity base. Another reason for the growth in capital and reserves was the continued growth in other revenue reserves, comprising retained profits for the year. By 1984 the capital and reserve figure reached SAMA's statutory levels, hence, from 1984 to 1989 the NCB's capital and reserve levels had remained constant and the main fluctuations experienced by the ratio were due to the volatile levels of assets. In those years the management of the bank decided that there was a need to increase and strengthen its existing provision for loan losses. To enable the bank to do so it transferred all its available profit for the years, to the provisions for loans losses - as discussed earlier in this chapter.

9.7 The NCB's Cash Fund to Total Assets and Loans and Advances to Private Sector to Total Assets Ratios

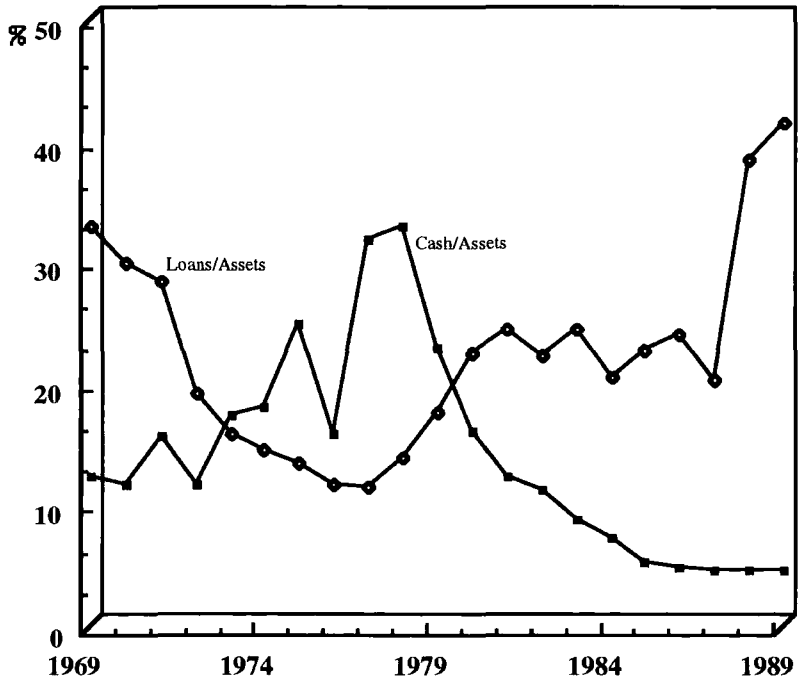
As can be observed from figure 9.8 the two ratios reflect each other. When the cash fund to total assets ratio is low the loans and advances to the private sector to total assets ratio is high and vice versa, as one increases the other decreases showing an inverse relationship between the two curves.

From 1969 to 1977 the loans and advances to the private sector to total assets ratio has been declining. The actual loans and advances to the private sector figures were on the increase but assets increased at a much greater rate causing the ratio to decline. On the other hand, the cash fund to total assets ratio from 1969 to 1978 was on the increase, but the cash fund figures were increasing at a greater rate than the total asset figures with the exception of 1972 and 1976. This suggests that the bank was very liquid - as discussed earlier. But what is apparent is that for this period the bank had available funds but was not able to identify the lending opportunities available to it. As mentioned earlier for the period 1970 to 1980 the two development plans were mainly concerned with setting up a good infrastructure for the country, therefore, the government did all the spending and

very little loan opportunities were left for the commercial banks, in fact the majority of loans given by commercial banks for that period were for consumer goods for import purposes and the occasional short term loans to contractors. Hence the bank was experiencing a crowding out effect, since there was a large amount of government activity in progress leaving very little room, if any, for the private sector to do much and since the government had its own money it did not need bank loans and, therefore, could finance its own projects and leave the private sector completely out. It could be argued, however, that the private sector depended on the government for work. Nevertheless, in Saudi Arabia it is apparent that when the government activities declined in the late 1980's the private sector picked up tremendously. This is apparent from the large increase in the loan and advances to the private sector to total assets from 1987. Another reason for the low loans required in the early and mid 1970's could be attributed to the general Islamic attitude towards interest and lending.

It is also worth noting that total assets were increasing at a faster rate up to 1977 because of the substantial deposits. However, from 1978 onwards the loans and advances

Figure No.9.8: NCB's Cash Fund to Total Assets and Loans & Advances to the Private Sector to Total Assets (1969 - 1989)



Source: National Commercial Bank's Reports

to the private sector to total assets ratio had increased in the NCB's claim on the private sector and the rate of growth of the total assets had moderated since 1978. Another factor contributing to the increase in loans and advance to the private sector was that in the earlier years of the bank's operations there were no specialised government credit agencies and Saudised banks had not yet dug their heels into the banking sector. Therefore, much of the demand for loans had to be met by the NCB, especially when it was one of the largest and oldest at that time, here the NCB had the most substantial share of the loans market. It is apparent from the graph that the cash fund to total assets ratio began to decline in 1979 and since loans to the private sector to total assets' ratio also increased in that year it is obvious that the bank utilised its cash liquidity to satisfy these loans. Another point worth noting here is that even with imports, businessmen were finding difficulties getting goods through into Saudi Arabia between 1974 and 1975. This was due to ships having to wait off Jeddah since the port was very busy getting government goods through. Hence, ships were unable to unload or were unloaded at expensive rates making it unattractive for traders at the time. Since much of the loans obtained from the NCB were for import purposes, not too many loans were required until the Jeddah port was enlarged. This encouraged traders to get back into business and to take loans for the purpose of importing goods.

The increase in the NCB's loans and advances to the private sector reflected well on the bank's performance because the bank could maintain this consistently high level despite the fact that in certain years the government's specialised credit agencies were also available to provide loans to the private sector. This was indicative of the extent of public confidence in the bank. Even the 1981 Ministry of Justice ruling preventing banks from using mortgage on borrower's property as security for the loans did not inhibit the growth of loans. Therefore, the NCB turned to other forms of collateral for its loans, actively lending to the general public. However, the rate of growth of the NCB loans to the private sector had tapered out after 1982. This year marked the end of the Saudisation process and despite the fact that the NCB's corporate lending activities were increased, the Saudised banks offered stiff competition.

The total assets increased over the period under review, but the rate of growth was slower after 1978. The primary reason for this was the level of SAMA's statutory deposits requirement which decreased during this period. It is worth noting that this decreased statutory requirement permitted the NCB to place more of its assets in alternative profit earning investments.

Attention is also drawn to the years 1988 and 1989 when the ratio had increased substantially. In these two years, the financial statement amount for loans and advances included an amount of SR 344.2 million paid by the NCB to its withdrawing partners, being the value of their share sold to the bank's remaining partners. These were temporarily included in loans and advances, pending completion of legal formalities relating to the withdrawal. This was an accounting policy matter only. Without inclusion of these amounts the ratio would have been only slightly lower. There were substantial increases in loans to the private sector during these two years. This was due to increased deposits received by the NCB and effective utilisation of funds deposited with the bank.

9.8 The NCB's Profitability Ratios

In this section an examination of the profits to loans and advances to private sector and the return on asset ratio (profit to total assets ratio) were examined. Looking at both figures 9.9 and 9.10 simultaneously it is apparent that they mirror each other, reflecting the importance of loans and advances to the private sector to the bank's overall performance.

The profits to loans and advances to the private sector ratio declined from 1971 reaching almost zero levels in 1972. This was probably due to the low amount of loans taken up by businesses, as the society was still very set in its ways, disapproving of usury and, therefore, reluctant to take loans, reflecting low profits for the bank. From 1973 the ratio began to increase reaching its highest levels in 1977. The increase in oil prices in the early 1970's, led to some businessmen demanding more financing for their trade activities i.e. related to consumer goods as apposed to infrastructural development, and since the NCB was the largest bank around many turned to it for their loan requirements. Hence, this profitability should not conflict with the notion that the public sector was crowding

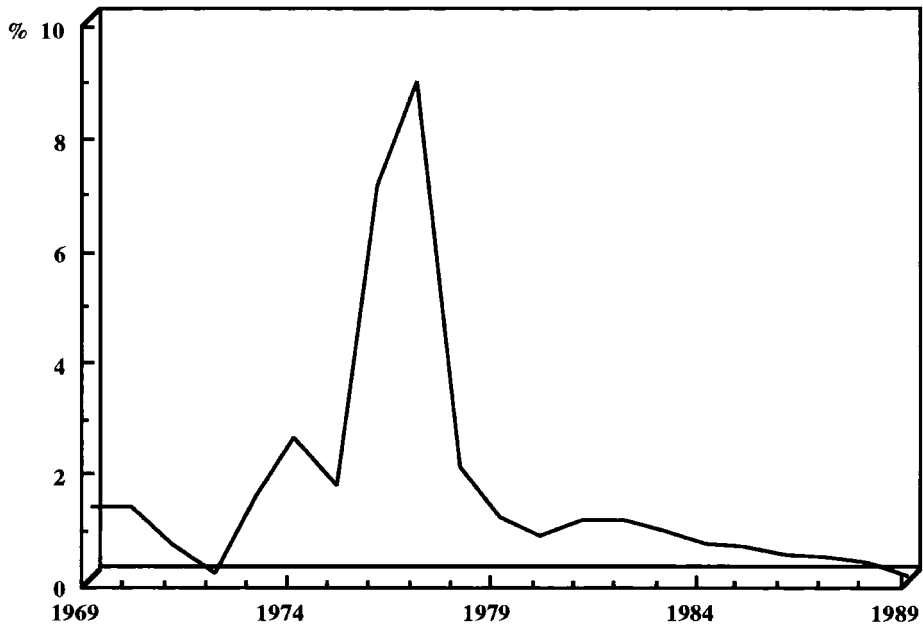
out the private sector as this was experienced only with the goods needed for the development process. Another reason for the increase in profitability could be attributed to the fact that often clients held their money in current accounts which meant that the cost of capital was very low for the bank.

However, after 1977, there was a decline in the profit to loans and advances to the private sector ratio as the major infrastructure developments were nearing completion. Another reason was the Saudisation of the banks which meant that the loans market was expanding in terms of supply and the share attributable to the NCB consequently decreased. Along with increased competition from the newly Saudised banks, the NCB had to compete with the Saudi Arabian government's own recently established specialised credit agencies, which offered a much cheaper source of finance. This encouraged the private sector borrowers to turn to those specialised agencies as opposed to commercial banks. However, when the government discovered that its development plans expenditure exceeded the budgeted amount it reacted by substantially reducing the credit agencies' lending levels, forcing the private sector to turn to the commercial banks yet again.

From 1982 the ratio of profits to loans and advances to the private sector has been on the decline and in 1983 SAMA imposed restrictions on offshore bank loans syndications to prevent any undesirable alliances and to stop it losing control of its money supply i.e. SAMA felt that too many Saudi riyals were deposited in Bahrain's OBU's, and that as a result too much borrowing was taking place from there.¹¹ These restrictions meant that the NCB and other Saudi banks were not able to compete with offshore banking units. It is important to bear in mind that the Saudi Arabian government plays a very powerful role in the economy by imposing restrictions on commercial banks. This serves to inhibit loan expansion with the Saudi banks and also diverts potential loan funds abroad. Loans continued to increase in mid 1980's, but, profits were diverted to provision for bad and doubtful debts and this was reflected in the very low ratio which reached almost zero levels in 1989.

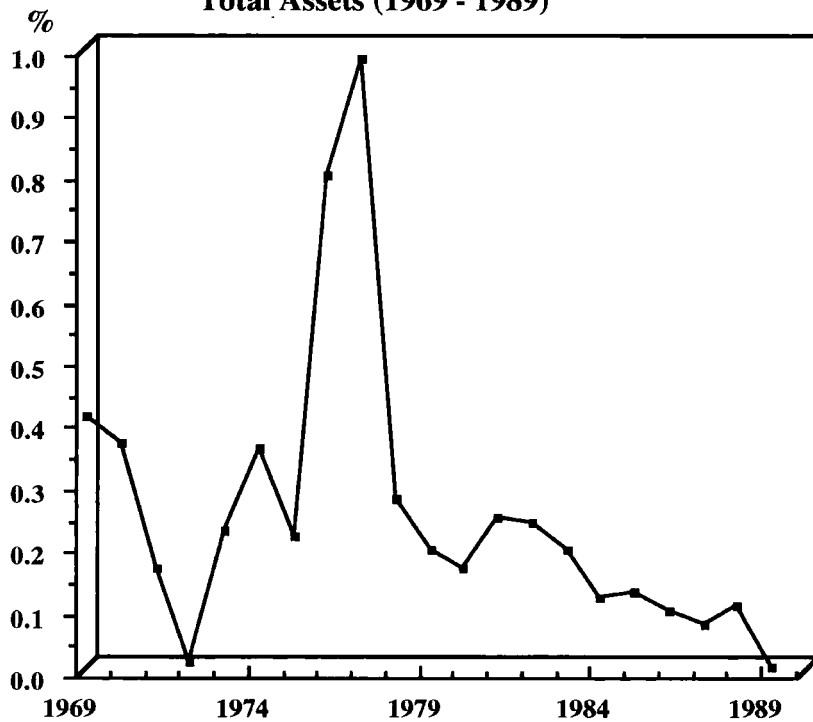
The return on assets ratio tells a very similar story. It can be seen from figure 9.10

Figure No.9.9: Profits to Loans & Advances to the Private Sector (1969 - 1989)



Source: National Commercial Bank's Reports

Figure No.9.10: NCB's Profit to Total Assets (1969 - 1989)



Source: National Commercial Bank's Reports

that the NCB's profit to total asset ratio declined from 1969 to 1972, reaching almost zero levels in 1972 as was the case in the previous profitability ratio. The ratio then increased from 1973 to 1977 reflecting the general boom in the economy, as was the case in figure 9.9. However, from 1978 to 1980 the ratio experienced a decline. This was due to the high set-up costs of new branches. There was a learning curve effect and cost inefficiencies were present. Salaries and other staff expenses increased as the NCB's operations increased. But it was the construction of the branches -especially those in the rural areas - which proved to be both costly and unprofitable during these periods, as new branches were increased at a faster rate than revenues.

As mentioned earlier, due to the increased oil revenues of 1973 which necessitated an expanded banking network, it took three years between 1973 - 1976 for the effect of this to be manifested in terms of profits for the bank. From 1978 onwards, the profits decreased for a variety of reasons. Firstly, the effects of the Saudisation process which commenced in July 1976 were now being felt by Saudi banks such as the NCB. The NCB was losing ground as the competition increased. The assets growth rate was much faster than growth in profits. The Saudised banks in comparison, had a much smaller asset base and yet were experiencing increased return on their assets. Another reason for declining profitability of the NCB was that it had concentrated on short term trade loans which were low risk, while the newly Saudised banks were more prepared to take substantial risks and hence were earning higher returns.

The NCB also realised the need for increased computerisation of its operations in the wake of the influx of newly Saudised banks. This increased its efficiency but also proved to be highly capital intensive and this eroded profits to a great extent. Operating expenses were increased as implementation and training costs increased. Profitability was also affected by the fact that the bank's customers were becoming increasingly more financially aware and sophisticated and the NCB was not always keeping pace. In fact, SAMA figures suggest that the ratio of savings to current account deposits grew, which meant that banks had to pay more interest. Customers were also making investments in banks abroad.

In the year 1989 there were no retained profits as the entire profits for the year had been transferred to the provision for loan losses. The ratio uses retained profit as the numerator and since there were no retained profits for this year, no ratio is available. To maintain comparability of ratios it was essential that the same definition of profit be applied each year.

It must be emphasised that the NCB's assets and balance sheet has continued to grow but the profit ratios have declined as a consequence of increased competition. This is a natural consequence of the Saudisation process as previously the NCB and Riyadh Bank controlled a majority of the banking sector, whereas after Saudisation, their share was taken up by the Saudised banks. This is not an adverse reflection on the NCB's management as some of the influences were outside their control. However, better management of the bank could have made sure that it was employing its assets in high growth investments to ensure that the return on assets was maintained.

It is apparent from the above discussion that the NCB's profits relied on its private sector borrowing and this in turn depended on the government policies. Often the private sector was left out of the major developments that were carried out in the country as the government undertook all major projects itself leaving little for the private sector and hence reducing the commercial banks' profit opportunities.

The above ratios have helped to a great degree to explain the evolution of the NCB from a small entity to the largest in the Middle East region. The Bank's overall liquidity decreased to very unexpected low levels, and at these levels one would expect higher profits since it meant that the Bank was utilising the funds available. Instead we see the bank's profits diminishing despite the increase in lending.

It is apparent from these ratios that the NCB was a passive participant in the country's development process. The Saudi Arabian government and its agencies financed both infrastructure development projects and industrial ventures. The only time the commercial banks were involved was when the government had overspent and was forced to reduce its expenditures by moderating its lending to the private sector, which in turn

looked for financing from commercial banks. The NCB then had to compete with the newly Saudised banks, which were by then well established, for a share in the lending market.

Hence, it is apparent that the NCB was greatly influenced by the economic swings in the Saudi Arabian economy. When the economy was experiencing a boom the bank experienced a healthy set of ratios, and when the economy was in a recession the bank suffered as a consequence. However, as the private sector becomes stronger the NCB, along with other commercial banks, will have to play a major role in the economic development of the country. As the Saudi Arabian government's reserve dwindles it will be the commercial banking sector under the influence of SAMA that will influence the success or failure of the economic challenges faced by the country.

Notes:

- (1) This matter was discussed extensively in chapter 6.
- (2) Collins, M. Money and Banking in the UK: A History London: Routledge, 1990, pp. 104-105.
- (3) This matter was discussed in more detail in chapter 5.
- (4) Jones, F. J. Macrofinance: The Financial System and the Economy USA: Winthrop Publishers, 1978, p.147.
- (5) Goods would often be loaded off by helicopters, see chapter 5 for more details.
- (6) Middle East Economic Digest, Vol.31, No.15, 11 April 1987, p. 26.
- (7) Middle East Economic Digest, Vol.30, No.5, 11 February 1986.
- (8) Middle East Economic Digest, Vol.31, No.15, 11 April 1987, p. 26.
- (9) "Arab Banking:SAMA Lends a Hand." Financial Times, 24 October, 1988, p. 38.
- (10) Ibid., p. 38.
- (11) Seznec, J. The Financial Markets of the Arabian Gulf London: Croom Helm, 1987, pp. 18-19.

Appendix No. 9.1: The National Commercial Bank Financial Ratios (1969 - 1989)

| Year | Cash Fund to Total Deposits | Loans & Advances to the Total Deposits | Provision for Bad & Doubtful Debt to Loans & Advances to Private Sector | Provision for Bad & Doubtful Debt to Total Assets | Investment Abroad to Total Assets | Customer Deposit to Total Assets | Total Capital & Reserves to Total Assets | Loans & Advances to the Private Sector to Total Assets | Provision for Bad & Doubtful Debt to Loans and Advances | Cash Fund to Total Assets | Profits to Total Assets | Profit to Loans & Advances to the Private Sector | Provisions to Loans and Advances |
|------|-----------------------------------|--|--|---|---|--|--|---|---|---------------------------------|-------------------------------|---|--|
| 1969 | 23.53 | 68.04 | 2.83 | 0.93 | 0.02 | 43.43 | 4.25 | 32.68 | 2.65 | 12.1 | 0.4 | 1.22 | 2.65 |
| 1970 | 22 | 60.87 | 2.43 | 0.72 | 0.02 | 43.82 | 3.97 | 29.5 | 2.26 | 11.45 | 0.36 | 1.24 | 2.26 |
| 1971 | 28.58 | 56.07 | 2.75 | 0.77 | 0.02 | 46.14 | 3.7 | 28.15 | 2.56 | 15.4 | 0.16 | 0.58 | 2.56 |
| 1972 | 20.63 | 42.51 | 0.92 | 0.17 | 0.08 | 48.64 | 2.99 | 18.94 | 0.73 | 11.45 | 0.01 | 0.04 | 0.73 |
| 1973 | 35.06 | 39.98 | 2.90 | 0.45 | 0.68 | 39.88 | 2.75 | 15.63 | 2.33 | 17.07 | 0.22 | 1.39 | 2.33 |
| 1974 | 35.79 | 40.25 | 3.82 | 0.55 | 1.12 | 41.44 | 2.46 | 14.34 | 2.75 | 17.72 | 0.35 | 2.46 | 2.75 |
| 1975 | 49.07 | 36.2 | 1.98 | 0.26 | 1.03 | 41.15 | 3.49 | 13.18 | 1.44 | 24.52 | 0.21 | 1.62 | 1.44 |
| 1976 | 32.4 | 32.76 | 0.99 | 0.11 | 0.79 | 38.75 | 2.08 | 11.38 | 0.72 | 15.65 | 0.79 | 6.97 | 0.72 |
| 1977 | 59.3 | 37.49 | 0.80 | 0.09 | 1.18 | 42.01 | 1.82 | 11.11 | 0.61 | 31.51 | 0.98 | 8.85 | 0.61 |
| 1978 | 57.07 | 29.64 | 1.01 | 0.14 | 1.16 | 43.69 | 2.09 | 13.51 | 0.80 | 32.68 | 0.27 | 1.97 | 0.80 |
| 1979 | 41.19 | 35.98 | 1.12 | 0.19 | 1.36 | 41.89 | 2.67 | 17.36 | 0.99 | 22.58 | 0.19 | 1.08 | 0.99 |
| 1980 | 29.1 | 45.41 | 0.46 | 0.10 | 1.33 | 44 | 3.19 | 22.11 | 0.41 | 15.85 | 0.16 | 0.74 | 0.41 |
| 1981 | 22.61 | 49.38 | 0.48 | 0.12 | 1.23 | 38 | 3.26 | 24.22 | 0.45 | 12.05 | 0.24 | 1.01 | 0.45 |
| 1982 | 19.69 | 43.6 | 1.23 | 0.27 | 0.94 | 44.91 | 2.94 | 21.91 | 1.11 | 10.95 | 0.23 | 0.99 | 1.11 |
| 1983 | 15.99 | 48.23 | 1.87 | 0.45 | 1.34 | 45.67 | 3.38 | 24.02 | 1.75 | 8.48 | 0.19 | 0.81 | 1.75 |
| 1984 | 12.34 | 38.8 | 2.32 | 0.47 | 1.75 | 49.47 | 3.53 | 20.22 | 2.12 | 7.03 | 0.11 | 0.55 | 2.12 |
| 1985 | 8.61 | 41.97 | 3.60 | 0.81 | 2.29 | 51.08 | 3.75 | 22.47 | 3.30 | 5.04 | 0.12 | 0.52 | 3.30 |
| 1986 | 7.09 | 41.98 | 3.85 | 0.91 | 7.78 | 50.34 | 3.5 | 23.74 | 3.42 | 4.51 | 0.09 | 0.37 | 3.42 |
| 1987 | 7.71 | 39.21 | 4.09 | 0.82 | 7.7 | 44.64 | 2.84 | 20.02 | 3.64 | 4.42 | 0.07 | 0.36 | 3.64 |
| 1988 | 4.71 | 43.34 | 3.20 | 1.22 | 12.17 | 73.58 | 4.04 | 38.09 | 3.03 | 4.37 | 10 | 0.27 | 3.03 |
| 1989 | 4.79 | 46.42 | 2.57 | 1.06 | 12.34 | 74.06 | 3.69 | 41.14 | 2.46 | 4.44 | 0 | 0 | 2.46 |

The ratios were calculated using figures from the National commercial Bank's Annual Reports.

Chapter Ten

The National Commercial Bank's Role in the Saudi Arabian Banking Industry

The previous chapter discussed the NCB's financial position. Several important financial ratios were the focus of the financial analysis done on the bank's performance. This chapter evaluates the Saudi banks' performance with particular concentration on the NCB's performance between 1937 and 1992. The discussion will relate the major transformations in the Saudi banking sector. It is known that the banking market in Saudi Arabia has experienced three stages of evolution during which the NCB was a major player and for many years it dominated the market and was the major decision maker.

The first stage was when the NCB had a monopolistic position. In the second stage the bank had another rival, namely, the Al-Riyadh bank, and both had to share the market. This stage witnessed the beginning of competition. In the third stage the NCB started to experience very serious market competition, as the number of banks had increased to 12, mainly after the completion of the Saudisation process between 1976 and 1982. Within the new competitive environment, the NCB undoubtedly was not the only market decision maker. Several competitive factors appeared and gradually developed in the banking area, such as new services, new technology, as well as the expansion of branches. These were among the most significant marketing techniques used to attract more customers.

Therefore, this chapter will discuss in detail the role and position of the NCB in the Saudi Banking industry. The discussion will be divided into three main parts. The first section will discuss the NCB as a monopoly. In section two, the discussion will deal with the NCB in a duopolistic market. The third section will discuss the NCB facing competition. This part will cover a wide range of issues, including, measuring the competitive performance, competitive characteristics of the Saudi banking market, service characteristics and trends of banks' market share. Other issues include employment, expansion of branches and measures of efficiency, such as, total assets to total employment, total deposits to total employment and total lending to total employment. In this section of the chapter, we will also discuss the role of money changers and Islamic services as competitive forces.

I will then go on to discuss the NCB's competitive market position. This section will try to evaluate the bank's overall market power and its position in relation to other banks in the industry.

10.1 The NCB as a Monopoly:

The branch of a Dutch bank, the Algemene Bank of the Netherlands, was the first commercial bank to operate in Saudi Arabia. It was established in 1926 to serve the Indonesian pilgrims.¹ Another powerful Dutch influence was the Netherlands Trading Society (NTS), which also controlled a large amount of the financial activities of the Indonesian pilgrims, and as a result of this, they also handled a large amount of the Saudi Arabian government's foreign exchange business alongside the Kaki and Mahfouz Company which was later to be known as the NCB. Kaki and Mahfouz jointly controlled the majority of money transactions within the Kingdom.²

It is worth noting that other European financial establishments were denied entry to Saudi Arabia by King Saud himself, which meant that the local business community had to rely on the money changers and lenders and on a trade company, which was known as the Gellatly Hankey, for the service they needed.³ The Saudi Arabian government did not permit any new entrants into the banking sector and therefore barriers to entry existed. These governmental barriers to entry were so strong that even banks from neighbouring Arab nations were not permitted to enter the Saudi Arabian banking sector. The Egyptian bank, Bank Misr, was refused permission to open a branch in Jeddah in 1936.⁴

All this encouraged the Mahfouz and Kaki families to appeal to the King to allow them to form a bank. Soon after, in 1938, as a result of the prolonged negotiations with the ruling family of Saudi Arabia, the NCB was formed. It started as a collaboration between the Bin Mahfouz family, owning 51.5 percent of the business and Abdel-Aziz and Musa Al-Kaki owning the rest of the shares.⁵ Hence, an exclusive right was secured by the NCB to provide banking services in the Saudi Arabian Kingdom. The bank could charge whatever price it thought fit for services provided by it. The only alternatives for the customer were to do their banking abroad, but this involved transaction costs, or use the money lenders, but they provided a restricted range of services. The founders recognised that by setting up a banking establishment they would be able to gain ground in the financial sector *vis a vis* the money changers. They also acknowledged the fact that they would be the Kingdom's sole bankers, as SAMA was established later in 1952.⁶ Since the banking sector in Saudi Arabia had only one seller, which was free of external constraints and was protected by barriers to entry, it can be concluded that there existed a total monopoly. Although the NCB's complete monopoly existed until the 1950's, its

expansion was very slow. It was only after the late 1940's that the NCB branches were established in Riyadh and Al-Khobar. One of the contributory factors to this slow development was the advent of the second World War, which was a hindrance to the commercial environment generally.⁷ However, in 1950, two banks were allowed access to the market, the British Bank of the Middle East, which opened a branch in Jeddah and another in Al-Khobar, and the French Banque de l'Indochine et de Suez.⁸ It is worth noting that both French and British banks' clients were mainly expatriates, i.e. the oil workers - who had come to the Kingdom to offer their services in the extraction of oil. Very few local nationals actually dealt with these banks, as they tended to rely on the NCB and money changers for their financial transactions.

The NCB provided the merchant community with the necessary banking services to facilitate their trading activities i.e. opening letters of credit and foreign exchange services. The latter however, was being undermined by the dominance of the money changers. The bank also provided the general deposit taking facilities and overdrafts, but the actual overdraft amount was always previously agreed upon. Credit was given to the reliable clients and a fee was charged on loans, as opposed to interest, thereby complying with the Sharia laws. However, it is worth noting that the majority of people held their deposits in current accounts, thereby avoiding the interest issue.

Money changers continued to offer some of the services that the NCB provided, but on a much smaller scale, thus preventing the erosion of the NCB's monopoly power. However, they did have an impact on the NCB's ability to expand its operations, because the money changers had certain advantages that enabled them to offer a more cost effective service. Firstly, they were themselves a cheap source of labour and their premises had very low rental costs. These low operating costs were coupled with the fact that they could offer more favourable exchange rates and a speedier service, which enhanced their competitive position. Furthermore, they were open for longer hours than the NCB and hence could command a greater market share. Finally, money changers had no minimum reserves tied up with SAMA. Taking advantage of this position in Saudi Arabia, money changers provided most foreign exchange services to visitors, that were bringing along with them various types of convertible as well as non convertible currencies. They also provided a vital service for the pilgrims during the Hajj period.

Pilgrims were bringing in with them their own home currency and coins and were paying for their daily expenses in riyals. Therefore, the need for money changing facilities existed. These pilgrims normally resided for a period of one to two months and therefore needed to bring with them substantial sums of cash for subsistence and other expenses. This translated itself into a high volume of currency exchange. The money changers were experienced in managing both coins and bank notes as well as precious metal, and could offer the exchange of money for gold and silver.⁹

In spite of the advantages discussed above, money changers were exposing themselves to a certain amount of risks. As they were receiving one currency from a Haji or a merchant and converting it into riyals and visa versa, they ended up holding a variety of currencies for a long period of time. They were running the risk of potential losses if these currencies were devalued due to economic or political factors.¹⁰

Having discussed the position of the money changers in the Saudi economy, and the hindrances it placed on the progress of the NCB, it is now appropriate to concentrate on the factors that enhanced the bank's position in relation to both money changers as well as other banks. It is worth noting that often on the journey to the Hajj the pilgrims would be robbed by highwaymen and therefore they found it was better to transfer their needed funds in advance, to a bank in Saudi Arabia. Thus, the NCB had some advantages compared with the money changers.

It must be remembered that it was often very difficult for local Saudi Arabian merchants to persuade the foreign banks in Saudi Arabia to deal with them. This was primarily due to cultural differences which resulted in divergent business ethos. Therefore, the NCB was one of the few banks these merchants could turn to. As mentioned earlier, at this time, the bank's main activity involved providing trade finance to these Saudi merchants and also providing services such as opening letters of credit on their behalf and other relevant documentation relating to imports. The NCB could then extend short term financing until such time as the goods that the merchants imported were sold and realised into cash. The NCB and the other Saudi banks usually preferred loans to be secured by mortgages on properties owned by the merchants, in spite of knowing that this security could not always be relied upon and there was no precedent of foreclosure.¹¹

Apart from trade financing, the NCB was also quite actively involved in foreign exchange transactions. Foreign exchange services were necessary in order to equip the Saudi merchants to meet their obligations in foreign currencies. Imports were paid for in British pounds, US dollars or other major world currency. In general, business was good, as apart from the money changers, there was no major competitive threat.¹²

The NCB started as a banking monopoly but always encountered a certain amount of financial competition, due to the existence of money changers. The NCB, however, was offering a differentiated service, i.e. distinct to that which the money changers were offering. Since the NCB was a formal commercial bank, it was in a position to provide a range of services that the money changers and lenders could not. This is particularly applicable to the areas of international transactions. Also, money changers could not act as licensed deposit takers. As far as the banking sector of Saudi Arabia was concerned, the NCB enjoyed a monopoly position to a considerable extent.

10.2 The NCB in a Duopolistic Market

The NCB continued as a virtual monopoly until 1957 when the advent of the Riyadh Bank created a duopoly. A duopoly market condition is a two firm oligopoly. There are only two large firms with high entry barriers and a mutual interdependence between firms. In the case of the Saudi Arabian financial market the duopoly situation was not a traditional one. The NCB was much larger than the Riyadh Bank and in 1964 the latter was experiencing financial difficulties which led to the intervention of SAMA to rescue the bank.

The problem of the Riyadh Bank arose because it had started extending credit to non creditworthy customers, who had already been refused by the NCB. Therefore, it was finding it difficult to compete with the NCB. Then SAMA stepped in, restructured the internal organisation and the management of the Riyadh Bank and acquired a 38 percent equity share. However, it has to be borne in mind that SAMA itself was facing difficulties due to its own resources being heavily restricted.¹³

It is essential to understand why the Riyadh Bank had accumulated such a large amount of bad debts. The main contributory factor was that the Riyadh Bank was trying

to expand its business too rapidly and beyond its capacity to win new customers, in an attempt to compete with the NCB. While trying to win new clientele, the Riyadh Bank failed to make appropriate creditworthiness checks. The Riyadh Bank also was not equipped with a strong management base. This compounded its problems. By 1964, there was a lack of confidence amongst the Saudi financial community and consequently, there were major withdrawals of deposits.¹⁴

As SAMA was successful in raising the necessary resources to salvage the Riyadh Bank, it demanded participation in the operation and management of the Riyadh Bank. These events also made SAMA more cautious and conservative in its approach towards the banking sector. Foreign banks were only permitted to establish themselves in Saudi Arabia if their home countries had a significant proportion of nationals employed in the Kingdom or there was a large volume of bilateral trade. Additionally, only one representative commercial bank from each of the foreign countries was given permission to operate in Saudi Arabia.¹⁵ These barriers to entry, enhanced the duopolistic market situation. The only two exceptions to this "one bank from each country rule" was made in the cases of Lebanon and Pakistan. Two Lebanese banks namely, Banque du Liban et d'Outre Mer and the Lebanese Arab Bank were permitted to open offices in Jeddah. The Lebanese Arab Bank was additionally allowed two further offices in Dammam and Riyadh. This was mainly attributed to the fact that the Saudi workforce comprised of a large number of Palestinians with Lebanese passports, who patronised these banks. Also, both these Lebanese banks had some element of Saudi Arabian ownership.

In the case of Pakistan also, two banks were licensed to operate in Saudi Arabia, but each bank was restricted to only one office. The National Bank of Pakistan was operating through an office in Jeddah while the United Bank was permitted an office in Dammam.¹⁶

SAMA permitted other institutions to operate only to the extent of handling remittances and providing ancillary services. The countries represented were Jordan (Arab Bank); Iran (Bank Melli), Egypt (Banque du Caire), United States (Citibank), Netherlands (Algemene Bank Nederland) and Korea (Korea Exchange Bank) - The Korean Central Bank was also allowed to operate in the Kingdom, but its operations were restricted to the extent of representing South Korea's interests relating to Korean companies conducting business in Saudi Arabia. The Korean Central Bank performs no

commercial banking functions and its presence is symbolic of the close link between government and industry in Korea. It is interesting to note that despite of the significant volume of trade between Saudi Arabia and Japan and Germany, no Japanese or German banks were operating in the Kingdom. The result of this conservative attitude on the part of SAMA was that by 1976, prior to Saudisation, there were, as already mentioned only 14 foreign banks operating in Saudi Arabia. This conservative attitude was an attempt to reflect the nationalistic spirit of the Kingdom and the fact that it was inappropriate for a country that was home to Islam's holiest places to aspire to become an international financial centre. If it became an international financial centre there would be controversial factors to be considered such as interest rate policy. Also, SAMA may have been concerned about the fact that if a vast number of foreign banks were permitted to enter the Kingdom, the magnitude of assets of these banks and the economic clout they would carry, would make it difficult for SAMA to exercise sufficient control.¹⁷ Another factor was that foreign owned banks were not really in competition with the NCB and Riyadh Bank for domestic deposits, or as alternative sources for domestic lending. Foreign banks largely served their own nationals, and did some limited financing with respect to trade with their countries of origin.

It has often been questioned whether a large number of foreign banks would have been able to enter the Saudi banking scene in the absence of the restrictions imposed by SAMA. Studies reveal that even in the absence of SAMA, Saudi nationals, who have a very strong sense of national identity, would still patronise local Saudi institutions.¹⁸

The published consolidated financial statements of the NCB and the Riyadh Bank reflect the fact that the NCB operates in a duopoly. These two indigenous banks dominate the Saudi Arabian banking system. The market share of deposits in the 1970's reflected this dominance; NCB 60 percent, Riyadh Bank 20 percent, while the other 14 foreign affiliated banks accounted for 20 percent. These percentages have remained constant during the 1970's and this indicates that the domestic duopoly was maintained throughout this period.¹⁹

The economic implications of the duopoly market have not always been positive. Islamic values have been emphasised at the expense of development in the financial and monetary sectors. The duopoly situation had itself created a sense of complacency and

both the NCB and Riyadh Bank were not sufficiently motivated to be dynamic. The range and diversity of services offered was extremely limited. A customer of a particular branch was not able to withdraw money at another branch, unless prior arrangements were made. The use of cheques was also limited and almost all operating transactions, including payroll and salaries, were strictly on a cash basis. The inefficiencies of the payment system included a lack of adequate record keeping consequently controls and checks had to be imposed throughout the systems.²⁰ Due to the Islamic prohibition against charging or paying of interest, credit cards were non-existent. Accounting systems were manual and there were no cash dispenser machines. All these inefficiencies were only attributable to lack of sufficient competition. Complaints against the “Big Two” included exorbitant bank charges and poor services. Yet, Saudi Arabia was the world’s leading petroleum exporter and the only Third World Nation with a permanent seat on the Board of Governors of the International Monetary Fund. Therefore, it was not appropriate for it to have such a dated banking system. Therefore, authorities started to take some form of remedial action in the mid-1970’s.²¹

10.3 The NCB Faces Competition

Recognising the fact that the financial system was too dependent on the NCB, and the Riyadh bank, in July 1976, the Council of Ministers authorised the Saudisation of Saudi Arabia’s foreign commercial banks.²² At that time there were only 14 foreign banks retaining offices in Saudi Arabia. As already indicated this was mainly due to the restrictive nature of SAMA’s approach towards foreign banks and for political, especially nationalistic, reasons. SAMA realised that those 14 banks were in a position to overshadow it, had it not been continuously able to enforce its control by not allowing them to open more than one branch per bank. Exceptions were made to this rule, namely in the cases of Lebanon and Pakistan as already mentioned.

In the 1970’s two more banks were permitted to have more than one branch in Saudi Arabia. These were, the British Bank of the Middle East and Banque de L’Indochine et de Suez, catering mainly for the large expatriate community there. Such a step was seen as a discriminatory move by the other foreign banks. Citibank, being the only American bank in Saudi Arabia, wanted to establish itself in the Eastern Province where there was a large

American community working with ARAMCO. The bank's request was rejected and it was only allowed to open an office in Jeddah, where there existed a competitive environment between foreign banks.

The two big commercial Saudi banks (NCB and Riyadh Bank) until the mid 1980's were able to continue to control most of the banking business with 80 percent of total bank branches between them, 70 percent of the total commercial bank assets, 80 percent of the total deposits and nine-tenths of all commercial demand accounts in the country. That is not to say that there was no competition from other foreign banks, but the big sizes of these two national banks, SAMA's conservative attitude, the political sensitivity and the nationalistic feelings in the Kingdom made all competition an impossible endeavour.

But how did the real competition start in this market? What was the solution open to the Kingdom to deal with such a problem and how could such a solution make every bank, national or foreign, compete in such market circumstances on an equitable basis? The market share controlled by the two big national banks, the NCB and the Riyadh Bank, was a serious matter of concern for SAMA. The agency was clearly in favour of developing the banking market into a controlled competitive market, while at the same time preventing any foreign influence in the country. The only way in which the two conflicting goals could be reconciled was to "Saudise" the existing foreign banks and then allow them to extend their services. Saudi citizens were invited to purchase 60 percent of the banks shares under the Saudisation conversion. The foreign banks were to offer one third of their shares to "founder members". As a result, the public and the business community were very happy to enter this market and have the chance to invest their private savings in such a business opportunity. But Citibank, which was against the Saudisation, felt that other countries might follow Saudi Arabia's move. Citibank tried to negotiate and then delay the negotiation which proved favourable for the bank. Finally the bank was Saudised since the advantages outweighed the disadvantages. However, during this period of time, the bank was able to design its marketing and advertising strategies for the coming period which enabled its management team to target key customer groups and prepare the most appealing services for each group. For example, they were able to provide separate banking offices run only by women for women .²³

Before one starts questioning the market competition and how the NCB and other banks were performing in this market, it is necessary to review some of the relevant issues in this area.

10.4 Current Developments in Banking

The banking industry internationally has been revolutionised over the last 25 years. This was due to the twin impact of deregulation and technological change. Derek Channon, of Manchester Business School, in his book on Bank Strategic Management and Marketing, was able to trace the most important changes in the banking industry. He found that during the 1970's, the banking industry, mainly in the developing countries experienced substantial changes in the competitive conditions. This was due to several factors. First, US banks played a leading role. This led to interpenetration by overseas institutional competitors and forced the indigenous banking market conditions to change, mainly in the corporate market. Secondly, new capital markets opened, such as the Euromarkets centred in London, which transformed the traditional pattern of funding for both banks and corporations. Thirdly, the European banks in response to competition reacted by building their own multinational presence and attacking the US domestic market with great success, despite the regulations set up by the Americans. Fourthly, the banking diversification move. For example, commercial banks moved into the area of asset-based finance, consumer credit finance, merchant banking, trust and pension management, Eurocurrency operations and syndication, credit cards and the like, while at the same time proliferating the range of products offered in conventional banking services. Later, other services were introduced without any legal constraints, such as insurance brokering and underwriting, travel, security management and computer services. As a result, by the end of this period the banks had become more complex in the range of services offered while competitive pressure had eroded margins on commercial lending. Finally, technological innovations began to affect the banking industry. Most notably, this was apparent in retail banking, where high administrative costs pushed banks to turn to plastic cards and cash dispensers.

Many banking institutions operating under competitive pressures in the market were able to provide more banking facilities such as American Express which found the

opportunities to offer various financial services. In the retail banking sector competition had increased. Savings and loan banks initiated the interest-bearing transaction account, to bring them into direct competition with the commercial banks. By the end of the 1970's, the banking market had become much more competitive with no boundaries between the financial institutions and the customers.

In the 1980's, the banking industry's process of change was accelerated. In the retail banking area for example, banks started to provide special customised services for private clients, mainly to the affluent, in countries with very low rates of tax and offered complete secrecy. Other banks started to pay interest on current account balances at money market rates. This has led to vigorous competition among banks. Banks retaliated by "identifying" accounts and providing them with special treatment and special services such as personal loans, credit finance, insurance, ... etc. Furthermore, computers replaced the manual systems on a large scale. This was in addition to the increased competition between all types of banks for deposit and loans through providing more services to consumers. Non-banking financial institutions entered the market with several competitive services.²⁴

Banks in the developed countries tried their best to widen the range of services they provided, moving into areas such as insurance and housing finance. There was an attempt at cross selling, whereby the client with a current account or savings account was offered other financial services. At the same time technical change has reduced the need for checking facilities, as debit cards have replaced cheques for many transactions. Credit cards were also made available. The banking environment in Saudi Arabia was not however subject to a fast change in the level of financial service and other financial facilities. There were many constraints which prevented quick response from the Saudi banks towards change especially as real competition only started to get serious at the end of the 1980's, after the completion of the Saudisation process. Development in the Saudi banking industry and its services will be one of the main issues covered in this chapter.

10.5 Measuring Competitive Performance

How could one measure the market competitiveness and the NCB's competitive position in

comparison to the other banks in the Saudi market? What methods can be used for such a purpose? The following section reviews the methods available and measures used in this particular area.

One technique is to use a combination of useful conventional performance variables such as turnover, number of employees, number of locations of overseas offices and subsidiaries, current assets, current liabilities and profitability. Another one is to look at the market itself from a different angle. This perspective might include the market characteristics, the service characteristics, competitive characteristics, market attractiveness and other related environmental factors. Channon suggested a new model introduced by one of his students, this measuring system can monitor the bank's current position in the market through what is called the SWOT (Strength, Weaknesses, Opportunities and Threats). As the analysis in this area depends mainly on the data, it is very important to select the appropriate type of data to be used. It is suggested that a comparison of the bank under consideration should be made with its three largest competitors. In our case comparison will be concentrated mainly on the big banks whose assets amount to 80 percent of the total market assets, liabilities, employment, owner equities, loans, total deposits,... etc. Under such criteria, the NCB will be compared to four other banks which are considered the biggest in the Kingdom after the NCB.

For the purpose of the discussion, and due to the limited information released on the Saudi banking sector, an attempt will be made to use a combination of the two approaches discussed above. In other words an examination will be made of any possible measures that could contribute towards providing a clearer picture of the nature of competition in the Saudi banking sector.

Therefore, the discussion will concentrate on the market characteristics, service characteristics, competitive characteristics, competitive position, market attractiveness and competitors analysis. These issues will cover several variables used by banks. In addition to such factors one should not forget that a market might have its own specific characteristics, which may not exist in other markets, due to cultural, social, political or any other specific unique reason. Such variables should be examined especially if they have any significant effect upon the market. In the case of Saudi Arabia, for example, the

Islamic business service is becoming very popular amongst banks while special branches for women is another attraction. Such issues are very specific to the culture of the country. The role of SAMA in encouraging competition and technology will be highlighted.

10.6 The Saudi Banking Market Characteristics

Since 1985, particularly after the bad debt crises in the Saudi banking sector, the market showed significant progress in terms of the industry as a whole, total assets, total deposits and lending growth rates. Total assets of the industry as a whole registered a significant growth between 1985 and 1992 from SR 164.7 billion to SR 297.9 billion, but the highest growth rate was in 1988, which reached 15.5 percent and then declined dramatically to below zero in 1990, due to the invasion of Kuwait by Iraq. The amount of total deposits is another indicator of the market development, especially with regards to the customers' relationship with banks. Total deposits growth rate showed a similar trend as that of the assets growth rate. Total deposits liability in absolute terms have increased steadily between 1985 and 1992, from SR 144.9 billion to SR 258 billion respectively or at an average of 8.28 percent for the whole period. But the most significant growth of deposits was between 1986 and 1988. According to internal documents from the NCB, the growth rate of total deposits reached its peak in 1988 at 15.7 percent, shifting toward more customer deposits rather than deposits from banks or other sources, mainly between 1989 and 1991. There was no significant change in 1992 for both types of deposits. However, this general growth rate reflects the increase of the monetisation trend and the expansion in the number of branches in the Kingdom. In terms of the use of funds by the Saudi banks, there is clear evidence that the amount of lending during the period between 1985 and 1992 has almost doubled from SR 6.2 billion to SR 11.8 billion. But the growth rate did not show a steady trend, and was fluctuating between 0.3 percent in 1985 and 26 percent in 1988 and -11.1 percent in 1990 reaching -0.1 percent in 1992. The effect of the Gulf war was very obvious in this area, although the trend does not reflect the growth of total deposits which means the banks were highly liquid. A low loan to deposit ratio indicates high liquidity and low utilisation and therefore potentially low profitability.²⁵

The retail market segmentation is another area of interest, mainly with regards to

classification. Information on the affluent private banking groups, professionals, the self-employed, students, senior citizens and youth, could give a clearer indication of market characteristics and segmentation, or any possible future changes in the industry. Due to the lack of information in this area, the discussion of such categories remains beyond the researcher's capacity.

10.7 Service Characteristics

In the period between the early 1970's and mid-1980's there was no serious service competition in the Saudi banking industry, although a differentiated product or types of services were developing gradually in the market. Abdeen and Shook stated that; "banks services expansion has not in the past been significant, primarily because Saudi banks have experienced high profit ratios due to the low cost of money (deposit). Consequently, the Saudi banking community, like most businesses in Saudi Arabia, has not seen the need to engage in services innovation."²⁶ However, development and implementation of banking services in Saudi Arabia later became an important issue, especially after the Saudisation process. Indicators of the heavy competition between the banks are an increase in the desire to develop services, expansion of branches as well as the overall technological drive in the market. The latest statistics published in 1993, on the branches of banks in the Kingdom, showed that the total number of branches had risen to over 1100. Such an expansion increases the capacity of the banking system. However, the ultimate constraint is the size of the Saudi market itself which will be another reason for making those banks improve their services in order to attract new clients and hence increase market share.

There is clear evidence that there has been a growing recognition and increasing demand for banking services by the Saudi population - both in the business and the individual household sector - including exclusive branches for women. Furthermore, there was an increasing demand for a more sophisticated service by both the private clients and business, for example, savings and investment accounts, credit cards, insurance, travel facilities, cash withdrawals... etc.

The Saudi banks now provide a wide range of services for their customers. For

example, services provided by the NCB include modern banking products, credit facilities, non-traditional banking services such as Musharaka, Mudarabah and Ijara (or leasing), access to most electronic banking services including mini-statements, travellers' cheques, dollar dispensing and account transfer facilities. They provide corporate banking services for local and international businesses as well as loan syndication. Other services include investment services such as mutual funds, including money market investment, bonds, equities, trade finance, commodities, real estate, currency funds and international brokerage services to the major stock exchange in the USA. The banks now started to focus their services on Treasury bills and Government Development Bonds, in addition to their overseas operations.

Another area of competition among banks is introducing new technology to improve their services such as automated teller machines or point of sale. The most important characteristics of the banking services provided by the Saudi banks, is the type of service itself and how it is differentiated from other services in the market. Recently the important feature is not only the type of service, but how quickly this service can be delivered to the customer by the bank. In this respect new technology as well as new financial facilities such as debit and credit cards are considered to be important criteria in attracting new customers to the retail banking business in Saudi Arabia, as well as in other Gulf countries. For example, in 1989 Saudi American Bank introduced the electronic funds transfer point of sales (EFTPOS) to Saudi Arabia as part of a significant upgrading of its consumer banking services. The bank introduced this new technology over three stages. This system was accompanied by converting its proprietary automated teller machine cards to Visa electronic cards, which enabled its customers to use their cards in Visa outlets worldwide. Saudi American Bank also planned by then to introduce a new type of ATM card which would handle a wide variety of functions previously offered on different cards. Such cards were also designed to allow the Saudi American Bank to stratify its customers according to their income and requirements.²⁷ Later in the same year, the NCB linked its new generation of automated teller machines to the national network and linked also two of its regional systems together, which enabled customers with ATM cards issued in one area to use them in the NCB's machines anywhere in the Kingdom. The machines were set up to operate for 24 hours, seven days a week, and would offer travellers cheques

and accept account instruction as well as dispense cash.²⁸ Al-Rajhi Banking and Investment Company was able to introduce new automatic teller machines and put them in operation within 50 days from the time the first software was installed, an impressive achievement by any standard.²⁹ However, the new systems which were introduced by the Saudi banks and encouraged by SAMA were mainly designed to increase the banks capacity to provide a quick service for the customers as well as allowing banks and their customers to engage in a variety of banking facilities and activities in the Kingdom and worldwide.

10.8 Competitive Characteristics of Saudi Banks

To understand the competitive characteristics of the Saudi banks and the NCB in particular, it is necessary to discuss factors such as the identity of major competitors and their market share, trends in market shares, relative profitability, relative service quality including delivery systems and its capability, time accuracy, relative marketing effort, and barriers to entry or exit. In this section a study is made of some of the important indicator such as total assets, total deposits, total lending and the number of staff. Other variables will be discussed later in this chapter.

The banking sector in Saudi Arabia is now mainly controlled by the six big banks, namely, the NCB, the Riyadh Bank, the Saudi American Bank, Al-Rajhi Investment Company, Arab National Bank and Saudi Faranse Bank. During the Saudisation period, (between 1978 - 1982), the major players in the banking industry were the NCB, Riyadh Bank and the Saudi American Bank. These three banks controlled approximately 70 percent of the market's total assets and over 70 percent of the market's total deposits and around 70 percent of the market's total loans. Table 10.1 shows how the market was dominated by those big banks. Data for the total number of employees for these banks unfortunately was not available to the researcher. In the next decade, the picture changed and competition in the market started to mobilise in a very serious way. The NCB alone was dominating the industry, over the last 6 years, accounting for approximately 29 percent of the industry's total assets and a similar proportion of the total deposit market share. Other major competitive banks have a substantial share of the market. Table 10.1 also shows how the average market share of the big Saudi banks between 1985 and 1992

| From 1978 - 1982 (%) | | | | | | |
|-----------------------------|------|------|------|------|------|------|
| | NCB | R.B | SAMB | SFB | ANB | |
| T. ASSETS | 40 | 20 | 10 | 7 | 5.5 | |
| T. DEPOSITS | 45 | 18 | 10 | 7 | 5 | |
| T. LENDING | 40 | 20 | 13 | 11 | 5 | |
| From 1985 - 1992 (%) | | | | | | |
| | NCB | R.B | SAMB | SFB | ANB | RJHI |
| T. ASSETS | 29 | 16.9 | 11.6 | 7.4 | 7 | 7.5 |
| T. DEPOSITS | 32 | 15.6 | 11.7 | 7.4 | 6.7 | 7 |
| C. DEPOSITS | 32 | 13.3 | 12.4 | 7.7 | 7.2 | 7.8 |
| T. LENDING | 32 | 12.4 | 8.8 | 6.8 | 5.5 | 17.5 |
| STAFF | 7157 | 4326 | 961 | 1226 | 2510 | 6983 |

Information between 1978 & 1982 compiled from annual bank reports. Data for the period 1985 - 1992 was extracted and averaged from special NCB Internal document, SAMA reports, other reports.

changed, compared to the previous period. It is obvious from the table that the NCB, in terms of these variables, has lost a large portion of its market share, however, it remains ahead of other banks. Does this mean that the NCB is the industry's leader, in terms of services, innovations and market satisfaction? The following discussion will reveal the nature of each banks position and the NCB's in particular.

10.9 Trends of Market Shares

In this section a discussion of the development of the NCB market share in relation to other banks, therefore, the growth factor analysis will be applied. An analysis of the growth of the Saudi banks must take into consideration both absolute and relative levels of banking activity, in order to ascertain the degree to which banks have provided a positive contribution to the economic and financial growth and stability of the Kingdom and as an indicator of successful competition between the banks.³⁰ The analysis proceeds to discuss deposits, equity, lending and assets.

10.9.1 Deposits Growth

Examining closely the sources of commercial bank growth and liquidity, it is clear that in absolute terms, deposit activity has provided the main growth impetus, contributing SR 89.3 billion of the total liabilities in 1982, SR 144.9 billion in 1985 and a record level of

over SR 258 billion in 1992. SAMA's annual reports on the aggregate commercial banks activities showed a continuous growth of bank deposits, amounting to 3.8 percent in 1973, 35.7 percent in 1978, 89.3 percent in 1982 and declining to only 4.7 percent in 1985. Total deposits growth rate from 1985 was increasing continuously up to 1988 at 15.4 percent, then declining to -1.3 percent in 1990. The decrease in total deposit in this year was due to the adverse economic climate that resulted from the invasion of Kuwait and the reluctance of depositors to keep their money in the banks, there was a high level of withdrawals and cash hoarding by customers.

However, not all banks experienced decline in their deposits. Most of the Arab and national Saudi banks showed such a decline, while Saudised Western banks recorded a reasonably high growth rate of deposits. The rate of decline experienced by the NCB was -7.9 percent compared to - 1.2 percent by the Riyadh Bank and -12 percent by the Arab National Bank, -19.8 percent by Bank Al-Jazira and -8.4 percent by the Saudi Investment Bank. The remaining banks, except for the Saudi Hollandi Bank, recorded an increase between 5.1 percent and 19.8 percent. This discrepancy in achievement between the Saudi national banks and Saudised banks implies that there was a shift in consumer preference toward Saudi-foreign owned banks rather than national banks in the Kingdom such as the NCB and Riyadh Bank. This was due to the war, which created an unfavorable atmosphere in the entire region of the Middle East. This motivated bank customers to seek safer places for their deposits in the Kingdom. The results of the following years confirm the above statement, as we find a higher tendency toward depositing in the Saudised banks. In 1992, the two national banks, in particular the NCB, experienced a sharp decline in deposits which amounted to 26.3 percent. The whole industry except the NCB, achieved a deposit growth rate of 10.8 percent in 1992. However, it seems that the deterioration of the NCB's deposit position was due to concerns about its financial position, especially with respect to its loans rather than to the Gulf War.

Figure 10.1 shows the development of total deposits of all Saudi banks between 1985 and 1992. Figure 10.2 shows the total deposit market share of every individual bank in the Kingdom. Both figures show that the NCB was the only bank in the industry who's position was declining. The absolute figures show that the NCB was able to attract higher

amounts of deposits than any other bank in the Kingdom until 1989, when its deposits were equal to SR 80.2 billion or 35.6 percent of the total industry deposits. It is indicated that some of the smaller banks are implementing effective policies since their share of the customer deposits are growing systematically. This means they are applying more successful strategies than those adopted by the NCB or the Riyadh Bank. The main beneficiaries of such successful strategies are the Saudi American Bank (10.5 percent in 1988, 13.2 percent in 1992), Al-Rajhi (6.54 percent in 1988, 8.4 percent in 1992), Arab National Bank (5.5 percent in 1988, 9.8 percent in 1992), Saudi British Bank (4.9 percent in 1988, 7.3 percent in 1992), and the United Saudi Commercial Bank (1.9 percent in 1988, 3.2 percent in 1992). The NCB has lost SR 24.2 billion in deposits from 1988 to 1992 or over 14 percent of its share of the total market deposits, which is equivalent to the share gained by these other banks (12.5 percent). The loss of such large amounts of deposits by the bank would definitely affect its lending position as well as its profitability. This is because deposits in the Saudi banking system are a considerably cheap source of funds. A loss of such magnitude reflects the inefficiencies of the bank's management and lack of strategic planning at the top management level.

10.9.2 Equity Growth

Equity is composed of share capital, reserves and retained earnings, and is very critical to the long-term success of a bank. The capital element of equity is essential for a bank to attract the other borrowed funds, primarily deposits, required to support its business. Therefore, an increase in the capital, means more confidence on the part of the bank's owners. This indicates that the bank is able to continue its banking activities into the future, as a going concern. Capital increases in the Saudi banks are subject to prior approval from SAMA. However, it is infrequent that SAMA authorises capital increases. Therefore, the most crucial source of additional capital is reserves. Most of the official Saudi banking reports do not identify the capital and reserves accounts separately and this provides serious difficulties for the researcher to work through individual bank reports.³¹

According to figures shown in the NCB's internal report, the total owner equity of the banking sector has shown continued growth, reaching SR 6.6 billion in 1982 and increasing over four times in a matter of 10 years, reaching SR 28.9 billion in 1992. The

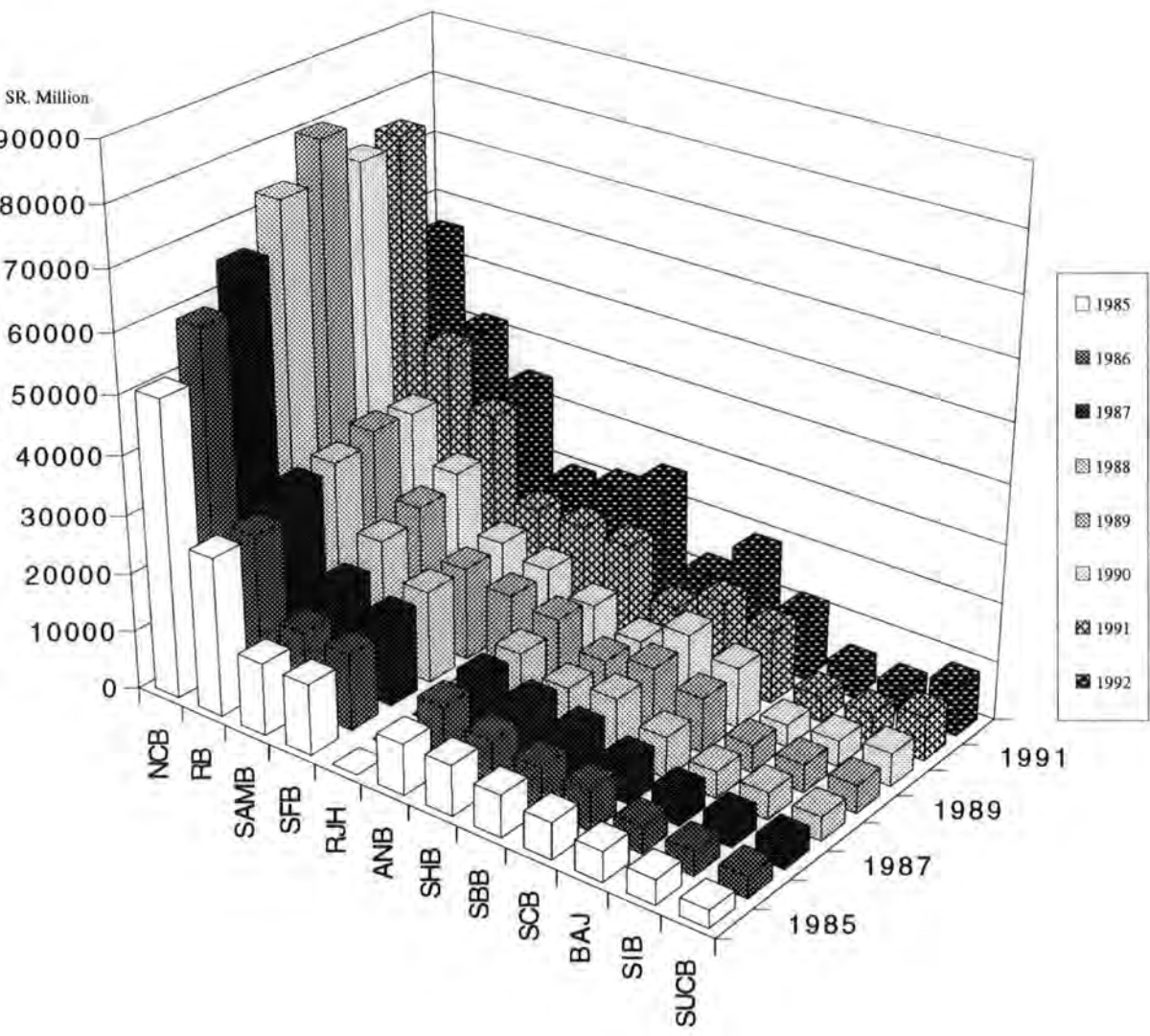


Figure 10.1 Total Deposits in the Saudi Banks 1985 - 1992

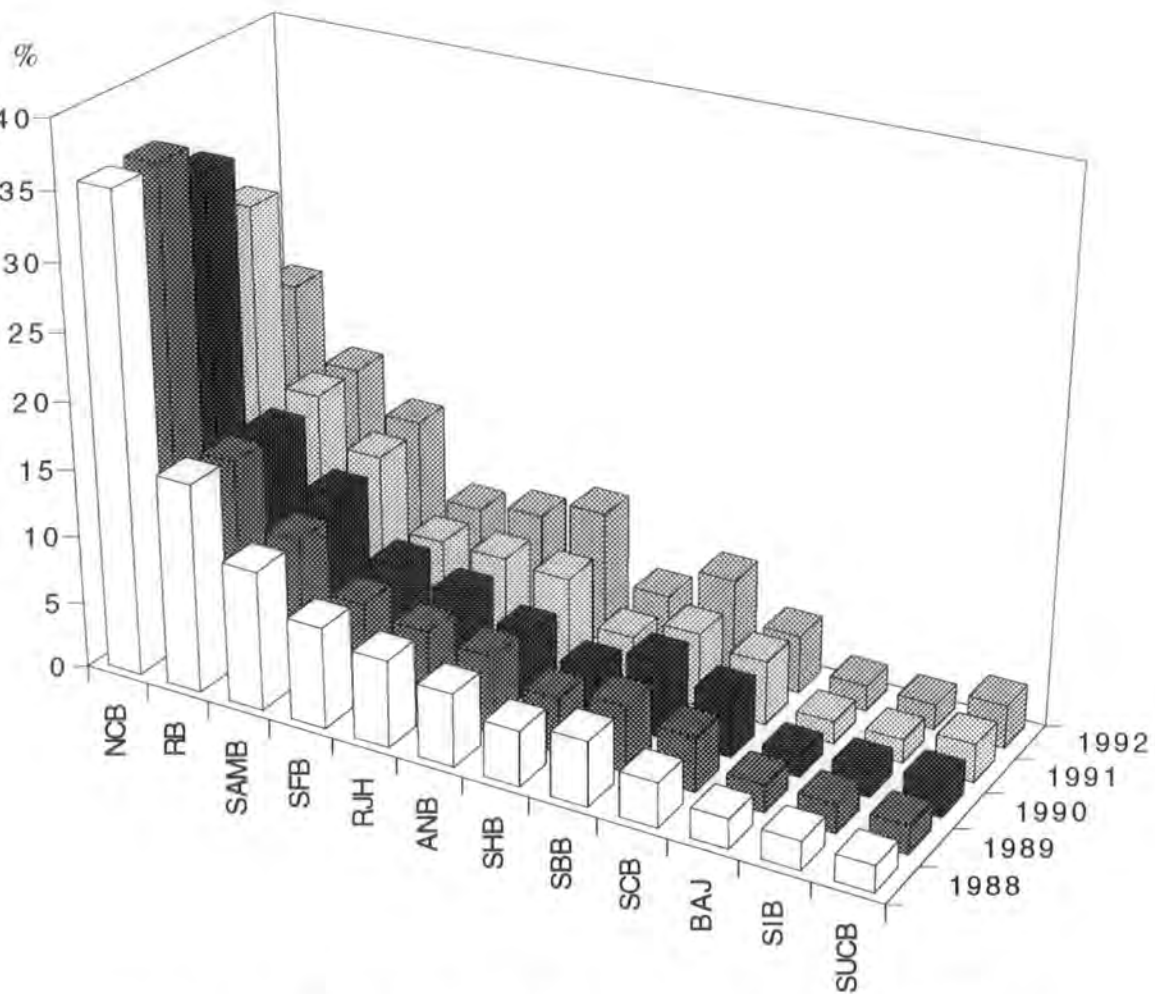


Figure 10.2: Total Deposit Market Share in the Saudi Banks 1985-1992

equity position of individual banks indicates that almost every bank in the Kingdom was able to increase its equity size, with the NCB being the only exception. The NCB was experiencing difficulties as regards its equity growth compared to other banks in the industry. There was no clear indication of such lack of equity growth especially since the bank is the biggest in Saudi Arabia. However, the continuous decrease of the owner equity, which was coinciding with the reduction of deposits and loans, indicates a serious internal problem within the bank. This problem seems to be unique to the NCB and its owners, otherwise, what can be the explanation to the fact that other banks were making profit while the NCB was not. The Bank's internal reports show that owner equity had decreased from SR 3.2 billion in 1989 to only SR 84 million in 1991. Other banks were increasing their equity almost every year through reserves.

The NCB's financial statements between 1989 and 1992 were not published until November 10, 1993, when the bank released its 1991 and 1992 financial statements, accompanied by an unqualified auditor's report.³² Presumably, the bank had improved its portfolio quality and had declared that it has dealt with the notorious special loans given to very senior Saudis. The owners have demonstrated their support for the bank through the injection of SR 5.93 billion of fresh capital. At the end of 1992, total owner equity amounted to SR 6.44 billion. At the end of 1993 the size of the owner equity had increased to SR 6.95 billion and represented the largest capital base amongst Saudi banks. Although the bank was able to increase its capital, it was unable to compete with other banks in terms of gaining more deposits and loans or other short term investments.

10.9.3 Loans Growth and Loss Provisions

Loans and investments traditionally represent the most important business areas for Saudi commercial banks. Most of the Saudi banks are known to be conservative in their lending and investment activities, since they are prevented from enforcing mortgages and collateral arrangements for term loans. Due to the restrictive laws which govern the foreign banks during the pre-Saudised period, the Saudi-owned commercial banks were able to control the bulk of commercial bank loans. The

situation was completely changed after the foreign banks were Saudised and the market was open for every bank to compete. Another factor that contributed to reduce the control exercised by the Saudi-owned banks over the lending market, was the government development agencies, which provided a huge amount of loans and grants to economic sectors such as construction, agriculture, manufacturing, education and medical facilities at very competitive rates, depriving commercial banks of a substantial share of this business.

SAMA's coverage of the early years of the 1980's, indicates that the growth rate of loans and private sector investments have declined, reflecting hesitation on the part of borrowers and lenders.³³ The main cause of such a decline was the government's diversification, in the late 1970's, by increasing the availability of low-cost medium and long term loans from the specialised development and credit agencies. The rules imposed by SAMA had a profound effect on the commercial banks. One was the requirement for commercial banks to place 7 percent of their demand deposits and 2 percent of savings deposits with SAMA, bearing no interest. In addition, if a bank accepts deposits in excess of fifteen times its capital and reserves, it must deposit with SAMA 50 percent of the excess deposit again on an interest free basis. This has had severe consequences for the expansion of some banks (e.g. Citibank). It has also drastically limited the volume of loans granted by some banks with relatively low levels of capital and reserves.³⁴

Therefore, the banks have had no other choice but to look to other sectors such as services, finance, transportation and communication to lend their money to. This shift was in favour of secondary markets, as the government was completely devoted to financing the development of the primary industry market, leaving the joint foreign partner financing to be done overseas. Thereby, the government was able to occupy a competitive niche in this area compared to other Middle Eastern countries and it was also able to prevent commercial banks from controlling economic development and growth.

John Presley suggests that after the oil revenue boom of the 1970's the government created new quasi-government financing agencies, reflecting greater public-sector participation in the financial sector and a lower private-sector involvement. To enhance competition, the Real Estate Development Fund has provided interest free loans for

private house-buyers, thus depriving the commercial banks from providing significant amounts of loans to the real estate sector. In the manufacturing sector, the Saudi Industrial Development Fund, has been generous in its lending, but it does not offer 100 percent of loan capital required, only 50 percent of the finance needed for fixed capital formation. As a result, the commercial banks found themselves financing a proportion of the remaining fixed capital and perhaps more importantly to date, have contributed significantly to the financing of working capital. In the agricultural sector, commercial banks could finance only less than one percent, as financing in this sector is monopolised by the Saudi Agriculture Bank. This means that the commercial banks are competing heavily with the government agencies in the areas of financing the public sector and some private sector activities.³⁵

Another important competitive area for banks is lending to the government which is becoming a serious talking point for all local banks, and lately several banks participated in government loans and syndications launched by corporations with government shareholdings. At the same time the slowdown in government cash flow spending is making banks more cautious. The \$ 1.3 billion general liquidity loan for the Ministry of Finance and National Economy signed in April, 1994 was supported by just seven local banks, including the NCB.³⁶

Another factor that affected the entire banking industry, was the bad debts problem and the non-performing loans. The Saudi banks were very concerned about their non-performing loans and therefore they reduced their loan portfolios between 1986 and 1987. This area was not very attractive to the banks due to heavy losses and so the majority of the banks started to channel their deposits into the interbank market and investments abroad and expanded internationally. Major banks in the Kingdom opened branches abroad, such as in London. The Riyadh Bank opened another branch in London and set up a joint venture bank with Union Bank of Switzerland, in Geneva.

In the mid-1980's the Saudi banks experienced a serious bad debt problem and struggled with an average of 25 percent bad loans in their portfolio, higher cost of funds, and increased competition. Within this environment, the NCB was the biggest loser in the banking industry. It had a ratio of provisions to loans and advances of 3.2 percent

compared to 2.1 percent in the previous year, while the world wide industry average is around 1 percent. Table 10.2 shows the development of provision for loan losses for the banking industry between 1985 and 1992. The table shows that the NCB had the highest provision of losses for loans compared to other banks, increasing from 43 percent in 1985 to 51 percent in 1989 and reaching 25 percent in 1992. The average for the entire period compared to the total provision for loan losses of the market was 37.7 percent, a very heavy burden on the bank and its shareholders. Hence, it could be argued here that it was the NCB's commitment to providing loans to the domestic market that resulted in its bad debt problems. The other banks avoided this by recycling more of their funds to the West, but arguably this did little to help Saudi Arabia's economic development. To some extent the NCB has suffered financially for its policy of supporting the domestic economy. It is apparent from the table that the national Saudi banks have suffered a higher proportion of losses. However, the Riyadh Bank loss was much lower than that of the NCB. Bank Al-Jazira was one of the most efficient banks in terms of recovering its bad debts, and it reduced its losses from SR 100 million in 1988 to only three million riyals in 1992. Al-Rajhi, in its second year of operations as a bank, experienced a loss of SR 234 million, a heavy burden for a new bank and an experienced exchange institution. However, the next year, Al-Rajhi was able to reduce its losses to only SR 11 million.

The bad debt problem had divided the government between its desire to strengthen the banks, and the necessity of maintaining Islamic laws. However, in the absence of collateral guarantees for bank loans, credit was becoming difficult for Saudi businessmen to obtain, particularly for the middle - sized ones. As a result, banks started to be more

Table10. 2: Provisions of Loans in the Saudi Banks: 1985 - 1992 (SR million)

| | NCB | RB | SAMB | SFB | RJH | ANB | SHB | SBB | SCB | BAJ | SIB | SUCB | TOT.IND |
|------|-----|------|------|-----|-----|-----|-----|-----|-----|-----|-----|------|---------|
| 1985 | 691 | 333 | 105 | 76 | 0 | 39 | 70 | 96 | 91 | 42 | 41 | 22 | 1606 |
| 1986 | 836 | 417 | 180 | 148 | 0 | 87 | 60 | 40 | 114 | 19 | 36 | 60 | 1997 |
| 1987 | 922 | 264 | 167 | 88 | 0 | 62 | 74 | 43 | 14 | 100 | 44 | 33 | 1881 |
| 1988 | 966 | 242 | 147 | 86 | 0 | 62 | 95 | 301 | 71 | 0 | 55 | 33 | 2058 |
| 1989 | 878 | 281 | 102 | 106 | 0 | 62 | 90 | 26 | 62 | 0 | 65 | 30 | 1702 |
| 1990 | 97 | 326 | 73 | 105 | 12 | 62 | 80 | 25 | 96 | 0 | 63 | 30 | 960 |
| 1991 | 471 | 182 | 50 | 92 | 234 | 73 | 40 | 36 | 227 | 10 | 35 | 35 | 1485 |
| 1992 | 81 | -160 | 34 | 98 | 11 | 62 | 50 | 36 | 54 | 3 | 35 | 30 | 334 |

Source: Special Document, National Commercial Bank

strict and asked for more detailed documentation from every customer. Under such difficult conditions, the banks have also sought to improve their position by offering Islamic banking products. All of the banks alleviated customers' religious qualms about accepting interest on savings accounts by offsetting services such as no-cost overdrafts, or concessionary foreign exchange rates. Most of the banks started to offer their customers some services like Islamic consumer finance by purchasing cars and selling them back to customers on an installment payment plan. Profit would be made by a mark up on the price, not by interest.³⁷

During the 1970's and 1980's the NCB was leading the market, providing almost over 30 percent of the total market loans. The average contribution to loans market share by the NCB between 1978 and 1982 was 31.5 percent. From the early 1980's to 1988, the NCB growth rate of total lending averaged at 21 percent. Figures 10.3 and 10.4, shows the total lending and total lending market share between 1985 and 1992. The total industry growth rate average, including the NCB, was 8.1 percent and excluding the NCB the growth rate was 6.3 percent. Most of the growth in total lending was due to the NCB lending share. As far as lending market share is concerned, the NCB was able to lend to the market a large share of the total loans mainly between 1980 and 1990, despite the lending problems it had suffered since the beginning of the 1980's. In 1985 the Bank loans amounted to SR 20.9 billion or 32 percent of the market, increasing in 1987 to 42 percent and recording a decline in 1990 to reach 30.2 percent, then to 21.8 percent in 1992. However, in the last five years the circumstances were not in favour of the NCB, thereby affecting its loan market share adversely, in comparison to the rest of the industry.

The trend in the market was in favour of small banks such as Saudi British Bank, Arab National Bank or beginners such as Al-Rajhi. The most significant performer was Al-Rajhi, increasing its market share from 14.7 percent in 1988 to 18.8 percent in 1992, almost equating NCB's share (21.8 percent). It was reported that "a significant part of the loans, granted during the early 1980's by the NCB to very senior Saudis, has been repaid."³⁸

10.9.4 Assets Growth

Total Assets growth provides an overall indication of the rate of development of the

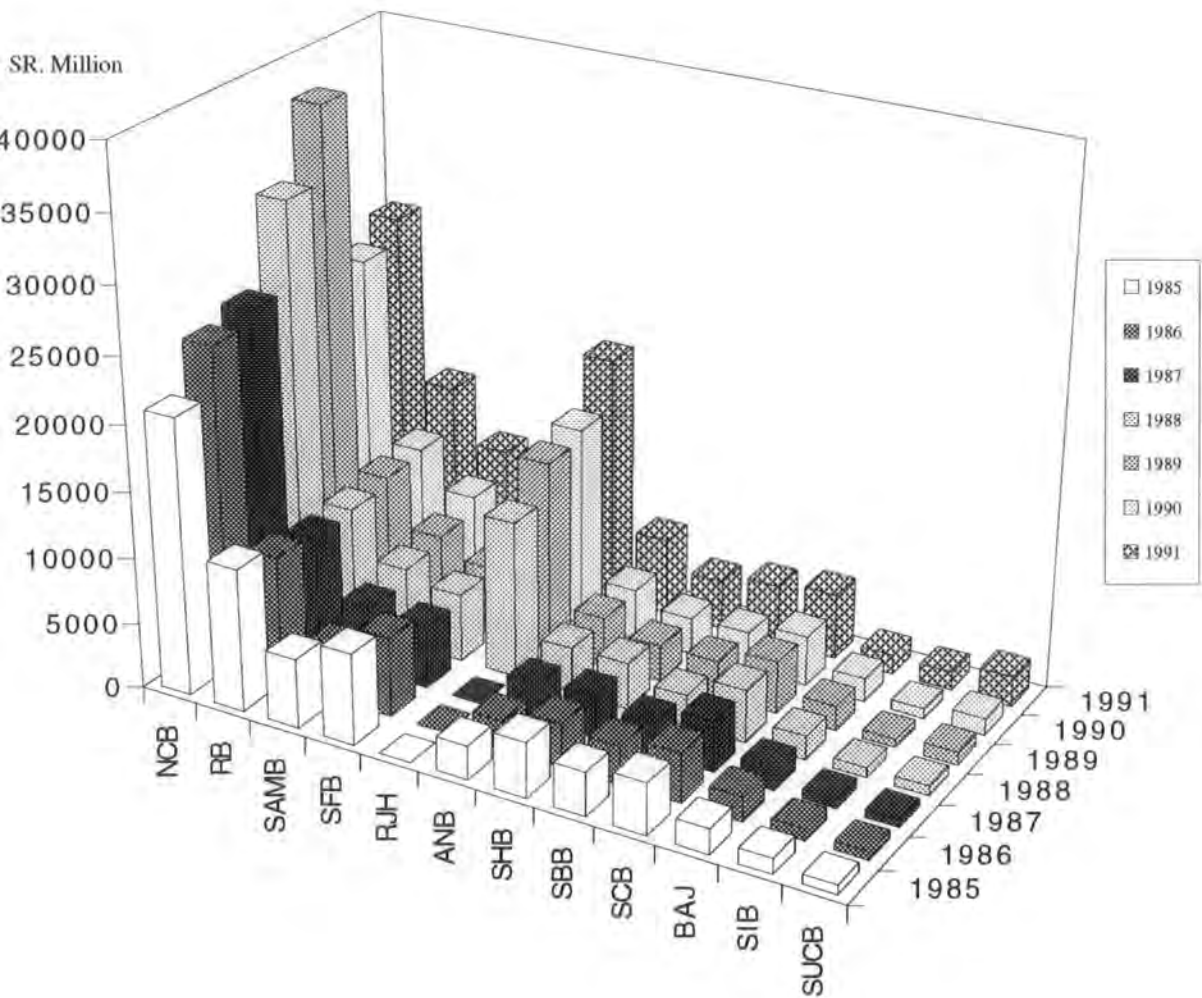


Figure 10.3: Total Lending by Saudi Banks 1985-1991

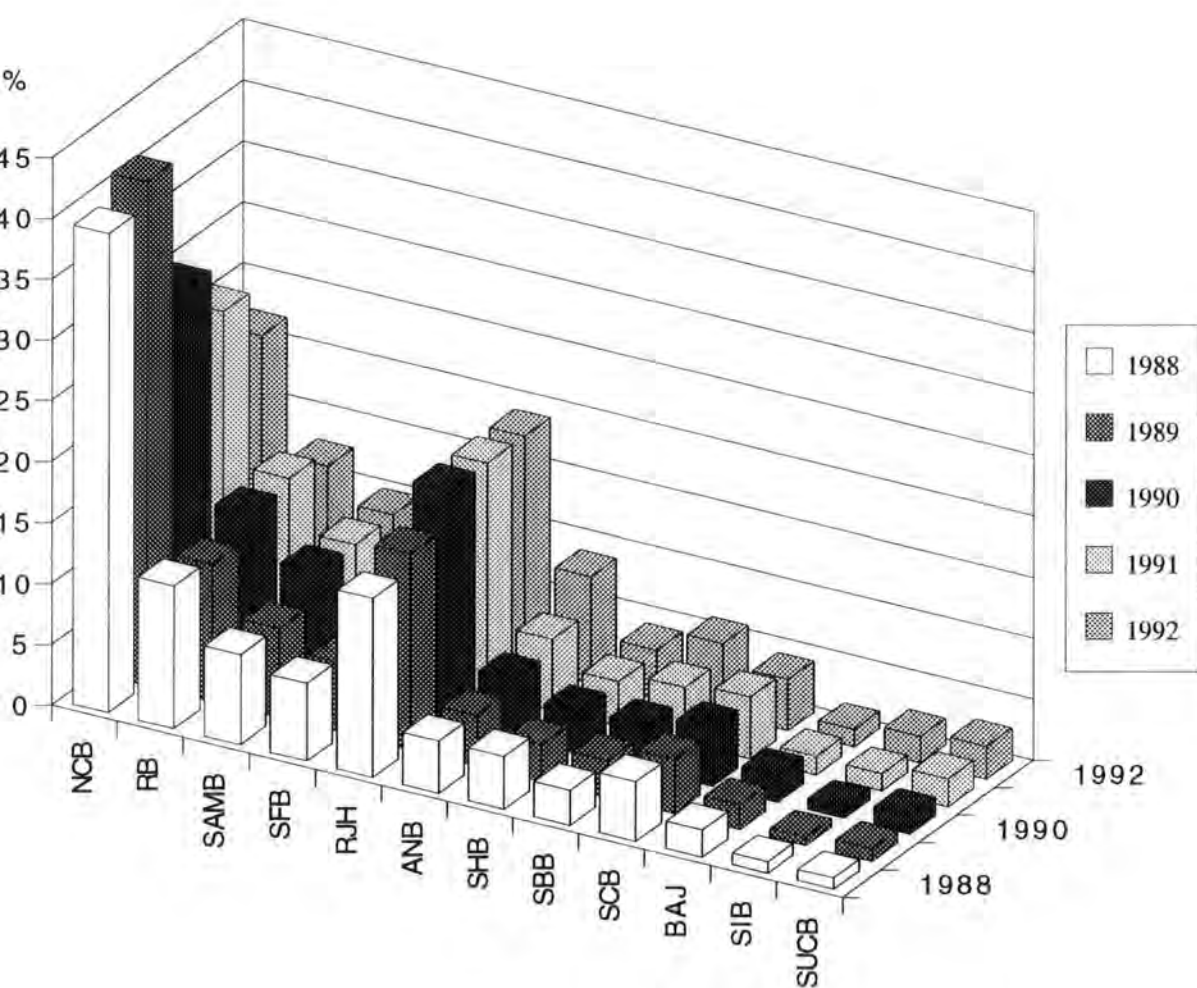


Figure 10.4: Total Lending Market Share by Saudi Banks 1985-1992

primary profit-making vehicles, normally loans and investments. The banking sector in Saudi Arabia recorded significant growth during the period 1973 to 1982, growing from SR 5.3 billion in 1973 to SR 110.3 billion in 1982. In 1979, the growth rate experienced was zero percent, while in 1980 the growth rate of assets reached 25 percent and 43 percent in 1981.³⁹ During this period of time the NCB average assets growth rate was 25 percent, compared to 29.5 percent for the Riyadh Bank, 26 percent for the Saudi American Bank, 43 percent for the Saudi French Bank and 36 percent for the Saudi Dutch Bank. Later the banking industry showed a steady continuous growth of assets. The total assets of the whole industry increased from SR 164.7 billion in 1985 reaching SR 297.9 billion in 1992.

Individual performance varied greatly between the banks. The most significant change in the banking industry was the performance of the NCB compared to others. Figures 10.5 and 10.6 shows the development of assets of the whole banking industry in Saudi Arabia between 1985 and 1992. The bank enjoyed steady growth in its assets from 1979 to 1989, despite the reduction in its customer deposits and the losses resulting from bad debts. Others, such as Riyadh Bank, showed a highly fluctuating growth rate varying between 3 percent and 65 percent in certain years. The turning point for the bank was in 1989 when its assets dropped from SR 86.6 billion to SR 77.2 billion in 1990, then to SR 63.7 billion in 1992, then increasing to SR 66.8 billion in 1993. The industry trend was quite favourable as regards asset growth except for the performance of most of the banks in 1990, due to the Gulf War achieving a growth rate of only -0.21 percent. Regardless of all the troubles the NCB was facing over the last ten years, it remains the Kingdom's largest bank and was able to raise its assets for 1993 by 5 percent and is planning a very important and ambitious restructuring programme.

10.10 The NCB's International Representation

The Saudi Banks have a well established network outside Saudi Arabia. Almost every bank has one or two branches in the Europe, United States, and the Far East including, Japan, Hong Kong and Indonesia. In Britain, for example, there are over ten Saudi Banks' representative offices including those of the Saudi American Bank, Riyadh Bank, Saudi British Bank, NCB. But the NCB closed its representative offices in both Britain and the

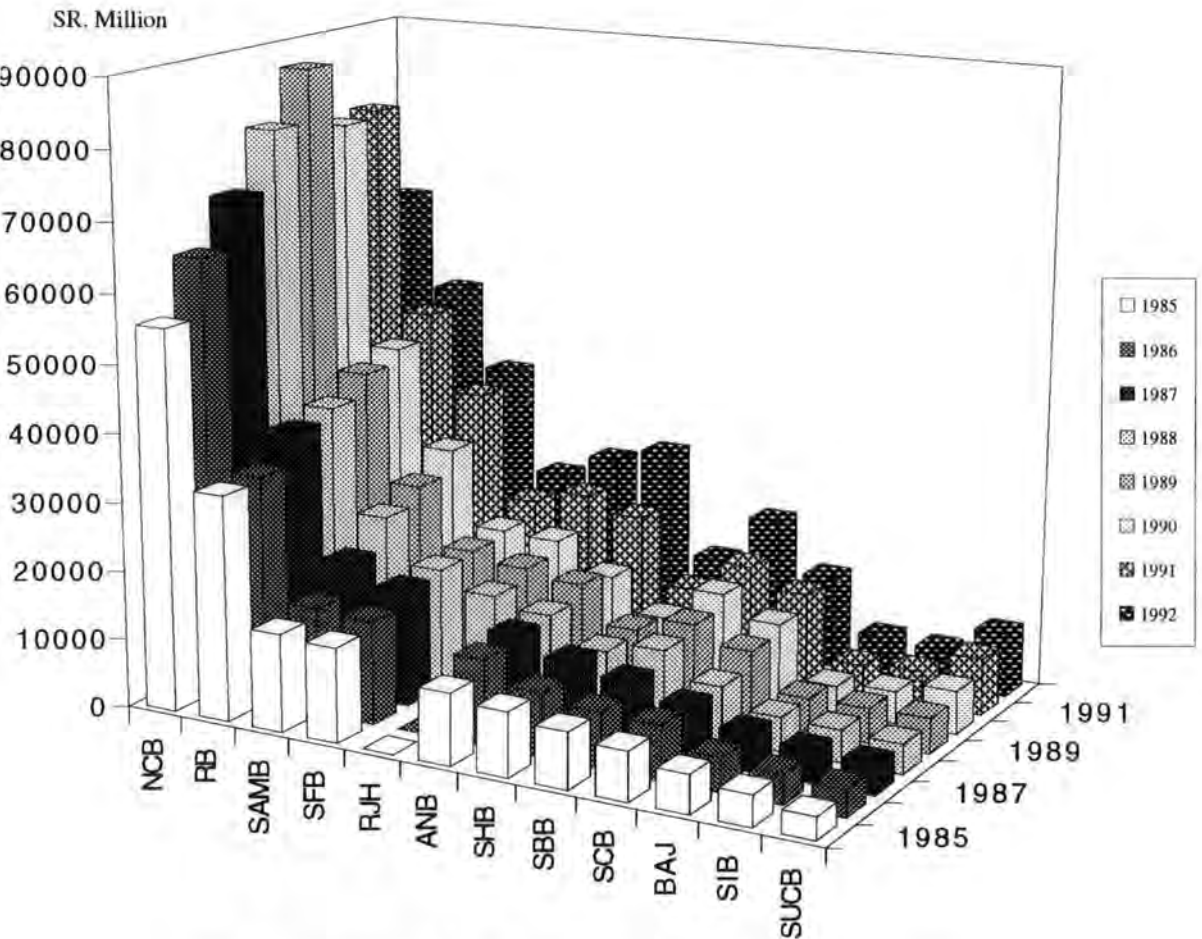


Figure10.5: Total Assets of the Saudi Banks 1985 - 1992

Source: Private Documents on Saudi Banking

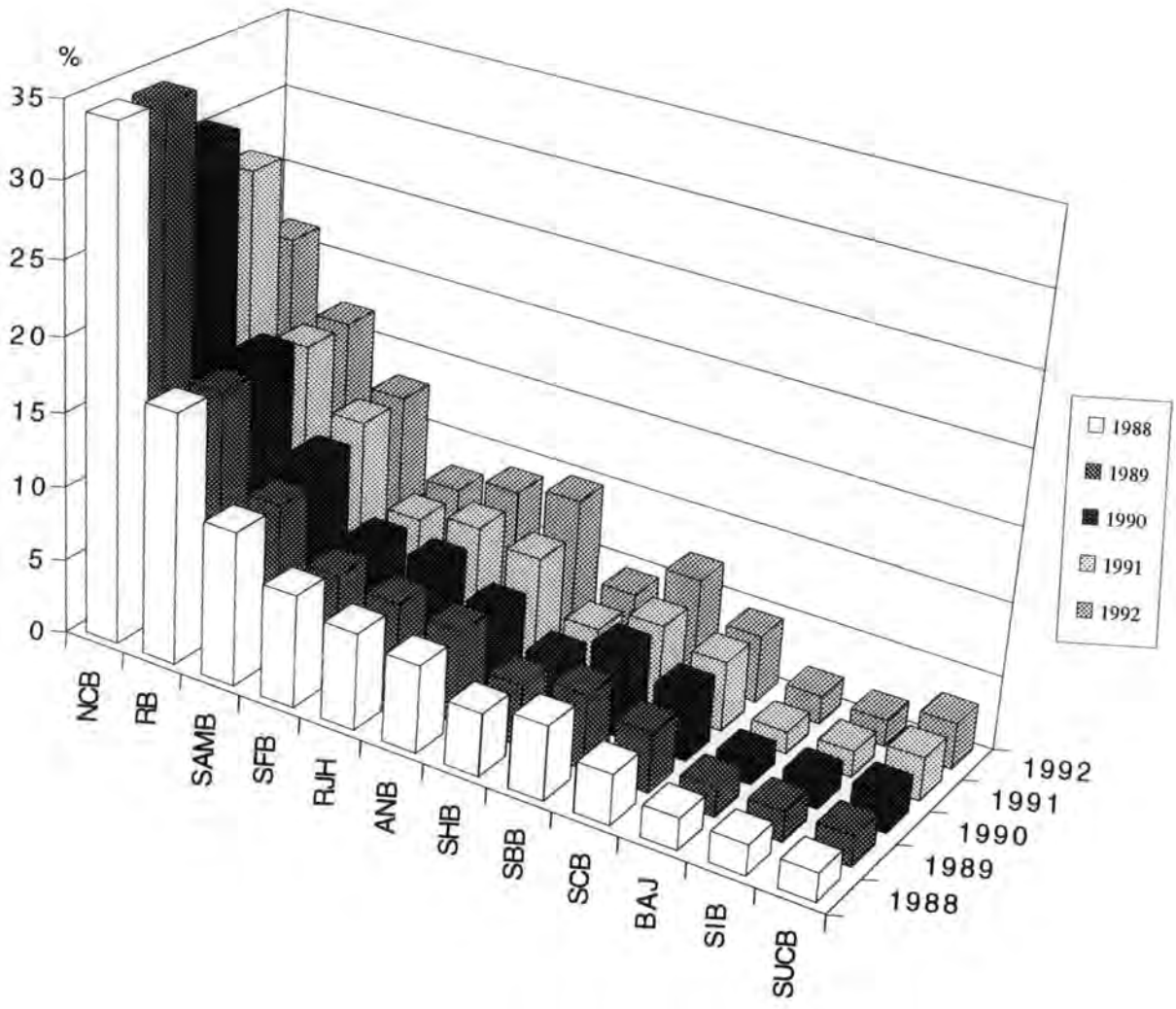


Figure 10.6: Total Assets Market Share of the Saudi Banks 1985-1992

United States of America. In July 1992, after the Bank of Credit and Commerce International collapsed, the Office of the Comptroller of the Currency (OCC) in the United States of America announced that it had ordered the NCB's New York branch to terminate its operations within 30 days.⁴⁰ Because of the BCCI collapse the NCB also had to close its branches in London and the Cayman Islands. As a result the bank lost a great deal of its business abroad and was faced with some international embarrassment. However, experts in the bank argued that the bank did not lose a lot of business as a result, and is still able to organise its business and its client's business in these countries without having an office as before. The management of the bank is now concentrating more on Beirut, Bahrain and Indonesia. In an interview with the General Manager of the Bank he was quoted to prefer at this stage to do more business in Beirut rather than New York, as the bank has considerable score for business due to the reconstruction process in Lebanon.⁴¹

Several field work studies conducted by the NCB between 1993 and 1995 were carried out, and examined the Bank's position in the market. The BCCI problem and international representation were two issues among many to be examined. However, the results of these surveys indicated generally that the customers of the bank were concerned about the BCCI problem, but this matter was not a major reason for them to change or to transfer their business from the NCB to another bank. This is interesting especially as a large proportion (84 percent) of the respondents have heard of the BCCI affair. However, one in three knew that there was some bank in Saudi Arabia which was involved or influenced by this affair. This proportion was higher among the high net-worth individuals than corporate clients. About seven out of every ten respondents that knew of a Saudi Bank "involvement" in the BCCI affair named NCB as being the bank which was affected. When these respondents were asked to describe the ways of the involvement, the most frequent answers given were that "the bank was not affected professionally by it" (57 percent) and "the bank wasn't affected financially by it" (26 percent).

The sample of people who were involved in these surveys seem to have enough knowledge on what has taken place with the BCCI collapse and were aware to what extent the management of the NCB has been involved. Two other frequently mentioned phrases were "through Sheikh Khalid Bin Mahfouz" (28 percent) and "bank was affected internationally" (22 percent).

Almost six out of every ten respondents said that a bank's involvement in the BCCI affair would not influence their decision to continue dealing with it. However, it should be emphasised that this proportion is highest among corporate clients (73 percent), but relatively low among the high net-worth individuals (33 percent).

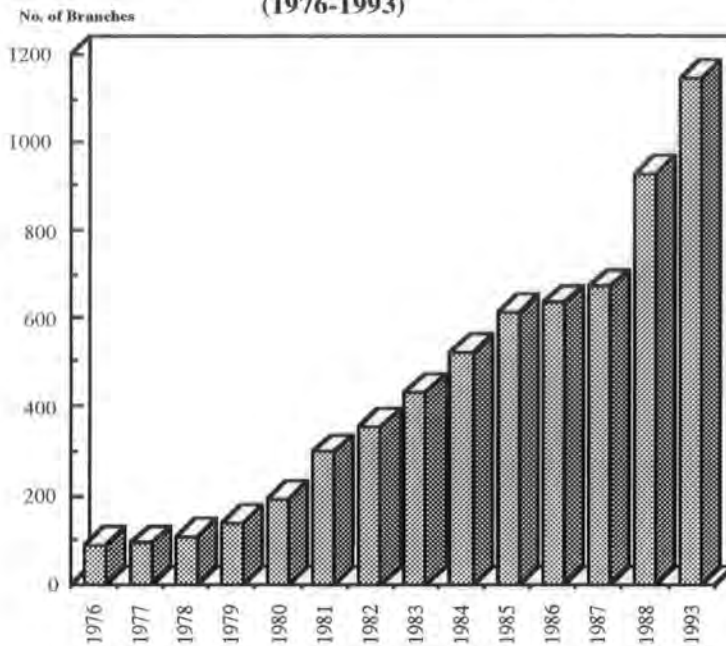
When respondents were asked to say whether the fact that a local commercial bank has a good international presence affecting their decision to use this bank locally, a positive response rate of 50 percent was given in the corporate sector and a positive response rate of 68 percent was given among the high net-worth individuals. Nevertheless, in the corporate sector 70 percent of the respondents said that they would still deal with a bank with no international presence. In the high net-worth individuals sector this proportion was slightly lower (59 percent).

Although it was known that a lot of investors from Saudi Arabia and other countries have lost substantial amounts of money in BCCI as a result of its collapse, they were reluctant to talk about or even to bring the matter to their authorities to follow it up. In the case of the NCB, Mickle Kalane, a special advisor to the General Manager of the NCB, said that the bank has lost as a result of the crises more than one billion Saudi riyals, and Khalid Bin Mahfouz, the Ex-general Manager of the NCB is dealing personally with this matter. It was beyond the researcher's ability to find adequate information to estimate how much this problem cost the NCB. However, the owners of the Bank are now trying to put this problem behind them and avoid involving the bank any further with this officially.⁴²

10.11 Employment and the Number of Branches

It is noticeable as a result of the Saudisation process in the Kingdom, that the number of branches were increasing at an unprecedented rate, being the highest in the Gulf and the Middle East. Figure 10.7 shows the trend of Saudi banks growth between 1981 and 1993. In 1981 the number of branches licenced by SAMA was 352 with most of them located in Jeddah, Mecca and Medina. Over 40 percent of these branches belonged to the two big national banks, the NCB and Riyadh Bank. Within a period of four years, the number of branches had almost doubled reaching 617 branches, of which 158 belonged to the NCB,

Figure 10.7: Growth of Saudi Banks (1976-1993)



Sources: NCB's Annual Reports; SAMA's Annual Reports.

131 to the Riyadh Bank, and 75 to the Arab National Bank while Al-Rajhi company for Currency and Exchange and Commerce has some 180 branches scattered around the Kingdom.⁴³ In 1988 the number of branches had increased to 926, and in 1993 the Saudi banking industry had over 1,142 branches. Out of these 20.1 percent or 230 branches belonged to the NCB.

In 1985, the banking industry in Saudi Arabia had 617 branches and employed just over 24,800 people or an average of 40.2 person per branch, costing annually average of SR 134,000 per employee. Table 10.3 shows the number of employees in the Kingdom's 12 banks from 1985 to 1992. The total number of employees in the industry as a whole has steadily increased, except for between 1986 and 1987 where there was a decrease from 22,603 people to 20,424 employees. This was followed by an increase to 24,411 people in 1989, 26,758 people in 1991 then to over 26,901 in 1993. The biggest share in the industry was the NCB's, as the bank was able to maintain an average of 23.2 percent of the market share over the period between 1985 and 1993. However, from 1991 onwards, the bank ranked second after the United Saudi Commercial Bank. The latter increased its staff number from 6,237 employees in 1990 to 8,174 employees in 1991, reaching over 9,209 employees in 1992.

Table 10.3: Total Number of Employees in the Saudi Banks: 1985 - 1992

| | NCB | RB | SAMB | SFB | RJH | ANB | SHB | SBB | SCB | BAJ | SIB | SUCB | TOT.IND |
|------|------|------|------|------|------|------|-----|------|------|-----|-----|------|---------|
| 1985 | 6230 | 4617 | 1434 | 1907 | 0 | 2478 | 922 | 1156 | 1517 | 957 | 297 | 3290 | 22000 |
| 1986 | 6123 | 4577 | 1087 | 1689 | 0 | 2333 | 842 | 1147 | 1281 | 938 | 189 | 3915 | 20603 |
| 1987 | 6315 | 4527 | 967 | 1520 | 0 | 2644 | 772 | 962 | 1247 | 871 | 172 | 4335 | 20424 |
| 1988 | 6561 | 4361 | 967 | 1395 | 3905 | 2536 | 772 | 937 | 1247 | 845 | 172 | 4337 | 24012 |
| 1989 | 6799 | 4300 | 961 | 1314 | 4681 | 2543 | 788 | 926 | 873 | 743 | 195 | 5161 | 24411 |
| 1990 | 6915 | 4280 | 961 | 1226 | 5453 | 2510 | 800 | 965 | 870 | 743 | 207 | 6237 | 25191 |
| 1991 | 7037 | 4326 | 961 | 1226 | 6983 | 2510 | 800 | 965 | 940 | 513 | 207 | 8174 | 26758 |
| 1992 | 7157 | 4326 | 961 | 1226 | 6983 | 2510 | 800 | 965 | 940 | 536 | 207 | 9209 | 26901 |

Source: Special Document, National Commercial Bank

The influx of the bank's branches in Saudi Arabia has increased the demand for highly scarce technical and professional staff, as well as increasing the salaries of new graduate entrants. Saudi banks are reported to have stated that they pay more than SR 130,000 a year (US\$ 36,000) for a graduate entrant who will also get health insurance in addition to social insurance contributions made by the employer. This would make the Saudi graduate trainee one of the most expensive in the world. According to the Andre van Hove, deputy general manager of the Saudi Cairo Bank, one of the biggest problems of Saudi banking now is cost and quality of service.⁴⁴

As the majority of banks were operating within a competitive environment, the number of branches were increasing rapidly, and therefore, the number of staff required to run and operate new branches, contributed to increased staff costs and operating expenses.

Cost of staff became a major problem facing the banking industry with limited solutions. Several reasons contributed to such limitations. Most of the banking staff in the Saudi banks are foreigners and cannot be substituted easily by local nationals. Although the number of Saudi employees is increasing significantly, this is not at the rate required to solve such a problem. Table 10.4 shows the average annual staff costs per employee from 1985 to 1992. Coordinating the information in this table and the information in table 10.3 (Staff Numbers) it can be concluded that despite the increasing number of staff in the whole industry, the banks were able to decrease the cost per employee in general. The average annual cost of one person in the banking industry was SR 121,000 and kept declining to an average of SR 102,000 in 1989, but increasing again to SR 119,000 in 1992. (See table 10.4) The NCB's annual average cost per employee

Table 10.4: Average Annual Cost per Employee (SR. 1000)

| | NCB | RB | SAMB | SFB | RJH | ANB | SHB | SBB | SCB | BAJ | SIB | SUCB | TOT.IND |
|------|-----|-----|------|-----|-----|-----|-----|-----|-----|-----|-----|------|---------|
| 1985 | 111 | 104 | 205 | 132 | 0 | 114 | 172 | 116 | 111 | 81 | 164 | 156 | 121 |
| 1986 | 106 | 95 | 213 | 132 | 0 | 106 | 160 | 115 | 95 | 83 | 148 | 141 | 114 |
| 1987 | 100 | 83 | 206 | 132 | 0 | 96 | 145 | 109 | 100 | 70 | 183 | 141 | 106 |
| 1988 | 138 | 99 | 221 | 131 | 65 | 97 | 142 | 115 | 99 | 75 | 140 | 151 | 117 |
| 1989 | 108 | 105 | 224 | 136 | 42 | 102 | 146 | 123 | 97 | 78 | 135 | 128 | 102 |
| 1990 | 111 | 105 | 248 | 148 | 43 | 106 | 164 | 132 | 112 | 64 | 137 | 134 | 104 |
| 1991 | 111 | 114 | 279 | 163 | 46 | 117 | 162 | 142 | 120 | 67 | 162 | 153 | 108 |
| 1992 | 120 | 125 | 331 | 171 | 67 | 111 | 160 | 153 | 128 | 75 | 165 | 174 | 119 |

Source: Special Document,
National Commercial Bank

over the same period was SR 113,000, which is almost in line with the industry's average.

The actual cost per staff member in 1985 to the NCB was SR 111,000 reaching SR 120,000 in 1992. In other banks, such as the Riyadh Bank, the average was not so different from the NCB's or the industry's average, but in some banks the actual cost was greater than the industry's average. For example, in the Saudi American Bank, the actual cost per employee was SR 205,000 in 1985 compared to SR 111,000 in the NCB and SR 104,000 in the Riyadh Bank, SR 81,000 in Al-Jazira Bank compared to SR 121,000 for the whole industry. Later in 1988, when Al-Rajhi Company started, the NCB's average annual cost per employee increased to SR 138,000, while the Riyadh Bank was able to decrease this cost to SR 99,000, remaining high was the Saudi American bank at SR 221,000. Al-Rajhi was able to recruit very cheap staff compared to other banking institutions in the Kingdom. The high variation of cost per employee is due to a number of factors. The Saudised banks were employing a proportionately higher number of foreign staff than Saudi national banks. This made a great difference in benefit payments such as insurance, housing and other fringe benefits. The national Saudi banks have a greater number of employees and branches, yet their foreign staff are cheaper than others, since they are often expatriates from Asian countries such as Pakistan and India. However, Saudised banks rely heavily on high technology compared to other national banks, but recently this trend started to change as all the banks started to compete heavily in this area, and SAMA has been pushing all the banks to join its network.

Another significant difference which exists between the Saudised banks and national banks, is that the Saudised banks were able to generate higher average profit contribution

per employee according to their financial statements. This must have encouraged those banks to reward their employees financially and nonfinancially. Table 10.5 shows the average profit contribution by each employee before any provisions. Such a measure is a sign of efficiency to output of staff in an institution. The higher the output of a member of staff the more likely it is that he is better trained and hence is of greater value to the bank. As table 10.5 shows, the most productive staff members in the banking industry were those of the Saudi American Bank followed by those of the United Saudi Commercial Bank and the Saudi Investment Bank. In both cases it is noticeable that high technology was introduced to increase their operational efficiency.

A striking feature was the productivity of the NCB's staff members. For example, in 1985, the average profit contributed by each employee was SR 128,000 which continued rising up to SR 150,000 in 1988, but showed a dramatic decline to only SR 72,000 in 1992, making it one of the lowest averages in the market. This decrease in the NCB's average profitability by each member can not be attributed only to the fact that the bank has a higher number of staff, since the Saudi United Commercial Bank, has a high number of staff compared to the NCB and yet it was able to attain higher profitability. One could, however, attribute it to the continuous policy of the NCB to recruit an average of 150 employees between 1985 and 1992, while most of the other banks were decreasing their staff members by an average of 75 employees annually. Also the NCB staffing policy was partially conducted as a personal favour and to a great extent was a national responsibility, as described by the owners of the bank. Another reason was that the NCB continued to

Table 10.5. Average Annual Profit Contribution per Employee in the Saudi Banks: 1985 - 1992 (SR. mil-

| | NCB | RB | SAMB | SFB | RJH | ANB | SHB | SBB | SCB | BAJ | SIB | SUCB | TOT/IND |
|------|-----|-----|------|-----|-----|-----|-----|-----|-----|-----|-----|------|---------|
| 1985 | 128 | 113 | 193 | 95 | 0 | 89 | 97 | 89 | 67 | 88 | 87 | 10 | 88 |
| 1986 | 148 | 127 | 207 | 135 | 0 | 99 | 77 | 43 | 39 | 27 | 152 | 100 | 96 |
| 1987 | 148 | 92 | 251 | 95 | 0 | 106 | 119 | 37 | -15 | 8 | 266 | 44 | 96 |
| 1988 | 150 | 114 | 395 | 118 | 301 | 124 | 172 | 65 | -70 | -59 | 355 | 146 | 151 |
| 1989 | 131 | 124 | 543 | 154 | 239 | 151 | 218 | 160 | 21 | -69 | 413 | 417 | 208 |
| 1990 | 0 | 140 | 624 | 185 | 215 | 155 | 206 | 230 | 110 | -44 | 330 | 566 | 226 |
| 1991 | 90 | 134 | 835 | 204 | 150 | 150 | 211 | 297 | 251 | 16 | 296 | 734 | 281 |
| 1992 | 72 | 135 | 982 | 243 | 105 | 178 | 230 | 315 | 201 | 83 | 366 | 825 | 311 |

Source: Special Document, National Commercial Bank

raise its staff salaries, which resulted in increasing the cost of its staff from SR 689 million in 1985 to SR 846 million in 1992. This contributed to a decrease in profitability from SR 128 million in 1985 to SR 72 million in 1992. Other banks such as Al-Rajhi was also able to achieve over SR 300,000 profit per employee in the first performing year, 1988. Later, in 1992, the average declined dramatically to slightly over SR 100,000 although the average cost per staff member of Al-Rajhi was the lowest in the market, which meant that they should have done better than others in the industry. Since 1987 a number of banks announced a plan of redundancy and technological improvement. The purpose of such a plan is mainly to improve the quality and the speed of the service provided, as well as decrease the number of staff and subsequently cut their high costs. The NCB reduced its work force during 1992-1993 fiscal year by 700 people, despite that its operating expenses were almost unchanged at SR 1.4 billion. However, in 1994, the bank shed a further 1,200 employees to reduce the work force to 5,500 people.⁴⁵

In the future, it is expected that the ratio of employees / branch will fall in the light of the new technical advances introduced by SAMA and the banking community to the industry such as the new automated teller machines and point of sale. Another factor is that several banks have announced redundancy plans.

10.12 Other Efficiency Ratios

Other efficiency ratios are total assets per employee, total deposits per employee, total lending per employee...etc. Such ratios would be able to show, for example, how well the individual employee is managing the bank's total assets or deposits, or how much profit or income is contributed by each individual in the bank, or how much are each individual's share of the total operating expenses. It is worth noting here that such efficiency ratios can provide only limited information on the business activities, and they are relative measures. But clearly, they can provide a better picture of the bank's efficiency and effectiveness in the market. They are also very useful in examining the efficiency of the employee and his level of achievement when performing his banking duties. They measure, indirectly, the skillfulness of the bank's employees and how heavily the bank depends on human efforts or other alternatives such as the automation of operations. It also reflects the type of business the bank is involved in. Banking for corporate customers

is less labour intensive than personal banking, although the distinction may be less clear in Saudi Arabia. However, if the bank's ratio of assets or deposits to the number of employees is high, it indicates that an individual in the bank is managing a large share of the total assets or total deposits, hence showing a higher degree of automation of operation which results in less manual work as well as less bureaucracy in the offices. This results in a more speedy delivery of service as well as a higher degree of accomplishing banking operations. The researcher was able to acquire detailed information on several factors pertaining to the banks in Saudi Arabia for the period between 1985 and 1992. Therefore, the analysis will be concentrated on this period of time and comparison to the previous period would not be possible due to the lack of information on the banks' performance.

10.12.1 Total Assets to Total Employment

This ratio will show how much assets are allocated to each employee in the bank. The higher the ratio is, the better the bank's assets position is in terms of the number of human resource cost within the bank, which means that the bank would be able to increase its assets such as customer deposits, deposits of other banks, and other assets at relatively low costs.

The total banking industry was able to show a steady growth of total assets to total employment during the period between 1985 - 1992. In 1985 the average size of assets to one employee was SR 7.5 million. Then the ratio increased to SR 9.8 million in 1987, reaching SR 10.06 million in the next year and managing to continue its growth to SR 10.7 million in 1991 then to almost SR 11.1 million in 1992. Individual ratios varied to a great extent between the banks. Several banks were able to show high levels of assets to employment. Those banks were the Saudi American Bank, the NCB, the Saudi Faranse Bank and the Saudi International Bank. Other banks ratios were for the whole period below the industry's average. The Saudi American Bank was able to show its strength in terms of its ability to utilise its employees productivity to its total assets better than any other bank. The Saudi American Bank was able to increase its assets at a higher rate than the whole industry's level. It recorded an average of SR 9.8 million assets per employee in 1985, managing to double this ratio in two years reaching a remarkable level of SR 49 million in 1992 compared to the industry's average which was SR 11.1 million. What

might have helped the Saudi American Bank to increase its assets, is its ability to rely on highly qualified and expert bankers, usage of a higher degree of automation in its operations, attracting higher number of high net worth individual and technical support from Citibank. The NCB was able to maintain a ratio that was very close to the industry's average. Although the NCB accounts for over 30 percent of the total assets of the market and employed not less than 28 percent of the total banking workforce, it experienced a continuous loss of a great proportion of its assets, as well as increasing its employment. Therefore, the NCB's ratio of total assets to total employment was showing a declining trend from SR 12.74 million of assets in 1989 to SR 8.9 million in 1992. Other banks such as the Riyadh Bank, the Saudi Cairo Bank and the Saudi British Bank were not above the industry's average, mainly between 1985 and 1987. But these banks were able to improve their asset's position later between 1988 and 1992 reaching better levels between 1990 and 1992 compared to that of the NCB.

10.12.2 Total Deposits to Total Employment

This ratio is quite similar to the total assets ratio. As deposits are mainly of two types, namely, customer deposits and other banks' deposits, the effect is normally felt from customer deposits as they account for over 92 percent of the total deposits of the Saudi banks for the period 1988 to 1993. This ratio is more critical and sensitive than the assets/employee ratio, because at least 11 percent of the total assets are removed when we consider total deposits only, while the number of employees remains unchanged.

The whole industry's ratio has varied between SR 6.6 million of deposits for each employee in 1985 and SR 9.6 million per employee in 1992, registering a steady growth in deposits per employee. Four banks had higher ratios than the industry's average, namely, the NCB, Saudi American Bank, Saudi Hollandi Bank and Saudi International Bank. The rest of the banks recorded very low ratios compared to the average ratio of the banking industry. Amongst the banks with the higher ratios, Saudi American Bank was in the lead, moving from SR 8.6 millions of deposits per employee in 1985 to over SR 35 millions per employee in 1992. The major reason for such a growth in the Saudi American Bank's ratio was its plan to cut down its total employment from 1434 employees in 1985 to only 960 employees in 1992. Also it had the ability to increase its total deposits from SR 12.3

billions in 1985 to SR 34 billions in 1992. Other banks such as the Saudi Hollandi Bank and Saudi International Bank, were able to achieve higher ratios due to similar reasons.

The NCB and the Saudi United Commercial Bank were experiencing a completely different trend to that experienced by the previously mentioned banks. These two banks were able to achieve two targets at the same time, one is increasing their proportion of deposits, another is increasing their total employment. Although The NCB was above the industry average most of the time, the bank was not quite able to raise its share of deposits like others in the industry. This was a major reason for the bank being unable to retain the same deposit levels in the market compared to previous years. The NCB's total deposits declined from SR 80.2 billions in 1989 to SR 55.6 billions in 1992, or a decline of SR 24.6 billions (30 percent) in a matter of four years. Some reports estimated that the NCB had lost around 800,000 depositors.⁴⁶ Although these may be exaggerated, nevertheless, it seems very likely that the NCB did lose a large number of depositors, for example between 1991 and 1992 the loss of deposits was over SR 18.9 billions. The Riyadh Bank was always below the industry average, but was able to increase its deposits and decrease the total number of employees. Other possible reasons that might have contributed to the NCB and other banks varying deposit levels is the type of clients in these banks.

The latest empirical studies conducted by the NCB on the Saudi Banking industry have revealed evidence supporting the above argument. It was found that the "NCB is serving around 25 percent of the banking population", but it was not clear from the report whether this percentage is represented by the same percentage in money terms or deposit size; current account holder or time deposit account holders in the banking sector. The studies found that the "NCB is relatively weaker in the customer group representing the under 25 age group and stronger in the 35-44 group. On the other hand, the share of Saudi American Bank is larger amongst the younger age groups. There is no clear age pattern for Al Rajhi. ANB's position is strongest among oldest age groups." This issue will be explored in more detail in another chapter.

10.12.3 Total Lending to Total Employment

The total lending to total employment ratio is another efficiency ratio which can indicate how many loans are granted by the bank per member of staff. It is an indication of the bank's ability to increase its business activity in relation to its total employment levels. As the ratio increases, it signals that the bank's business has grown at a faster rate than that of its employment growth. Otherwise, it means that the bank is experiencing a higher rate of employment and as a result higher expenses would be recorded in its financial statements at the end of the year. It is known that the Saudi banks have suffered heavy losses from lending during the 1980's. In this difficult situation, SAMA was not able to help much, as the law in the Kingdom does not support the banks in taking mortgages as securities. It is against this background that banks were very cautious in their lending policies in general. Some banks such as the NCB have suffered great losses reaching over 25 percent of the total industry bad debts. It is, therefore, not surprising to find that the total lending ratio to total employment was at very low levels. As the lending circumstances affected the industry and its performance, several banks experienced a decrease in lending and therefore, the ratio of total lending to total employment reflected the difficult times experienced by banks.

The banking industry in the Kingdom has shown a relatively slow growth of loans compared to the growth of total employment. The ratio of lending to employment has moved from SR 2.8 million per employee in 1985 to SR 4.4 million in 1992, compared to SR 6.6 million of assets per employee in 1985 and SR 9.6 million of assets per employee in 1992. The gap between depositing per employee and lending per employee has widened for banks whose major source of income is customer deposits and major business is lending. This gap was growing over the period between 1985 and 1992, from SR 3.8 million to SR 5.1 million. This does not suggest that the banks are not taking the opportunity of using their funds, but it is a clear indication that this money is being used in another investment area rather than lending. It also means that the Saudi banks were unable to fully utilise their funds and this explains why they remain highly liquid banks.

There were only three banks who attained a higher ratio than the industry's average ratio, namely, the Saudi American Bank, the NCB and the Saudi French Bank. Among these, the Saudi American Bank was able to double its loans between 1985 and 1992 from

SR 5.2 billions to 11.6 billion respectively, while the ratio of its deposits to total employment has increased from SR 3.67 million per individual in 1985 to SR 12.1 million in 1992. The Saudi French Bank has increased its ratio from SR 3.62 million to SR 7.7 million over the same period. However, the NCB was unable to improve its lending to employment ratio at the same rate as the two previously mentioned. The ratio of total lending to total employment achieved by the NCB was SR 3.37 in 1985, increasing to SR 5.48 millions in 1989 and then decreasing to SR 3.6 million in 1992. Major reasons for this ratio not being in line with the industry ratio were the bank's new conservative lending policy, the shifting of its business from lending locally to investing abroad, high provisions of loss due to the large amounts of non-performing loans and the decline in the size of its deposits. As a result, the NCB has decided to diversify its investment portfolio into different areas, so as to eliminate the high risk generated from local lending. This diversification involves investing in government bonds and investments abroad. This of course will not help the private sector to develop within the Kingdom. It seems that the pressure to stay competitive, and to perform as well as Saudi American Bank, is almost forcing the NCB to turn away from the domestic economy and avoid lending risks.

10.12.4 Other Competitive Factors

The majority of banks operate within a competitive environment, and in most markets the degree of competition has been increasing in recent years. Therefore, to improve their ability to take the initiative in competitive situations, some banks are now following the practice of leading industrial companies by developing a competitor intelligence system. Such a system is an important element in strategic and market segment planning.⁴⁷ Other competitive sources which affects the banks position are technology, the increasing Islamic services and the new women branches.

The banks are well aware of their fixed costs and therefore, they are trying to reduce them by improving the speed of their customer services as well as their internal operations. New technology is the only answer to such a problem. SAMA, in this respect, is playing an important role, mainly by increasing competition between banks as well as by reducing the proportion of cash in the money supply.

SAMA is primarily responsible for encouraging the Saudi banks to use sophisticated new technology including ATMs. This is a new competitive area for the Saudi banks. However, not all banks were interested in joining such systems. By mid-1989, only four of the twelve banks offered the service of automated teller machines (ATM), at least seven of the remaining were planning to introduce (ATM) by the end of the 1990's.⁴⁸

The Saudi American Bank decided at the end of 1989 to introduce about 100 Electronic Funds Transfer Points of Sale (EFTPOS) machines at its branches as part of a significant upgrading of its consumer banking services. The Saudi American Bank also introduced a new type of ATM card which handled a wide variety of functions previously offered on different cards. This card was also designed to allow the bank to stratify its customers according to their income and requirements. Such plans were totally supported by SAMA.⁴⁹ The Agency also encouraged several banks to introduce such a system with software accessible by other banks' cards.⁵⁰

The Saudi Cairo Bank, signed a contract in November 1989 with Saudi Business Machine, to design and install a computer system to link its operations and this can also be used for the proposed national ATM clearing system that SAMA is pioneering.⁵¹ The NCB also took a further step in this direction by linking its new generation of automated teller machines to the national network. The new machines, installed by the NCB, are designed to operate for 24 hours, seven days a week and will offer travellers cheques and accept account instructions as well as dispense cash.

ATM cards are considered to be an important instrument in attracting customers and are a very competitive area in the retail banking business. Banks, even in the neighbouring countries, were rushing to install such new machines and were offering their customers new services as such machines not only offer cash, but are also expected to dispense traveller's cheques, issue balance of statements and take orders for cheque books. Six banks were ready to join the new Saudi-net namely, Saudi British Bank, Al-Rajhi Banking & Investment Company, Saudi American Bank and Arab National Bank. However, Al-Rajhi's presence in the network was very surprising for the banking industry, nevertheless such a move has helped to promote the bank's image. Al-Rajhi was successfully able to go into operation after 50 days from the date of installation of the first

software, a step which was highly appreciated by many banking observers and was considered to be extraordinarily fast progress by any standard.⁵²

In 1990, all the 12 banks sent two of their staff for a training programme on the screen-based stock trading system and SAMA was hoping all the commercial banks would be equally active in stock trading.⁵³ SAMA has also established the electronic securities information systems to be used by banks, where details of orders such as the price and number of shares involved in the transaction are directly inputted into the system. SAMA introduced its network system as part of its efforts to improve the financial market, especially the stock market. By mid-1991 around 15 percent of the trading was taking place through the new systems.⁵⁴ The NCB's management announced in May 1993 that the bank was trying to "implement a complete automated system for its operation which is expected to be completed by the end of 1994".⁵⁵

SAMA is pushing the banks towards high-tech methods, as a way of reducing the volume of currency circulation in the country. The next technological change by SAMA and the banking system is a national electronic point of sale (EFTPOS) system. Several banks such as Arab National Bank and Saudi Faranse Bank are testing, under SAMA's supervision, EFTPOS pilots with selected customers. Many other banks announced their willingness to join in the EFTPOS pilot test. If the EFTPOS system succeeds, it will be a major step in the Middle East. However, to fully implement this system, it needs to be installed in two phases; the first phase is expected to introduce electronic cheque settlement among the local banks to replace the old system. The second phase will open up the system to corporations to settle their accounts with each other through the system. This phase is shelved for the time being. Regardless of sceptics bankers see it as the key to keeping Saudi banking a profitable and expanding industry, with standards that are equal to any in the world.

10.13 Money Changers and Islamic Investment Services

Money changers and Islamic investment services are a serious threat and a source of serious competition to the banking industry in the Kingdom. Wilson (1983) described money changers as those who "have played a much more significant role in Middle

Eastern finance than conventional commercial banks and, even today, they continue to serve a wider section of society than the banks, which tend to cater for the middle and upper classes only."⁵⁶ He added that money changers such as "Al-Rajhi Company of Riyadh has become the largest money changer in the world,.... As deposit takers they rank third in the Kingdom after the NCB and Riyadh bank, their deposits being worth almost \$1.5 billion by 1979."⁵⁷ The Saudi market has several aggressively active money changers such as Al-Subeaei, Al-Mukairin, Bamaodah and Kaki.⁵⁸ Presley states that "the four money changing companies in the country continuously remain competitive with the commercial banks. Together, up to 1982, they had over 250 branches with 150 of them located in Jeddah, Mecca and Medina. Money changers remain as a source of worry to the commercial banks because they are able to complete their operations, such as banking services, at lower costs than banks, and are not subject to the SAMA controls imposed on the commercial banks, particularly the reserve requirements. Although there have been many measures set up by SAMA to curb and regulate the expansion of the money changers, they still are one of the most competitive financial institutions and form a serious threat to the commercial banks."⁵⁹

Al-Rajhi's decision to transform its extensive money changing operations into an Islamic bank had an immediate impact on the market. Bankers believe that Al-Rajhi will compete fiercely for deposits and are already looking at ways of taking on the challenge. After Al-Rajhi, many banks started to offer their customers interest-free loans in lieu of paying interest on deposits.⁶⁰ Other investors in the market believe that such services have tremendous potential. The managing director of the International Investor, one of the growing Islamic institutions, is reported to have said that Islamic financial institutions will be managing about 50 percent of the deposit market in five years time. In support of such a view, an advance has been given to the Islamic banks and other financial institutions, by the finance ministers of the 45 members of the Islamic Development Bank who have approved to double its subscribed capital to \$5.7 billion.⁶¹

Another surprising challenge might be that the banking industry in Saudi Arabia is expected sooner or later to be opened to new entrants. Faysal Islamic Bank of Bahrain (FIBB), part of the Faysal group of banks, and Al-Baraka Investment & Development Company of Jeddah, which has established banks outside the Kingdom, have both been

told, reportedly from the highest levels, that they will be granted banking licenses in the Kingdom.⁶²

As the banking sector was facing more difficulties, the banks were trying their best to offer different sophisticated financial services. Many banks started to move into the business of portfolio management, where the market leaders are the NCB and Saudi American Bank, the Citibank affiliate. In this period of time most of the banks, despite the difficulties, strengthened their management teams and, in some cases, restructured boards of directors to face the challenges that lie ahead. The NCB also announced management changes in May 1989 when Khalid Bin Salem Bin Mahfouz took the position of chief executive manager, effectively heading day to day management of the bank. His brother Mohammed, became the chairman of the management committee. Many other banks, such as the Riyadh Bank, also made changes in their management team.

The NCB management, after the announcement of its financial results in 1993, expressed concern about the bank's future and put forward the bank's plan,⁶³ promising better service for the customer and less operational costs for the bank. The bank seems to be looking to improve the quality and the efficiency of their service and speed, and simultaneously provide its management with more sophisticated information, allowing for greater efficiency in decision-making and planning. It will be thoroughly modern, aggressive and innovative without jeopardising its traditional customer relationships. The bank always refers to the importance of its relationship with its customer, which was developed over the past 40 years. The NCB management was planning to introduce international brokerage services to its clients last year in Jeddah and other places. Other investment banking services are also being provided, including corporate advisory services, portfolio management for high net worth clients and trading in various treasury instruments.⁶⁴

10.14 The NCB's Competitive Market Position

As a result of the previous discussion, it is quite clear that the NCB was able to maintain its leading role in some areas, whereas in other areas the bank lost its leading role and its market share. It is therefore, not easy to rank the bank in a certain position, without a

clear examination of several performance variables. This was done in terms of examining each variable separately, this section is designed to give a comprehensive assessment on the bank's overall competitive position.

There are 16 different performance variables chosen for this assessment namely, total assets, total deposits, current deposits, total lending, the lending ratio, return on assets, return on equity, return on equity before provisions of losses, net profit, total operating profit, return on investments, staff cost, staff cost to total assets, number of employment per SR 100 million of assets, total deposits per employee and total assets per employee. Each variable was taken separately and averaged for the period between 1985 and 1992 for each individual bank, a score was then given for each factor from 1 to 12, with a high score representing a very strong competitive position and a low score, a very weak one. Then the scores for each bank were added to give the total score of the bank, then each bank was ranked according to its total score. Weighting issues are ignored, as assigning weight to particular variables would involve value judgements.

Channon points to new important financial institutions emerging from the newly industrialised countries and those countries with substantial petrodollar surpluses. "Banks such as those of the Gulf States can be expected to play a greater role in the world of international banking in the future."⁶⁵ Could this statement by Channon be true? If so, then the Saudi banks are major players in the financial field with the NCB presumably in the lead.

Table 10.6 is the Saudi Arabian banking industry's grading matrix for the period 1985 to 1992. The table shows that the Saudi American Bank was in the top position, followed by the NCB, then Al-Rajhi followed by the Saudi French Bank and then Riyadh Bank. These were the top five banks in the Kingdom's banking industry, according to their individual performance. However, if we viewed the table from a different angle, the result then would be completely different and would place banks in different ranks.

If we only consider the market share variables in the table, such as, the total assets, total deposits, customer deposits and total lending, it is very obvious that the NCB remains the leading bank in terms of its asset value, size of deposits and the amount of loans

Table 10.6: Saudi Arabian Banking Industry's Grading Competitiveness Matrix 1985 - 1992

| BANK* | T.A | T.D | C.D | T.L | L.R | R.O.A | R.O.E | N.P | T.OP | ROI | ROEBP | S.C | SC/TA | E/100MA | TD/E | TA/E | TOTAL | RANK |
|-------|-----|-----|-----|-----|-----|-------|-------|-----|------|-----|-------|-----|-------|---------|------|------|-------|------|
| NCB | 12 | 12 | 12 | 12 | 10 | 4 | 11 | 8 | 12 | 3 | 11 | 1 | 1 | 7 | 6 | 6 | 128 | 2 |
| RB | 11 | 11 | 11 | 10 | 6 | 8 | 1 | 10 | 11 | 7 | 1 | 2 | 3 | 5 | 4 | 4 | 105 | 5 |
| SAMB | 10 | 10 | 10 | 9 | 4 | 10 | 8 | 11 | 10 | 10 | 8 | 4 | 8 | 11 | 12 | 12 | 147 | 1 |
| SFB | 8 | 9 | 8 | 8 | 9 | 7 | 4 | 7 | 9 | 6 | 4 | 5 | 6 | 8 | 8 | 9 | 115 | 4 |
| RJH | 9 | 8 | 9 | 11 | 12 | 12 | 10 | 12 | 8 | 12 | 10 | 6 | 4 | 1 | 1 | 1 | 126 | 3 |
| ANB | 7 | 7 | 7 | 7 | 3 | 11 | 6 | 9 | 7 | 11 | 6 | 3 | 5 | 2 | 2 | 2 | 95 | 8 |
| SHB | 5 | 5 | 4 | 5 | 7 | 6 | 5 | 4 | 5 | 8 | 5 | 7 | 10 | 9 | 9 | 8 | 102 | 7 |
| SBB | 6 | 6 | 6 | 4 | 5 | 5 | 3 | 6 | 6 | 4 | 3 | 8 | 9 | 6 | 7 | 7 | 91 | 10 |
| SCB | 4 | 4 | 5 | 6 | 11 | 2 | 2 | 1 | 4 | 2 | 2 | 9 | 7 | 7 | 5 | 5 | 76 | 11 |
| BAJ | 2 | 2 | 1 | 3 | 8 | 1 | 12 | 2 | 2 | 1 | 12 | 10 | 11 | 3 | 3 | 3 | 76 | 12 |
| SIB | 1 | 1 | 2 | 1 | 2 | 3 | 7 | 3 | 1 | 5 | 7 | 12 | 12 | 12 | 11 | 11 | 91 | 9 |
| SUCB | 3 | 3 | 3 | 2 | 1 | 9 | 9 | 5 | 3 | 9 | 9 | 11 | 2 | 11 | 12 | 10 | 102 | 6 |

Source: Special document: NCB; * - Banks names: NCB: National Commercial Bank, RB: Riyadh Bank, SAMB: Saudi American Bank, SFB: Saudi Faranse Bank, RJH: Al-Rajhi Banking Company, ANB: Arab National Bank, SHB: Saudi Holandi Bank, SBB: Saudi British Bank, SCB: Saudi Cairo Bank, BAJ: Bank Al-jazira, SIB: Saudi International Bank, SUCB: Saudi United Commercial Bank. ** - Variables : TA: Total Assets, TD: Total Deposits, CD: Customer Deposits, T: Total Lending, LR: Lending Ratio, ROA: Return on Assets, ROE: Return on Equity, ROEBP: Return on Equity Before Provisions, NP: Net Profit, TOP: Total Operating Profit, ROI: Return on Investments, SC: Staff Cost, SC/TA: Staff Cost to Total Assets, E100MA: Employment per 100 millions of Assets, TD/E: Total Deposits per Employee, TA/E: Total Assets per Employee.

granted. The Riyadh Bank is placed second followed by the Saudi American Bank and Al-Rajhi. Table 10.7 shows details of each bank score and rank.

If we consider the other variables in table 10.6 which represent, to a great degree the efficiency variables and banks' productivity, then the view will again be completely different. Table 10.8 shows details of the efficiency variables and each bank's rank. As a result of this assessment we find that the Saudi American Bank is leading the Saudi Arabian banking sector, followed by Saudi United Company Bank, then Saudi International Bank. The NCB ranks at the 7th position. This could mean that the bank, in terms of its efficiency variables, compared to other banks' performance in the industry, is in a very critical position in terms of its competitiveness in the Saudi Arabian banking industry. The market environment, and even nationalistic considerations, are not sufficient for the bank to remain as the leader. In fact it is very likely that other competitive factors are becoming much more important in an industry that has started simply by moving coins and banknotes between shops and money changers. Despite the fact that the entrepreneurial idea behind building the Saudi banking empire remains forever in the hands of the NCB founders, success in a competitive environment, requires the same quality of understanding of the market and its needs, as was prevalent in 1937, when the NCB was established.

Table 10.7: Saudi Arabian Banking Industry's Market Share Matrix 1985 - 1992

| BANK* | T.A | T.D | C.D | T.L | TOTAL | RANK |
|--------------|------------|------------|------------|------------|--------------|-------------|
| NCB | 12 | 12 | 12 | 12 | 48 | 1 |
| RB | 11 | 11 | 11 | 10 | 43 | 2 |
| SAMB | 10 | 10 | 10 | 9 | 39 | 3 |
| SFB | 8 | 9 | 8 | 8 | 33 | 5 |
| RJH | 9 | 8 | 9 | 11 | 37 | 4 |
| ANB | 7 | 7 | 7 | 7 | 28 | 6 |
| SHB | 5 | 5 | 4 | 5 | 19 | 8 |
| SBB | 6 | 6 | 6 | 4 | 22 | 7 |
| SCB | 4 | 4 | 5 | 6 | 19 | 9 |
| BAJ | 2 | 2 | 1 | 3 | 8 | 11 |
| SIB | 1 | 1 | 2 | 1 | 5 | 12 |
| SUCB | 3 | 3 | 3 | 2 | 11 | 10 |

* See footnote of Table 6.

Table 10.8 : Saudi Arabian Banking Industry's Efficiency Performance Matrix 1985 - 1992

| BANK* | L.R | R.O.A | R.O.E | N.P | T.O.P | ROI | ROEBP | SC | SC/TA | EA100MA | TD/E | TA/E | TOTAL | RANK |
|-------|-----|-------|-------|-----|-------|-----|-------|----|-------|---------|------|------|-------|------|
| NCB | 10 | 4 | 11 | 8 | 12 | 3 | 11 | 1 | 1 | 7 | 6 | 6 | 80 | 7 |
| RB | 6 | 8 | 1 | 10 | 11 | 7 | 1 | 2 | 3 | 5 | 4 | 4 | 62 | 11 |
| SAMB | 4 | 10 | 8 | 11 | 10 | 10 | 8 | 4 | 8 | 11 | 12 | 12 | 108 | 1 |
| SFB | 9 | 7 | 4 | 7 | 9 | 6 | 4 | 5 | 6 | 8 | 8 | 9 | 82 | 6 |
| RJH | 12 | 12 | 10 | 12 | 8 | 12 | 10 | 6 | 4 | 1 | 1 | 1 | 89 | 3 |
| ANB | 3 | 11 | 6 | 9 | 7 | 11 | 6 | 3 | 5 | 2 | 2 | 2 | 67 | 10 |
| SHB | 7 | 6 | 5 | 4 | 5 | 8 | 5 | 7 | 10 | 9 | 9 | 8 | 83 | 5 |
| SBB | 5 | 5 | 3 | 6 | 6 | 4 | 3 | 8 | 9 | 6 | 7 | 7 | 69 | 8 |
| SCB | 11 | 2 | 2 | 1 | 4 | 2 | 2 | 9 | 7 | 7 | 5 | 5 | 57 | 12 |
| BAJ | 8 | 1 | 12 | 2 | 2 | 1 | 12 | 10 | 11 | 3 | 3 | 3 | 68 | 9 |
| SIB | 2 | 3 | 7 | 3 | 1 | 5 | 7 | 12 | 12 | 12 | 11 | 11 | 86 | 4 |
| SUCB | 1 | 9 | 9 | 5 | 3 | 9 | 9 | 11 | 2 | 11 | 12 | 10 | 91 | 2 |

* See footnote of Table 6.

10.15 Conclusion

To sum up the discussion of this chapter, the following points are to be noted. Firstly, during the early period, the NCB was the only bank in the Kingdom and therefore, it was the sole banking decision maker in an industry that was just building itself. In the second period of duopoly, the Al-Riyadh Bank entered the industry and became slightly more competitive. It is important to note however that NCB was never the sole financial institution that could provide financial services to customers, as there were always money changers in the market who were able to provide almost the same financial services.

SAMA was founded in 1952, but it only really played an acting role in banking following Al-Riyadh bank's bad debt problem. In 1964 it stepped in to enforce its role as a bank regulator, and started to show its effectiveness.

In the third period, the presence of many foreign banks had opened the market to competition. Again SAMA proved to have a very effective banking policy, as evidenced by the successful completion of the Saudisation process between 1975 and 1982. SAMA was clearly in favour of developing the market into a controlled competitive market and as a result of the Saudisation process, 60 percent of the banks market share became controlled by Saudi citizens. The Saudi banking industry as a result achieved a high growth rate of assets and showed an increasing trend towards a better organised banking system.

During this period of time there has been an increasing demand for more sophisticated banking services and more focused banking marketing strategies to stimulate new clients. At the same time the number of branches have increased significantly as retail banking expanded.

The banking sector in Saudi Arabia is now controlled largely by six banks, namely, the NCB, Al-Riyadh Bank, Saudi American Bank, Al-Rajhi Investment Company, Arab National Bank and the Saudi French Bank. The first three banks control 70 percent of banking assets. The NCB was and still remains the major bank in Saudi Arabia and holds the largest proportion of the market's total assets and total deposits. However, the share has declined by 10 percent of the total market share over the last decade, and it now accounts for 30 percent of the market.

Deposits of banks grew over most of the period, the greatest rise being in 1982, when growth reached 89.3 percent. Some banks experienced a dramatic decline. The NCB's deposits declined by -7.9 percent by the end of 1992, while the Al-Riyadh Bank's decline was equal to -1.2 percent, the Arab National Bank's was -12 percent and the Al-Jazira bank's was -19.8 percent. After the Gulf War, there was a clear shift in deposits from national Saudi banks to the Saudised Banks. However, the deterioration of deposits in the NCB was attributed to factors within the bank itself and not only external factors of the Gulf War. Since then the NCB's lending policies have altered which should be reflected in its profitability. Reducing domestic lending may lower credit risks and result in less bad debt, but it is more questionable from the point of Saudi Arabia private sector development.

Total equities of banks in Saudi Arabia showed a continuous growth. For example, between 1982 and 1992, the total equities have increased over four times. The NCB was an exception to this growth and its total equity had decreased from SR 3.2 billion in 1989 to only SR 84 million in 1991. In 1993, the owners of the NCB showed more support to the bank and as a result, the total equity increased suddenly to over SR 6.9 billion, representing the biggest capital base amongst banks in Saudi Arabia. Such equity changes did not help confidence in the bank.

In the area of loans, the Saudi Banks continued to practice a very strict and

conservative lending policy, yet the bad debt problems persisted. The active government agencies have clearly limited the commercial banks from controlling a big share of the lending market at very competitive rate and repayment conditions. SAMA's annual reports clearly indicate a serious decline in lending by commercial banks. Therefore, commercial banks, have opted to lend to the government instead, trading in government bonds and increasing investments abroad.

The bad debts problem adversely affected the NCB lending position, compared to the impact on other banks. Some reports indicate that around 25 percent of the total debts were in the NCB portfolio. The BCCI collapse showed how vulnerable the NCB was to external factors, and as a result of the bad management of the bank's international affairs the bank had to pay high cost in the form of losing its good will and financial costs, in addition to losing its most important international branches in Europe and the United States. However, it is very likely that the NCB's troubles, mainly those which occurred in the 1980's, were rather internal than external.

Lending in Saudi Arabia remains difficult, due to the lack of protection of loans by SAMA. This is due to the Sharia law against interest rate. Despite such problems, the NCB continued to lend the market over 30 percent of the total loans granted between 1980 and 1990. However, the bank has clearly reduced its commitment to lend to the private sector because of its bad debts experience. Unfortunately, it is not known how the bank is doing in other areas, especially short term business such as foreign exchange, or the long term business as in government securities, through which both depositors and shareholders may benefit from such returns.

In terms of assets, the Saudi banking industry showed a steady and continuous growth. For example, in 1985 the total asset of Saudi banks amounted to SR 164.7 billion, while in 1992 the total assets increased to SR 297.9 billion. The NCB was the only bank that suffered a sharp decline in its assets. The turning point for the bank was in 1989, when its assets dropped from SR 86.6 billion to SR 63.7 million in 1992. Regardless of such troubles the NCB remains the Kingdom's largest bank asset holder.

The number of branches have increased rapidly and therefore the number of staff required for operations has also increased. This has resulted in increased cost and

expenses. The total number of branches estimated in 1993 was approximately 1,140 branches. Out of these 230 branches (21 percent) belonged to the NCB. This expansion of branches increased the demand for highly qualified staff, which is rare in this sector of Saudi Arabia. Therefore, the salary paid to new graduate entrants reached over US\$ 36,000 per year, which makes the Saudi graduate trainee one of the most expensive in the world.

In 1992, the number of staff in the Saudi banks amounted to over 9,200 employees. The ratio of employee per branch has changed from 35.6 employee per branch in 1985 to 29 employee per branch in 1988 and increasing again to 32 employee per branch in 1993. However, this ratio is expected to decrease due to the new technology introduced by Saudi banks, the high cost of staff and the lower profitability per individual employee contributed to the bank. The highest average cost per employee was experienced by the Saudi American Bank, which amounted to SR 205,000 per annum compared to SR 111,000 paid by the NCB in 1985. Yet the high staff productivity ensured the Saudised banks were able to maintain a higher profit contribution per employee. The total assets to total employment, total deposits to total employment and total lending to total employment, are other efficiency ratios discussed in this chapter.

Other competitive factors, such as Islamic services, special branches for women and advanced technology, were among the key sources of competition for Saudi banks. Money changers remain a major competitive force in the banking sector because of the flexibility they have in the market and they adapt quickly to any new service introduced by banks.

The NCB competitive position was discussed in depth. Sixteen different performance variables were considered and examined individually. Each variable was separately averaged for the period between 1985 and 1992, for each individual Saudi bank. Then a score was given to each variable and ranked from 1-12, with the high score representing a very strong position. Then a performance matrix was produced, showing the competitive position of every individual bank. As a result, the NCB was found in the second position after the Saudi American Bank. However, this analysis was further divided into two approaches: The first is the bank performance in terms of its market

share, the second is the bank performance in terms of its efficiency and productivity variables. The results of the first approach showed that the NCB is the leader in the banking industry. However, in the second approach, the analysis showed that the Saudi American Bank was the leader and the NCB was in seventh position. This means that the bank's performance in terms of its efficiency and productivity is less adequate and serious consideration must be given by its management in order to put the bank back in the lead. This indicates that the Saudi banking industry is becoming more open to competitive market forces, and performance and meritocracy are the key to survival.

Notes:

- (1) Johany, Ali D. Berne, Michel and J. Wilson, Mixon Jr. The Saudi Arabian Economy London: Croom Helm, 1986, p. 150.
- (2) Young, Arthur N. Saudi Arabia: The Making of a Financial Giant New York: Longman, 1983, p. 65.
- (3) Wilson, Rodney. Banking & Finance in the Arab Middle East London: Macmillan, 1983, p. 87.
- (4) Ibid., p. 87.
- (5) Niblock, Tim. State, Society & Economy in Saudi Arabia. London: Croom Helm, 1983, p. 280.
- (6) Ibid., p. 280.
- (7) Ibid., p. 281.
- (8) Sez nec, Jean-Francois. The Financial Markets of the Arabian Gulf London: Croom Helm, 1987, p. 3.
- (9) Ibid., pp. 1-2.
- (10) Ibid., p. 88.
- (11) Ibid., p. 3.
- (12) Ibid., p. 4.
- (13) Wilson, op. cit., p. 88.
- (14) Niblock, op. cit., p. 282.
- (15) Ibid., p. 282.
- (16) Ibid., pp. 282-283
- (17) Ibid., p. 283.
- (18) Ibid., p.284.
- (19) Ibid., p.285.
- (20) Wilson, op. cit., p. 89.
- (21) Ibid., p.89.
- (22) Abdeen, Adnan M. and Shook, Dale N. The Saudi Financial System London: John Wiley & Sons Ltd., 1984, pp. 55 and 61.
- (23) Niblock, op. cit., pp. 287-288.
- (24) Channon, Derek F. Bank Strategic Management and Marketing London: John Wiley, 1993, p. 5.
- (25) Abdeen and Shook, op. cit., p. 86.
- (26) Ibid., p.101.
- (27) Middle East Economic Digest, Vol. 33, No. 44, 10th November, 1989, p. 9.
- (28) Ibid., Vol. 33, No. 47, 1st December, 1989, p. 9.
- (29) Ibid., Vol. 34, No. 11, 23rd March, 1990, p. 18.
- (30) Abdeen and Shook, op. cit., p. 64.
- (31) Ibid., pp. 75-76.
- (32) Capital Intelligence Report, 24th November, 1993.

- (33) Abdeen and Shook, op. cit., p. 86.
- (34) Presley, J. R. A Guide to the Saudi Arabian Economy London: Macmillan, 1984, pp. 100-112.
- (35) Ibid., pp. 100-112.
- (36) Middle East Economic Digest, Vol.38, No.19, 13th May, 1994, pp. 11-12.
- (37) Financial Times, 21st April, 1986.
- (38) Capital Intelligence Report, 24th November, 1993.
- (39) Abdeen and Shook, op. cit., p. 67.
- (40) Middle East Economic Digest, Vol.36, No.26, 3rd July, 1992, p. 4.
- (41) Ibid, and special interview with the General Manager of the NCB in Jeddah, February, 1995.
- (42) Special Survey conducted by the NCB on the Saudi banking industry market position, 1993.
- (43) SAMA, Quarterly Bulletin, 4th quarter, 1409/1989, and Middle East Economic Digest, Vol.29, No.30, July, 1985.
- (44) Middle East Economic Digest, Vol.38, No.19, 13th May, 1994, p.16.
- (45) Middle East Economic Digest, Vol.38, No.13, 1st April, 1994, p. 25.
- (46) Ibid., Vol. 37, No. 19, 14 May, 1993, p. 6.
- (47) Channon, op. cit., p. 62.
- (48) Middle East Economic Digest, Vol.33, No.28, 21st July, 1989.
- (49) Middle East Economic Digest, Vol.33, No.44, 10th November, 1989, p. 9.
- (50) Ibid., Vol. 33, No. 44, 10th November, 1989, p. 9.
- (51) Ibid., Vol.33, No.45, 17th November, 1989, p.8.
- (52) Ibid., Vol. 34, No. 11, 23rd March, 1990, p. 18.
- (53) Ibid., Vol. 34, No. 4, 2nd February, 1990, p. 8.
- (54) Ibid., Vol. 35, 22nd November, 1991, p. 46.
- (55) Ibid., Vol. 37, No.19, 14th May, 1993, p. 5.
- (56) Wilson, op. cit., p. 3.
- (57) Ibid., p. 12.
- (58) Ibid., pp. 12-13.
- (59) Presley, op. cit., pp. 100-112.
- (60) Middle East Economic Digest, Vol. 29, No.30, July 1985.
- (61) Ibid., Vol. 36, No.38, 25th September, 1992, p. VIII.
- (62) Ibid., Vol. 36, No.45, 13th November, 1992, p. 54.
- (63) Ibid., Vol. 37, No.19, 14th May, 1993, p. 5.
- (64) Ibid., pp. 5-6.
- (65) Channon, op. cit., p. 5.

Chapter Eleven

The New Strategies For The National Commercial Bank

In the previous chapters, an extensive discussion was presented on the performance of the NCB from different aspects in Saudi Arabia. Although the information was very limited in some areas due to several factors mentioned in these chapters, internal information, made available by the recommendations of the owners of the bank, has provided essential pointers towards very important issues. Moreover, it was concluded in the previous chapter that the NCB was "fairly uncompetitive" amongst its peers in the market. However, a trip was made to Saudi Arabia, between January 15th and February 10th 1995, where recent information was acquired on the newly introduced changes to the NCB and its competitive position. This information is considered vital, as it shows the impact of changes that took place in the bank within a period of only two years. The importance of such changes in the NCB was enough to justify writing a special chapter on the "new NCB" or the newly designed bank. Therefore, this chapter should be viewed as an extension to the previous one.

The most important changes that took place between early 1992 and early 1995 form the framework of this chapter. Therefore, this chapter will discuss the difficulties that NCB encountered in implementing the new strategies. The issues covered in this chapter will be as follows: how the bank started to prepare itself for changes by restructuring its organisation; how it defined its competitive position within the market, through the application of practical field work or market surveys; the bank's emerging new strategic vision and the other significant changes that took place during this time period. It is worth noting, that several interviews were conducted with the bank's top managers regarding the newly introduced changes. The contents of these interviews will be used in the relevant sections of this chapter.¹

11.1 The Idea of Change in the NCB

It was noted in the previous chapters that the bank had faced very serious problems, such as bad debts, the Gulf war repercussions, the slow down of the Saudi Arabian economy, and finally the consequences of the BCCI dilemma. The owners and the management of the bank were very concerned about its performance and its image in the market. Therefore, the decision to implement radical changes had become inevitable.

In fact, the idea of a face lift i.e. by updating and modernising the bank, dated from

before 1993. According to some senior figures in the bank, there was a clear intention by the owners, to improve the bank, even prior to 1990. Sheikh Khalid Bin Mahfouz, the then General Manager of the Bank, had intended to introduce several changes in the bank, but the circumstances within the bank at that point of time were not conducive to change.

Nevertheless, being at "crossroads" as one report describes the bank, the authorities started to consider seriously the nature of the changes and their timing, and the management strategies necessary to direct and engineer these changes. The owners bravely emphasised the necessity for change by injecting new blood into the bank. Therefore, in order to define its position, the bank had to investigate its performance in different forms, internally and externally. Three surveys were conducted, which put the management on a very clear path and made it possible for them to understand what was happening in the bank, as well as compare its performance to that of other banks in the sector.

11.2 Talking About Reforms in the NCB

Within the bank, there were serious discussions about the necessity of reform and gradually, the NCB's internally published magazine started vigorously talking about changes in the bank. The quarterly bulletin of the bank (Ausrat Al-Bank Al-Ahly "NCB Family" Volume No. 24) carried, on its front page, the following words "NCB: the changes". Inside this particular volume, the management published its views regarding the necessity of changes in the bank and put forward the main reasons behind the changes proposed for the bank. The management introduced radical changes that would cover the restructuring of the bank's operations and its administrative organisation in order to improve its performance. There was also the need to improve the skills of its employees.

Therefore, one can describe the management as "determined to improve the quality of its services in terms of speed, efficiency and simultaneously provide more sophisticated information, allowing for greater efficiency in decision-making and planning."

However, before we move into discussing the strategic changes introduced to the NCB during the last two and half years, it might be useful to review some of the relevant literature covered in the theory of organisational management and management in banking.

11.3 Approach to Organisational Change

Dynamic organisations cannot remain rigid and without interaction with their environmental changes. A dynamic and assertive organisation observes two important factors; one is the changing factors in the environment within which it operates, another is the expected change in the future. Although some organisations can survive by being traditional, this is difficult to sustain in the long run as gradually change will occur in customer behaviour. Newly developed product and services might be created by rivals to stimulate the taste of the customer or provide a new service in the market, and firms which ignore this will lose market share.

In the banking industry there are many factors that might lead to or force change, and those factors may vary between one environment and another, but in all cases change is not an easy decision to be taken or a task to be implemented.

Some organisation might, as a result of internal or external pressures, feel forced to change their structure of sales, products, management, employment size, financial resources, or other organic elements in the organisation. Huse and Bowditch (1980) suggest: "the need within the organisation for change, organisational crisis, increasing rate of change, product obsolescence, changed laws and regulations, changing values with the work force, lowered productivity and quality, changed managerial viewpoints and systems."²

Kanter et al. (1992) referred to three clusters of forces that create motion in and around organisations-notions that trigger change. "First, is the relationship between organisations and their environments. The second is organic, "growth" through the life cycle. The third is the constant struggle for power, which is political." They add: "these forces represent, in a varying degrees, "inevitable" forces,...., and likely to accumulate over time, and such unattended accumulation of change pressures can often result in an abrupt crisis or a radical wrenching change."³

Kanter et al. (1992) gave some examples of such clusters of forces around business organisation, and that would show how important for an organisation to watch carefully the effect of any change in the environment as it could in one way or another affect the organisation and its members.

The Banc One case is an ideal example here. Over a thirty-years period, Banc One changed from an obscure local branch banking system in Columbus, Ohio, and its rural surroundings, heavily reliant on manual technology, to a technology and product pioneer with a sophisticated network of major banks in five Midwest states and Texas, with an organisation honoured for its excellent financial performance and technology leadership.

The company saw the potential of computers to transform banking and invested heavily in state-of-the-art data processing systems. It experimented with automatic teller machines well before others did. The bank also started to provide new financial products at a time when other banks were not. The bank was able to grow to a stage which led its organisation to attain a size that forced structural change, because it became impossible for all the banks to report directly to top management. As a result a state holding company structure was developed, with a state president located between local presidents and top executives. The very large size of the bank produced organisational complexities, these complexities forced managerial changes that brought their own dilemmas - more steps in the decision making process, more loops in the communication chain. Growth and ageing led to other consequences, the infrastructure began to disintegrate, leading to the question whether to fix or invest in new systems. As part of its main strategy, Banc One decided finally to grow in size, scope, and geographic extent, and therefore their organisational structure had to change accordingly. ⁴

Anticipating the environment in which commercial banks will make their management decisions during the next several years is clearly important. It is, of course, impossible to predict accurately all aspects of the future environment for bank management decisions. However, some reasonable inferences can be made about the future environment by studying economic trends, recent legislation, developments in the banking industry, the changing nature of money and capital markets, as well as management developments. ⁵

Successful management must measure its strength and weaknesses. Market position should be honestly and accurately evaluated. The bank's board and top management must determine their target level and mix of risks for the environment expected in the next few years. Strategic planning is necessary for achieving the desired return-risk position by providing the right means to deal with change. The change in economic conditions by providing, growth and diversification, and increased competition must be projected and

dealt with effectively. Strategic planning in any case should be reassessed with some degree of regularity. Another concern is that plans derived from any new strategy must be flexible enough to adapt to external or internal conditions of the organisation. Some degree of control by the management is required, especially if change is forced upon them.⁶

It is expected that during any phase of change, the performance of the organisation could be adversely affected. It could be very tough and challenging, regardless of the form of change, whether in the formal structure of the business, production structure, management structure, market structure or financial structure. In the case of internal structure where reform is decided the job could be difficult mainly because of the internal resistance which might be faced from within the organisation and its old culture. A new structure might mean new responsibilities and authorities, or new products and services or completely the opposite. In these two cases many of the existing staff may dislike the new changes and therefore some form of conflict might occur between the old and new staff. According to Canals (1994), the biggest danger in improving bank performance especially, in the restructuring process, would be a continuation of weak and unharmonious management for a period of time.⁷ Also the external environment - competition, geographic and product deregulation, and so on, may make any good performance difficult. For instance technological innovation has generated the development of a very wide range of products such as computers and telecommunication innovations. In the banking industry, "these innovations have resulted in significant cost reduction, quick services, new products and a variety of financial services. One side effect of such innovations is that it has distanced customers from bank's main offices, as much as putting a limit to the possibility of selling a new service."⁸

All of this has had far-reaching consequences for the banking business and has greatly affected the strategic planning of the firms.

In the case of the NCB it is quite clear the reasons behind the inevitable change is environmental, organic as much as political, in the sense of struggling for a recognisable position within the banking community in Saudi Arabia. However, against this organisational change and developmental background, the purpose of this chapter is to investigate what changes have been introduced and brought in by the NCB organisation and what the bank has meant by its organisational overhaul.

11.4 The General Manager's Opinion on the Reform

In an extensive interview, Sheikh Mohamed Bin Salem Bin Mahfouz, General Manager and Chairman of the Management Committee of the NCB, outlined the motives behind the reform process and restructuring in the bank.⁹ He stated that "in the past the model which characterised the management of the bank can be described as "one man's vision", or one man's model. This model was able to survive without any consideration of continuous radical or moderate modification. Therefore, the bank was able to reach its ultimate peak in a certain period of time, but was unable to meet efficiently and effectively encompass modern changes and developments, to the extent that its management became untouchable." The General Manager continued "from 1970 onward, the bank started to lose its competitive position in the market. As a consequence, it experienced a serious drop in its market share, while in addition there arose some inherited debt problems beyond its control. Frankly speaking, the cause of the drop in the bank's general performance was not due to the Saudisation process as some people have said. The reason for the bank's decrease in market share was due to problems of its own making. Firstly, it had been over zealous in its lending. Secondly, employed more people than was necessary for the bank to be run effectively. The bank employed people as a social and national responsibility and not because the bank needed employees. One serious cause of the bank's bad performance was the management inability to direct and put the bank on the right track."

The General Manager strongly believes that "the bank is changing at a speed that should enable it to catch up with its other competitors, but at the present time, it is still at the stage in the process of the warming up exercise for the take off. This should ensure that it will be the leading bank in the very near future." He adds; "that is why we are conducting a series of intensive training programs for the bank's staff and managers, we are developing the bank's ability as a whole." He goes on to say "my own opinion is that the new vision of the bank should be ready and complete at the end of 1995, instead of mid-1995, then we will examine and judge ourselves against this vision. We were able to improve the bank's image by over 66 percent during the last two and half years, as well as improve customer services at a personal level from three out of ten to 5.5 out of ten. This is a good improvement in relation to the time spent to raise the level of customer service. We

now have a management team working together to achieve the bank's new vision."

11.5 Restructuring the Organisation of the NCB

One of the strategic moves taken by the bank was to alter its organisational structure, by eliminating some of its organisational levels it then widened its business divisions to replace its old concentrated regional sub-decentralised units. A team of managers were trained and given the task to direct and oversee these new divisions. Four members of this team were introduced to the following divisions: retail banking, corporate banking, private banking and Islamic banking divisions. This team was also supported by a high calibre of financial and banking consultants. They, collectively, form the general management committee which is headed by the Chairman and the General Manager of the bank.

The executive management committee is composed of 11 divisions which are made up of four administrative and seven profit-centre divisions. Figures 11.1 and 11.2 show the old and new organisational structures of the bank respectively. By this restructuring process, the bank has eliminated its regional structure, replacing it by a group of divisions which report directly, through their executive managers, to the general management committee, which in turn reports directly to the General Manager. One of the main advantages of this new structure is that it shows the extent of the bank's concern for customer services. This is represented by establishing and enhancing new services divisions such as the private business division and Islamic business division. In contrast to the idea of widening the bank's organisational structure, and under the newly proposed central processing operations, some of the jobs have become centralised, such as issuance of letters of credits. Under the previous structure, all 230 branches of the bank used to perform this job, while under the newly formed structure, only three main branches will be responsible for carrying out this task. This is expected to result in a more efficient method of dealing with such tasks, which should improve the quality of such services by ensuring that specialised teams are equipped to handle such tasks.

Under the new structure, two former senior Citibank managers were appointed by the bank; one as a personal advisor to the general manager, the other to run the treasury division.

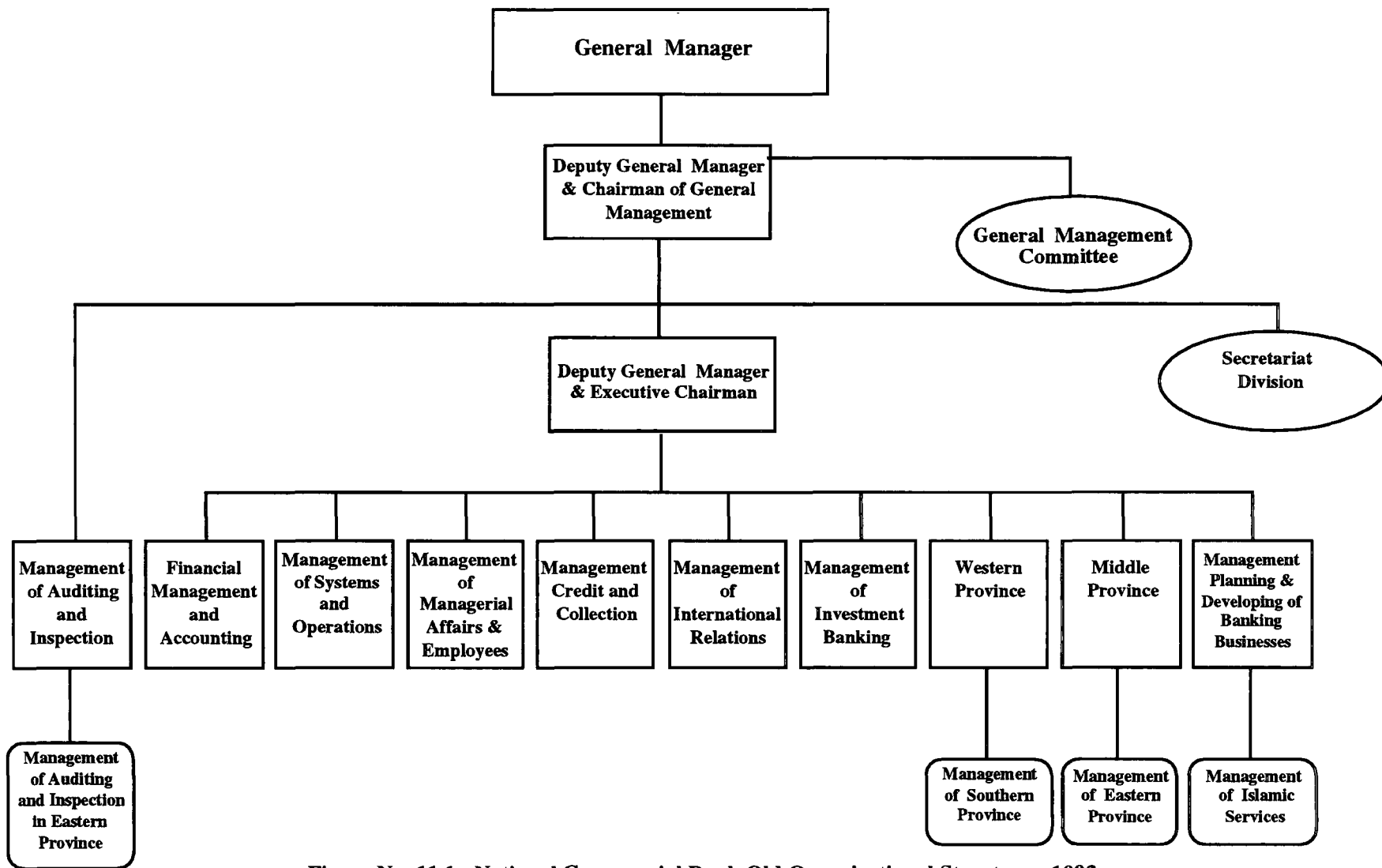


Figure No. 11.1 : National Commercial Bank Old Organizational Structure - 1993.

Source: National Commercial Bank

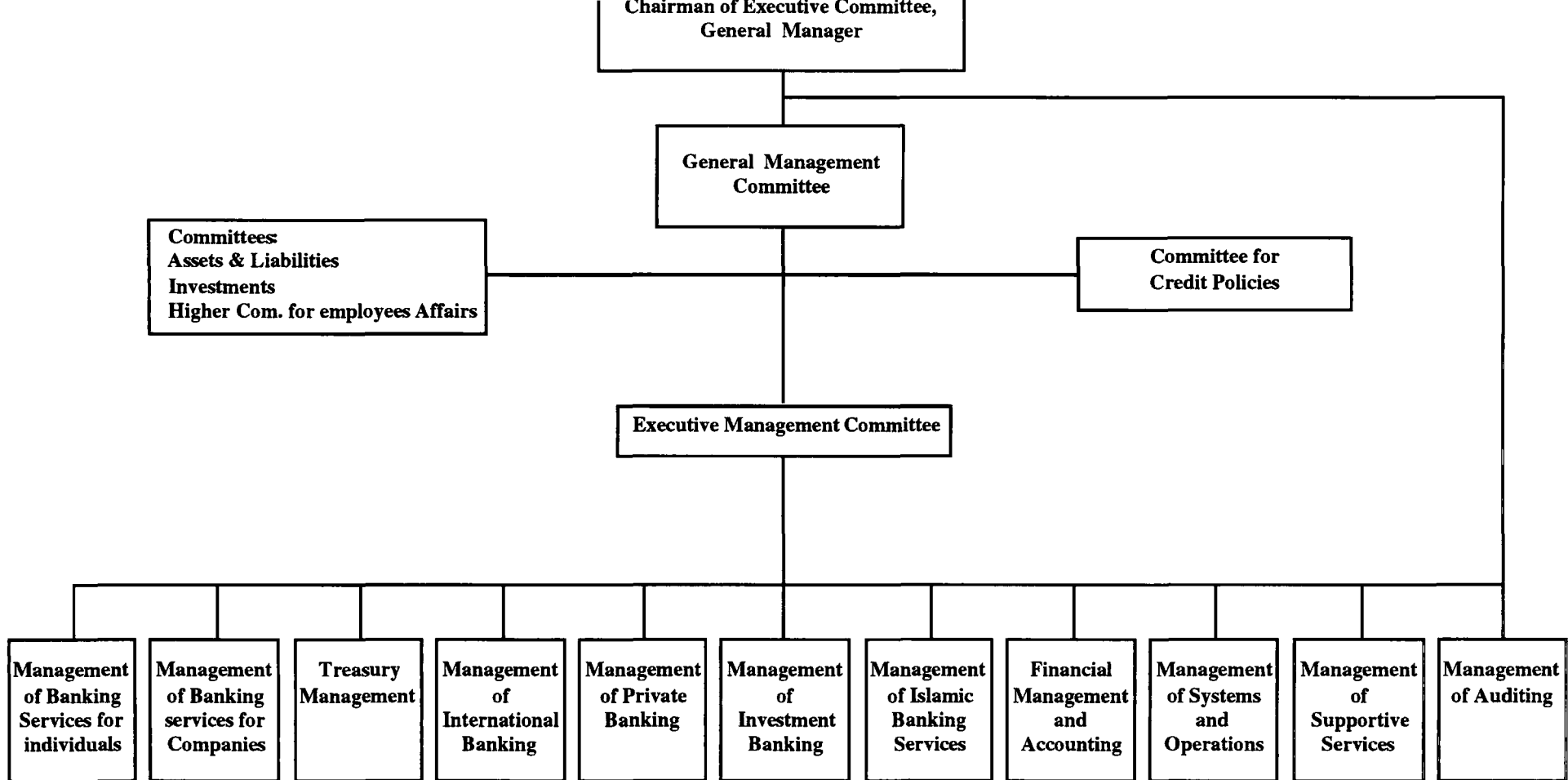


Figure No. 11.2 : National Commercial Bank New Organizational Structure - 1994.

Source: National Commercial Bank

Moreover, in 1993 the bank designed a new strategic marketing plan. The major purpose of this plan was to, a) improve the image of the NCB, b) enhance customer confidence in the bank and encourage them to take advantage of the other services, and c) promote the NCB's services to clients of other banks.

As a result of the new organisational structure, some operational changes took place and special procedures were followed under the bank's direction. A new team of experts were employed, which comprised 25 specialists from within and outside the bank. The main function of this team was to formulate a new general strategy and implementation plans.

The team was carefully selected and it drew up a short term plan which was to be implemented. The objectives of the plan were as follows:

- a. More efficient staffing with a reduction in the number of the bank's employees by 10 percent.
- b. The setting up of a new incentive programme for the bank's employees.
- c. The employment of a new director for the Treasury.
- d. A streamlining of the branches of the bank by merging some of them, and closing the poorly performing branches.
- e. Restructuring two "model" branches, one in Jeddah and the other in Riyadh, so that in the future all bank branches would be designed as an exact copy of these two branches.
- f. Introducing a new computing system for the whole bank and employing the use of new financial and accounting software.
- g. Issuing new types of credit cards and installing new points of sale.
- h. Publishing the balance sheet of the bank.
- i. Informing the bank's employees about these changing programs. ¹⁰

11.6 How the NCB Evaluated its Position in the Market

At this stage the bank started to operate under a management team, each member having specific targets and implementation tools. However, the team wanted to gather more information on the bank, therefore they started to control it in a different manner to the old management system. The new management found that there is a critical need to understand the bank's present position, both internally and externally. Therefore, they decided to commission a major market research programme aimed at collecting detailed, critical information needed by the management to optimise its marketing activities and the ultimate

delivery of its services to its customers. The research programme comprised three separate studies. One study dealt with issues related to corporate customers and high net-worth individuals. Another study covered the issues of the bank's image and customer satisfaction among retail customers. The third study was conducted internally amongst the bank's own staff.

The survey which covered the retail business was distributed to 1,181 persons of which 184 were non-NCB clients, while the remaining 997 were NCB clients. In terms of the age distribution of the sample, 21 percent were within the range of 20 to 25 years, and only 4 percent were above 55 years. The remaining 75 percent were located in the range between 26 to 54 years. In terms of their nationalities, 62 percent of the sample were Saudis and 38 were non-Saudis. The survey covered six major cities in the Kingdom namely; Jeddah, Riyadh, Dammam, Mekkah, Medinah and Abha. The survey was started and accomplished in 1993.

The survey of corporate and high net-worth individuals was smaller than the retail survey due to the nature of those covered and the high sensitivity of the individuals and the companies involved. Interviews were carried out either at places of work or in-home. A total of 183 interviews were made, while age and nationality used as quota controls. Included in the sample were 56 high net-worth individuals and 127 corporations located in Jeddah, Riyadh, Dammam and Al-Khobar. The survey started in July 1993 and was finished in September 1993. The third survey on staff attitude covered the branches of the bank in all the regions in the Kingdom, the questionnaire being personally and confidentially distributed to the staff.

The mystery shopper approach survey has become a regular survey by the bank which covers all aspects of business activities in the NCB as well as other banks over all the regions of the Kingdom. At the time of preparing the material for this chapter there had already been four mystery shopper surveys completed. Some data from the first three were made available to the researcher. However, in the first survey 262 persons were interviewed, and over 9,600 transactions were covered. The first survey was conducted in the period between October (1993) and January (1994). The survey covered most of the banks in the Kingdom such as NCB, the Saudi American Bank, Saudi British Bank, Saudi French Bank, Saudi Holland Bank, Arab National Bank and Riyadh Bank, in all the regions

and provinces. The same banks were involved in each of the three surveys. The second survey included a greater number of activities and respondents, with around 4840 persons involved, and 10,900 transactions covered. This survey was concluded between February and May 1994. The third survey included even more transactions and a larger number of people were interviewed. The survey covered 14,000 transactions with 6,400 people interviewed. This survey was conducted between June and September 1994. The fourth survey was conducted in the beginning of 1995, but the results are not available yet.

11.6.1 Customer Satisfaction Survey (Corporate)

The first survey studied the bank's image and customer satisfaction amongst corporate customers and high net-worth individuals. Switching between banks might be one explanation for the NCB deposit decline, but when a bank starts to suffer from such a phenomenon on a large scale, then it is essential to find out why is it happening and what might be the motive behind the customer's decision to switch to another bank. This would also give a useful insight into the relative performance of each branch. It was apparent in the previous chapter, that the NCB was suffering a clear decline in its deposits and in the number of its clients. Regarding the switching between banks, it was concluded by the survey report that the "biggest loser in the switching process has been the Riyadh Bank and the biggest winner has been Saudi American Bank."

However, the survey reported that "the biggest winners of the switching process have been the Saudi American Bank and NCB, followed distantly by Saudi French and Saudi British. The biggest losers have been the Riyadh Bank and Al Rajhi. Moderate losses were also experienced by Saudi Cairo Bank and Arab National Bank." By going back to the actual results we find that the NCB has lost 8 customers out of ten and gained 9 customers out of ten, making the net gain only one company or one high net-worth individual. In the case of Saudi American Bank, we find the bank lost four customers out of ten and gained eight customers out of ten, the net gain of four new customers out of ten, while in the case of Arab National Bank it shows the bank has lost three customers and gained four new ones, making its net gain only one customer out of ten, exactly the same net as that of the NCB. Nevertheless, it is worth noting that the loss of eight customers out of ten and the gaining of nine out of ten, indicates that the movement of accounts in the NCB is more

volatile than that of any other bank, which contradicts the statement reported by the survey. Moreover, the total sample in this case was 183 companies and high net-worth individuals, while the respondents to this specific question were not more than 40, or 21.8 percent only. Nevertheless, among all the banks mentioned by the reports the NCB had the largest customer turnover.¹¹ With reference to factors affecting the choice of bank, it was found that the most frequently mentioned factor in this respect was the bank's reputation.¹²

The major reason for switching between banks which was emphasised by the respondents, was due to the need for "better and faster service". The most important reason given by respondents for holding their accounts with the NCB was that the bank "had many branches" and generally was considered to be a "good" bank. The Saudi American Bank, was chosen because of its ability to provide a "good and fast service", while Al Rajhi bank was chosen because it had a large number of branches which were conveniently located. In the case of ANB, convenient location was the most distinctive reason. The NCB despite its large number of branches, was loosing in this area, because a great number of its customers were using other bank's ATM's, for which the NCB would be charged for each transaction. The manager of the corporate division referred to a high percentage of the NCB's customer who are using other bank's ATM.

Brand mapping analysis (Factor Analysis) was used by the bank to identify its position among other banks according to certain selected factors. This type of analysis is "a multivariate analysis which is ideal for exploiting relations between variables to reach or summarise something they have in common."¹³ However, the result of the analysis conducted has shown that NCB does not occupy a highly distinctive position in the map, mainly because of its very strong association with mainstream attributes that define the norms. Thus, NCB is positioned relatively close to the centre of the map (trustworthy, reputable, wide service range, polite and professional staff, high quality service and to a lesser extent everybody's bank, traditional and Islamic banking, the latter being a very powerful distinctive attribute). But according to the report, the NCB did not gain a good score in most of these described adjectives which centres the map. In fact, such mapping totally contradicts the graph presented by the research on the adjectives which best describe NCB and its peers and to which this particular graph placed the NCB below the average of the banking industry in 12 categories, and above the average in three characteristics only,

which were successful, responsive and competitive. This represents the exact description given to the bank in the same report on the bank image.¹⁴

The Arab National Bank, Riyadh Bank and Al Rajhi Bank appear to share the same attributes (Al Rajhi was mostly associated with Islamic banking). Foreign banks (Saudi French, Saudi British, Saudi Dutch, Saudi American) were clearly perceived to be realistic, (an attribute that is appreciated by the affluent), using modern technology and less bureaucratic. High quality service and professional staff were also adjectives that were used to describe the foreign banks. Interestingly, NCB is the only local bank to share these attributes with the foreign group. United Saudi Bank, Saudi Cairo Bank, Saudi Investment and particularly Al-Jazira were described negatively with terms such as inefficiency, unfriendliness, restricted service range and branch maintenance. Al Jazira, however, was the most negatively perceived.

11.6.2 Customer Satisfaction Survey (Retail)

The second survey conducted by the bank covered the bank's image and customers in the retail business. Interesting results were obtained from this study. Generally, it was found that banks are extensively used by people in Saudi Arabia. The result of the survey showed that "more than eight out of every ten respondents had an account with a bank. Bank usage is higher among the Saudis in, the better educated, and the richer income class." And there is only a "minority, (although sizable), who do not use a bank on moral or religious grounds."¹⁵

It was found also that the "NCB is the dominant bank, serving around 25 percent of the banking population", but it was not clear from the report whether this percentage is represented by the same percentage in terms of the number of or value of total bank deposits, current account holders, or deposit account holders in the banking sector. This observation is supported by other results which suggest that the "NCB is relatively weaker in the under 25 age group and stronger in the 35-44 age group. On the other hand, the share of Saudi American Bank is larger amongst the younger age groups. There is no clear age pattern for Al Rajhi, whereas ANB's position is strongest among oldest age groups. On the basis of this information, one might expect Saudi American's share to increase in the future and that of ANB's to drop. NCB would also be expected to

experience a slight drop as well". However, the survey revealed that the NCB is more popular amongst Saudis rather than expatriates, it is also more appealing to the older age groups and the higher income bracket. The solid base amongst Saudi citizens and the higher income categories was encouraging for the NCB, but the age structure of the bank's clients was less encouraging. Banks are mainly concerned with finance and its trends which in other words means "future". Reliance on older customers is not a healthy sign for the future. This argument suggests that in the future the NCB is expected to lose more customers if they are not replaced by future generations of the families who bank with it.

It was also recognised that the Saudi American Bank is more competitive compared to the NCB in attracting clients, especially those with "higher education, the younger and the newly rich". This result confirms that NCB will continue to experience loss of customers. In contrast, some banks such as ANB and SAMBA were found to promote special programs for the youth.

Most of the accounts used by bank customers are related to payment facilities rather than deposit (savings) accounts. Around 90 percent of the bank account holders have a current account and almost six out of every ten use an ATM card. Deposit (savings) facilities are used by a significantly smaller proportion of bank's clients. Credit cards are hardly used by bank clients as "less than one out of every ten customers has a credit card". Compared to other banks, however, the NCB's customers hold larger proportion of funds in investment accounts (time deposits) with the bank.

The proportion of "bank switchers" in the retail business is quite high, since almost three out of every ten respondents stated that they have switched their main bank. The incidence of bank switching is higher among the older people and higher income classes. People switch banks because of their dissatisfaction with bank service. Given such switching, this confirms our concern expressed earlier in this chapter. It was indicated before that a high proportion of the NCB customers are classified as older people rather than younger age groups. This means that there is a greater chance that the NCB is likely to lose a large number of its customers due to this switching.

It was also found that the proportion of clients that currently use Islamic banking products is very low (only one in every ten bank clients). The clients willing to use Islamic

products however, are significantly more (seven out of every ten clients). The reasons given for why they have not made use of the Islamic products is that they have not been well informed of this service. The Islamic products most frequently used are Morabaha, Modarbah and Mosharka. Islamic product users were generally satisfied with the service from the bank. One of the main problems of the Islamic business units and departments of banks in Saudi Arabia is that they can not advertise their products in the media, as it is forbidden by law although they do advertise in foreign publications.

All respondents were asked to express their opinion on the present state of the banking system in Saudi Arabia. It was reported that "the vast majority of the comments received in this respect were positive, indicating that respondents are generally happy with their bank, the service offered and the quality of the employees". The unfavorable comments were negligible and they were mainly related to the fact that banks resort to usury. The report does not emphasise this sufficiency as it could be an important reason for dissatisfaction. Indeed this could be seen as a highly relevant issue which should arguably encourage the bank to promote Islamic products such as modarabah and morabaha. This is another way in which the bank can access new market segments and extend its customer base.

When respondents were asked to name the top three banks in Saudi Arabia, NCB and Saudi American Bank received the most responses, with NCB having a slight edge over Saudi American Bank. However, there is no indication in the quantitative data presented in the report to justify such a statement.¹⁶

11.6.3 Quality of Service

Bank clients showed a great concern with regard to service standards. When asked to specify the importance of a number of attributes, in relation to their impact on the quality of service, the most frequently mentioned factors were quick service, service efficiency, friendliness of tellers and length of queues. Directional signs for customers and availability of brochures received low ratings. Figure 11.3 shows the relative importance attached to the services delivered by the NCB. The figure reveals the importance of delivering a high quality service on time, as much as making the service available and accessible. Over 75 percent of the respondent, according to the figure, confirmed this fact and showed how

important it is to give attention to the provision of a high quality service to the client.

Saudi French Bank and Saudi American Bank were found to be "the most consistent best performers" in terms of the quality of services provided. The most frequent worst performers were Al Rajhi and Saudi Cairo. NCB ranked medium-to-bad (in relative terms). NCB's performance was below average in "quick service", "staff efficiency", "friendliness of tellers", "staff's product knowledge", "helpful staff", "working hours" and "punctuality of documents". Better than average performance was exhibited in "availability of services", "many branches" and "ease of procedures". NCB's rankings were generally better in the not-so-important service features.

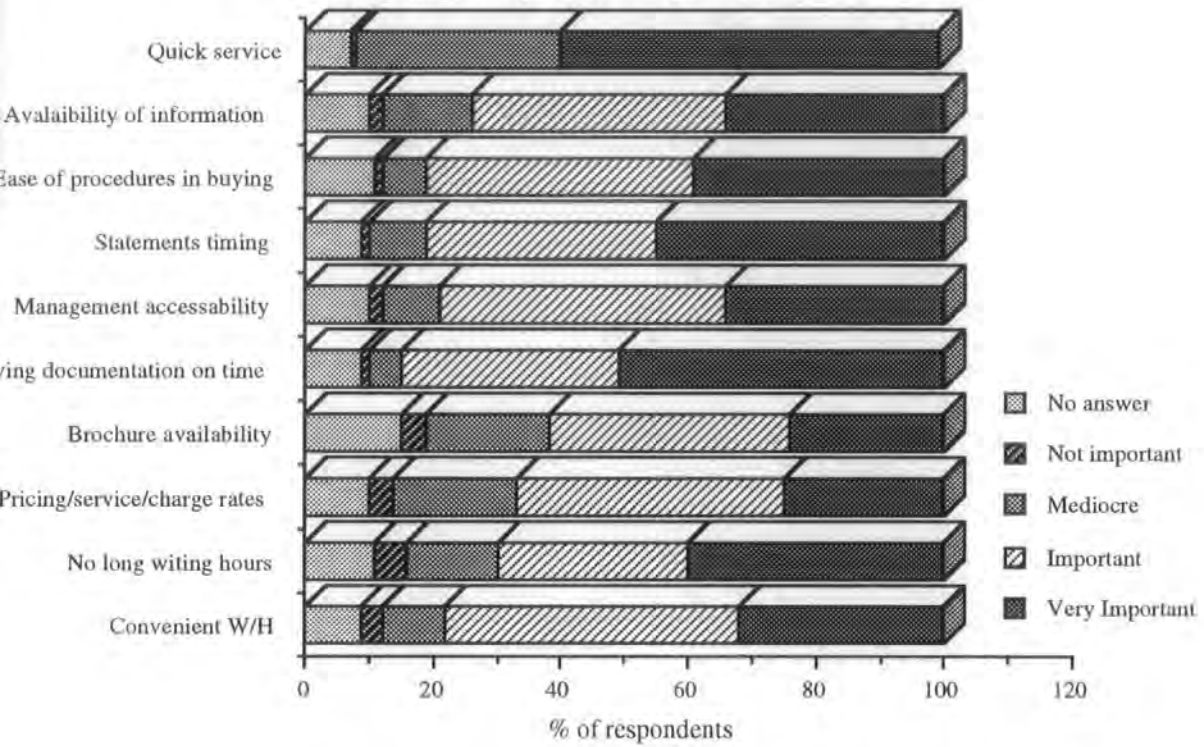
A comparison of the findings of the 1993 study with those of 1989, revealed that, despite some general improvement, NCB had become more bureaucratic in its management style and less accessible. Physical infrastructure (branches, reception/sitting areas, availability of brochures) had significantly improved. However, the general satisfaction with the product range and prices seems to have increased.

Respondents were asked to specify their assessment of the overall quality of service that was offered to them during their last transaction. The report found that the average waiting time (to see the teller or a particular bank employee) during the customer's last visit was 10.8 minutes. In the case of NCB, it was 11 minutes. The proportion of the clients of NCB who said that they had to wait longer than expected was comparable to the industry's average.

11.6.4 ATM Services

The use of ATM cards is very high, since seven out of every ten bank clients have an ATM card. The proportion is higher amongst higher income classes and more educated people. The proportion of NCB customers who have ATM cards is very close to the average. ATM card holders use their cards 4.6 times per month. Four out of every ten ATM card holders are NCB customers, followed very closely by Saudi American Bank (39 percent). The vast majority of ATM card holders were satisfied with the product range offered through the ATM's. The proportion of NCB clients that are satisfied with the product range is slightly higher than the average for the market as a whole.

Figure 11.3: Importance of Specified Attribute for Delivering Quality Service by the NCB



Figures number 11.4 and 11.5 shows the frequency of using ATM Cards in Saudi banks and the average length of time waiting to see a teller. In both cases it seems that there is no big difference between the banks in the area of such services. In both cases the NCB is ranked very close to the average. However, in the area of using the ATM cards it seems that there is an encouraging sign of a tendency toward using such facilities instead of going to the bank for normal transactions such as money withdrawals or ordering a cheque book. Customers show that, on average, they are using the net work almost once every six days.

With reference to the image of banks i.e. whether they are private or public, the vast majority of the respondents said that the ownership status of the bank does not influence their decision in choosing which bank to use. (Nine out of every ten respondents said that this does not influence their decision).

11.6.5 Staff Attitude Survey

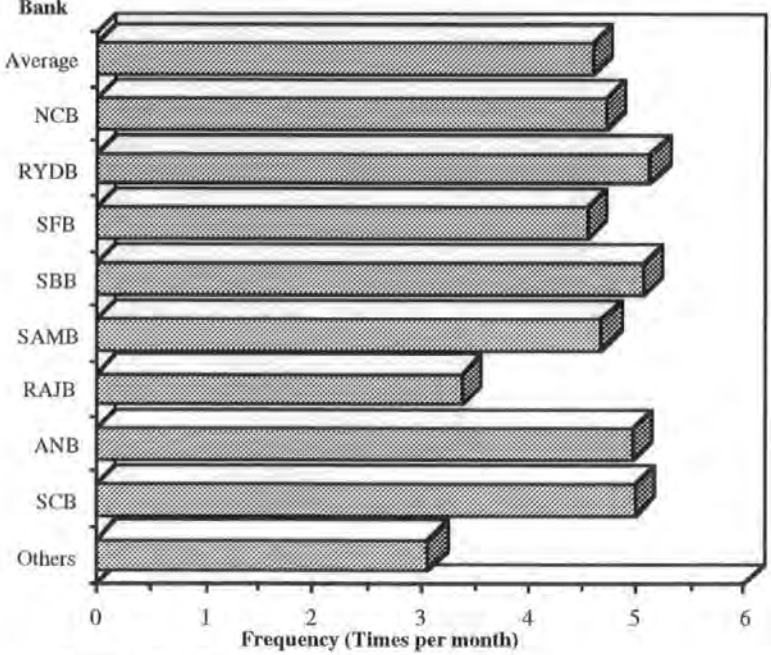
The third survey conducted by the NCB was in the area of staff attitude. The previous two surveys covered external groups, the corporate and personal clients, to ascertain the bank's

image and customer satisfaction in the corporate and retail areas. The staff issue would add another dimension to the overall view of the NCB image, and its performance level internally, from the point of view of its staff. However, on the whole, the respondents expressed their satisfaction in working for the NCB. A large proportion agreed with the statement "NCB is a good place to work", and many felt that there had been an improvement in the working conditions at the bank during the last few years.

The survey showed that respondents felt that NCB could best be described as "safe" and "well financed", and that these characteristics have not changed during the last three years. The respondents also felt that the bank was becoming increasingly more capable and modern. By referring to the main questionnaire distributed by the bank to its staff, it was found that there is no clear definition of what they meant by being "modern and capable", as no such question was posed to the staff.

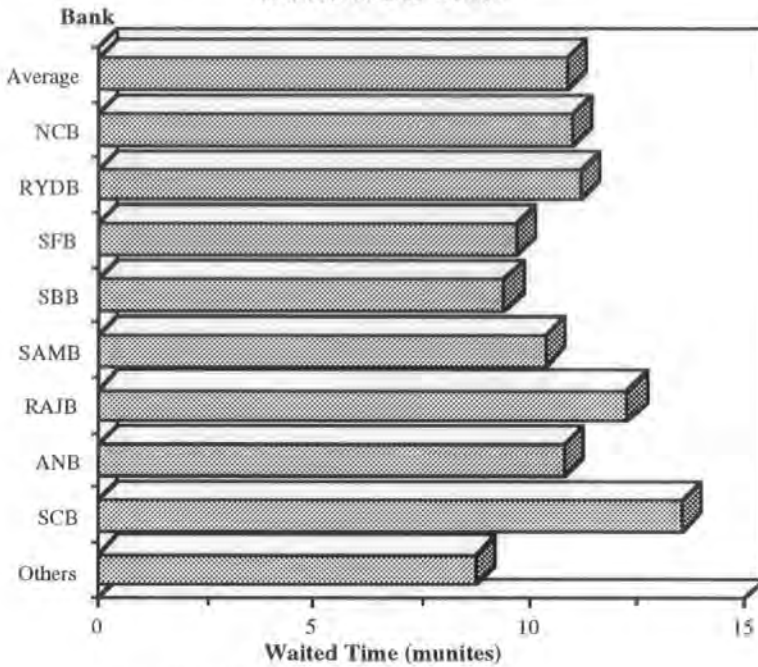
The climate in the bank was described by the respondents as "being one of mutual respect and friendliness." Generally, "staff members were pleased with the relationships with their immediate supervisors and subordinates." There was also strong feelings against the way NCB's management behaved towards its employees and this opinion was stronger

Figure 11.4: Frequency of using ATM Cards in Saudi Banks



Source: National Commercial Bank

Figure 11.5: Average Length of Time Waited to See Teller



Source: National Commercial Bank

amongst respondents holding managerial positions." However, most of the respondents found that they had pressure in their daily work which might cause them some stress.

Significant disappointment was indicated by the employees regarding their jobs as compared to their initial expectations. Nevertheless, a high proportion of the staff response was that they "would consider joining NCB again if given the chance to restart their career."

Staff of the bank believe that a "happy family life, salary and a permanent, secured, stable job are the most important attributes that characterised a successful, satisfactorily performed job as well as a successful life".¹⁷ Tables one and two show more detail of factors which help in understanding the NCB's staff attitude toward the meaning of success and the ways of achieving success in life.

It was concluded by this survey that "based on both the employees' feelings as to what constitutes a successful life, as well as what they regarded as the main contributors to job satisfaction, the employees do not seem to be particularly career oriented and seem to derive little satisfaction from the intrinsic nature of their work. Therefore the satisfaction that they feel with their job at NCB suggests a slightly complacent atmosphere within the bank rather than one which is more aggressive and challenging. This ties in with the

friendly attitude at NCB as described by the employees". Table three shows the most important factors that contribute to job satisfaction in the NCB.

11.6.6 Education and Training

The survey reported that more than three quarters of the staff who had responded to the questions felt that NCB had a well organised educational programme which was available to most of the employees. However, many of them felt that there were several problems with the current programme. About half of the employees that had attended the company sponsored seminars, aimed at improving their professional level, felt that they had not found them beneficial to their work or to their professional self-development. There was a belief that the courses were badly designed and organised. There was also a feeling that attendance on such courses was hampered by the diverse educational backgrounds of the employees. This also resulted in many of the courses not being directly relevant to the training needs of the participants. In this case, one cannot make a judgment as to whether the training programme was at fault or if the trainees themselves and their response to such training programs, was the cause for dissatisfaction.

With respect to the quality of service provided by the bank to its customers, the staff of the bank referred to three main elements which can help to deliver quality service for customers. These elements were; "the friendliness of the tellers, the helpfulness and good attitude of the counter staff, and the staff being knowledgeable about the bank's products and services". It was found also that "40 percent of the respondents did not believe that NCB was performing adequately on each of these three key points". In fact, just under half of the employees felt that they themselves did not know enough about the bank's products and services. They also mentioned that there are several factors which might prevent delivering a quality service. Amongst the most frequently mentioned were the following: a lack of the relevant technology, poor quality and calibre of staff, and badly designed and organised educational courses.

The survey also suggested that there is a potential problem regarding perceived discrimination within NCB. "More than half of the respondents reported that they had not been treated fairly in terms of promotion. There was a feeling that some people had reached positions they did not deserve, and some respondents were not satisfied with their

Table No11.1: Meaning of Success in Life for the NCB Staff (1993)

| | Management | Head Section | Staff | Average |
|--|------------|--------------|-------|---------|
| Important place in Society | 42 | 44 | 40 | 42 |
| Make Significant Contribution to Society | 57 | 43 | 49 | 49 |
| To be Rich | 12 | 18 | 22 | 19 |
| To have a happy family life | 56 | 65 | 59 | 60 |
| To advance to a high position in the Company | 40 | 34 | 27 | 31 |
| To have a stable and Permanent job | 12 | 23 | 29 | 24 |
| To be respected by others | 19 | 16 | 18 | 18 |
| To have extensive knowledge | 55 | 45 | 44 | 46 |

Source: National Commercial Bank

Table No.11. 2: Ways of Achieving Success in Life by the NCB's Staff (1993)

| | Management | Head Section | Staff | Average |
|---|------------|--------------|-------|---------|
| Have friends in high positions | 25 | 20 | 25 | 23.5 |
| With hard work | 80 | 71 | 72 | 74 |
| Have a good relation with supervisor | 17 | 20 | 24 | 20.3 |
| Have appropriate academic qualification | 56 | 58 | 51 | 55 |
| Have good knowledge of your profession | 68 | 54 | 62 | 61.3 |
| Sociable and have good relation with others | 49 | 62 | 56 | 55.6 |

Source: National Commercial Bank

Table No.11. 3: The Most Important Factors that Contribute to Job Satisfaction

| | Management | Head Section | Staff | Average |
|--|------------|--------------|-------|---------|
| Appreciation of supervisor | 50 | 41 | 49 | 46 |
| Job security | 56 | 52 | 46 | 51.3 |
| Oppourtunities for advancement | 40 | 48 | 34 | 40.6 |
| Office hours | 24 | 20 | 27 | 23.6 |
| Salary | 46 | 54 | 52 | 50.6 |
| Pleasant environment and working conditions | 15 | 10 | 12 | 12.3 |
| Opportunities to develop skills | 26 | 22 | 27 | 25 |
| Initiative given to employees | 9 | 11 | 10 | 10 |
| Good relations with subordinates and supervisors | 29 | 22 | 29 | 26 |

Source: National Commercial Bank

superior's capabilities in making the right decisions. Many were also of the opinion that management was not fair in applying its decisions to all employees throughout the company and all were not given a fair chance to attend the educational programs offered by the bank".

In order to defend its position, NCB found that it is necessary to investigate in greater depth the corrective measures in several areas. In the area of the quality of customer services it is necessary to improve its systems and procedures as well as developing its human resources through training. An upgrading of the level of technology used is necessary to enable the bank to compete in the market, especially in relation to ATM's procedures and management information systems. In the area of the bank image, it was recommended that the "NCB's image as trustworthy, reputable, with a wide service range, must be upgraded and complemented by features such as innovative, modern, responsive to customer needs." In the human resources area such as, personnel, premises, technology, advertising...etc., there is a great need to meet several objectives. These include improving the quality of service, upgrading the bank's image both internally and externally, and being generally better than its main competitor, Saudi American Bank.

For the above reasons, the bank's management decided that "a specific strategic development plan should be drawn up, which will set medium-term corporate goals (financial targets as well as other qualitative objectives), departmental goals, strategies and most important, relevant action plans."

11.7 New Vision: Policy Making and Vision Statement

The three surveys provided the management with sufficient information to assess the position of the bank from different perspectives. Due to availability of this information, the management was able to formulate its new strategic policies. Therefore, owners of the bank consulted its management as well as other experts in the banking industry and made some decisions with regard to remedial measures.

One of the first new policies set up by the management, was a vigorous cost-cutting programme to boost net earnings. Staff numbers, totalling 7,400 in 1993, were reduced significantly. The percentage cut was estimated at 10 percent of the total number of

employees i.e. a reduction of around 750 employees. Generous compensation was given to those who were made redundant by the bank.

Then, the new general management put a new "vision" for the bank and revised its corporate strategy, by setting up a short term strategy as a first practical step in the re-structuring plan.

The vision statement concentrated on the future of the NCB, and aimed at making it the best and most efficient bank in Saudi Arabia. This vision focused primarily on the followings:

- NCB should be the leading bank in Saudi Arabia in terms of deposits.
- NCB's purpose would be to enhance the value of Saudi Arabian firms and to serve society.
- NCB would be the first choice for customers and for talented employees.
- NCB would primarily be a consumer bank, providing deposit, investment, and innovative, tailored asset products to retail, affluent, and high-net worth customers.
- NCB would engage selectively in corporate business, with a full range of financial services for the commercial segment and corporate finance services for large corporate clients. NCB would build a diversified portfolio with returns commensurate with the risks.
- NCB's core values are customer service, reward for performance, and teamwork.¹⁸

The management team at this stage became totally convinced that the "NCB must strengthen its position significantly during the next five years....will be a much different bank from today, will be thoroughly modern, aggressive and innovative without jeopardising its traditional customer relationships." However, as the reform process is continuous in the bank, another mechanism was needed to keep the management in touch with the evolving performance of the bank. Hence, they asked one of the marketing institutions to conduct a quarterly survey. This is known as the mystery shopper survey.

11.8 Mystery Shopper Approach

Responding to its new mission, the NCB management directed its efforts to improve the bank's services to retail customers, and has started to monitor individual branch performance against that competitors.

The purpose of conducting such regular surveys was, as the bank stated, to objectively measure NCB's branches efficiency in delivering banking services at regular time intervals,

to use the same criteria and methods to measure competitor's performance based on a sample approach rather than the universal approach used in the case of NCB, to establish targets for achieving acceptable timing in conducting different transactions and hence reduce waiting times.

These surveys were carried out in major cities such as Jeddah, Riyadh, Dammam and Alkhobar, and include all NCB automated branches. Furthermore, a sample was drawn from each of the following six banks which were situated in the same areas as those of NCB. Saudi American Bank, Saudi British Bank, Saudi French Bank, Arab National Bank, Riyadh Bank and the Saudi Holland Bank.

The surveys focus mainly on monitoring efficiency in service, delivery and quality of service in the following areas: tellers services, customer service, telephone operators and premises (quality only).

The approach used to conduct such surveys was the mystery shopper research approach, whereby independent auditors regularly visit the NCB branches and competitor banks' branches and carry out predetermined transactions in a methodical and accurately planned manner. This survey was planned to be repeated at regular intervals of four months, in order to provide regular monitoring and insight on branch performance. A number of transactions were chosen under the supervision of the NCB officials for monitoring.

These transactions fell into two categories; core/branch transactions and non-core/bank transactions.¹⁹ Core/branch transactions are those transactions for which the company conducting the survey will report at NCB branch level as well as at bank aggregate level. For this reason those transactions will be carried out repeatedly, five times per branch, so as to accumulate enough readings in order to allow objective reporting for that particular transaction at the branch in question. Non-core/bank transactions are those transactions for which the reporting company will report at bank level. For this reason, the timing for these transactions will be recorded from some branches during each period. These transactions will be repeated around five times per city, for each bank, in order to allow the objective reporting of timing by bank.²⁰

So far, the bank was able to conduct three surveys, covering the period from October

1993 to September 1994. It is quite difficult to outline every single finding of these surveys, due to the detailed discussions of each specific branch case. Nevertheless, the major findings will be discussed, especially with respect to: transaction completion, opening an account, issuance of cheque books, account to account transfers, queuing time, encashment of cheques, receiving statements, quality of service delivery and staff teller attitude.

The general impression derived from the first mystery shopper was that "overall services were seen as being on the slow side".²¹ Although the performance varies between one bank and another and from one branch to another of the same bank, nevertheless, it was obvious that several banks were doing better than the NCB. Banks were also described as "quite slow and bureaucratic, causing delays and inconveniences. This implied opportunities for significant differentiation in service delivery." Saudi American Bank, Saudi French Bank and Saudi Holland Bank showed, in the first two reports, to be in the lead in many areas of business transactions and services and were ranked as "above average in terms of overall service", although they lacked time to complete such transactions in some places, such as in Riyadh, this being due to their limited network in this region. Arab National Bank and Riyadh Bank were viewed as just "average" banks. Later, however, the other surveys reported that it was very clear that the performance of the NCB had started to show significant improvement in many areas where performance in the past was poor.

In opening bank accounts it was apparent that it took a longer time than anticipated to process an account. Therefore, all transaction related to opening an account, such as issuance of ATM cards, cheque books and stage statements were delayed. Only Saudi American Bank, Saudi British Bank and Saudi French Bank issued a cheque book on the opening of the account. Others quoted times from one week to six weeks or not at all due to the sum of money deposited. Hence this prevented clients conducting some transactions in months following the opening of their account. The average time of issuing a cheque book in the first half of 1994 varied between "25 to 29 days, with Saudi Holland Bank ranking as the fastest in providing a cheque book, followed by Saudi American Bank and NCB, with the latter showing a better performance compared to 1993's results."²²

Encashment of cheques in the NCB seems to present serious problems, particularly with cheques drawn on other branches. The first survey reported that the NCB branches

greatly exceed the time required by any other bank. In some of the NCB's branches encashment of cheques took an average of one hour, whereas in other branches it took no more than 2.5 minutes. Overall, the NCB was the slowest. In the period which the second survey took place, 1994, the NCB showed no improvement compared to other banks, although the time for such transactions has dropped in general for all banks.²³

In the case of account to account transfers the NCB scored an average level of achievement and was slightly slower than other better performing banks such as Saudi American Bank and Saudi British Bank, which took them on average 5 minutes to accomplish this task.²⁴ Major reasons for such delay were factors such as "only accounts holders in person can carry out this transaction, or there is no such account to transfer the money into, or there is minimum amount of 500 - 1000 SR for such transaction to be carried out, or tellers sometimes insist that the signature on the bank form is not correct."²⁵

Receiving a statement was another type of transaction tested by the surveys. This service was found to be deficient in all three time periods in all banks in the Kingdom and had the lowest rate of improvement. The NCB was able to complete only 25 percent of the transactions while the rules for other banks varied between 45 to 50 percent. The most striking reason for not completing such a transaction by the Saudi banks was that when ATM cards were used, the computers were out of order, statements will be sent by post, only monthly statements are sent and only the account holder in person can obtain a statement. It is noticeable that in all the three surveys, these reasons were repeated exactly and consistently.²⁶

Queuing time recorded in the NCB branches proved to be the shortest compared to other banks. Over the three periods, the NCB generally was able to maintain its position and improved significantly in the last period of time. The queuing time for the NCB has improved from 6.3 minutes in the second period to 3.4 minutes in the third period, hence the waiting time for customers was shortened by 2.9 minutes.²⁷

In the first mystery shopper survey, the auditors attempted to accomplish around 9,600 transactions, of which 70 percent were completed successfully. The NCB was able to successfully achieve a 70 percent, success rate, while the Saudi American Bank accomplished 73 percent, and the Riyadh Bank was able to accomplish 59 percent.²⁸ In

the second period the number of transactions tested in the survey was increased to 10,980 transactions, of which 75 percent were accomplished successfully. The NCB and the Saudi Holland Bank completed 79 percent, followed by Saudi American Bank with a success rate of 78 percent, while Saudi British Bank, Saudi International Bank, Arab National Bank, and Riyadh Bank had rates of 76 percent, 74 percent, 69 percent, and 64 percent respectively.²⁹ In the third period, around 14,000 transactions were attempted, out of which 82.5 percent were completed successfully, an increase of 7.5 percent over the previous period. However, the NCB was first in carrying out its transactions successfully with a rate of 89 percent, an improvement of 11 percent over the last period, which was a significant improvement for the bank. The performance of other banks also showed some improvement. The Saudi American Bank had a success rate of 84 percent, an increase of 6 percent over the last period. The Saudi Holland Bank, Saudi British Bank, Saudi French Bank, Arab National Bank, and Riyadh Bank had success rates of 79 percent, 79 percent, 79 percent, 71 percent, and 71 percent respectively.³⁰

Many other services and issues were examined in these surveys, such as teller staff, customer staff and telephone operators. It was quite clear from the results that the best performing banks were those banks whose employees were found to be more friendly and welcoming. The overall impression of the NCB was that it was able to improve its staff attitude and their relationship with customers, as the bank was monitoring its branches on a case by case basis where the staff were not performing well. Furthermore, the bank improved the interiors of its branches in many places. NCB was rated in this area "second best overall behind Saudi Holland Bank."

The surveys also covered extensively the performance of other banks in Saudi Arabia to enable the bank to determine its position in relation to that of other bank's performance, for the purpose of competition and planning.

11.9 Other Major Changes in the NCB Between 1993 and 1995

11.9.1 Electronic Banking Division

One report produced by a local monitoring agency stated that around 10,000 POS terminals were installed in Saudi Arabia by the end of 1994, while in 1993 only 1,274 terminals were connected over a period of 9 months.³¹ The banks which installed the greatest number of

terminals were ANB, NCB, SFB and RYB. The ANB has 2051 terminals i.e. 20 percent market share and NCB has 1774 terminals i.e. 18 percent market share. Together they comprise 38 percent of the market. The success in the rapid installation of point of sales terminals can be attributed to the potential benefits it offers banks, retailers and consumers. However, there is still much slack in the system.³² Figure 11.6 shows the percentage distribution of installed Points of Sales by the Saudi banks during the period up to the end of 1994.

As shown in the figure, the NCB has tried to put much effort into improving its services, in order to compete with other banks in the country. Therefore, the new management committee gave authority to their electronic banking division to improve the bank's capability to meet the market demand and compete with others. Consequently the electronic banking division drew up the following agenda:

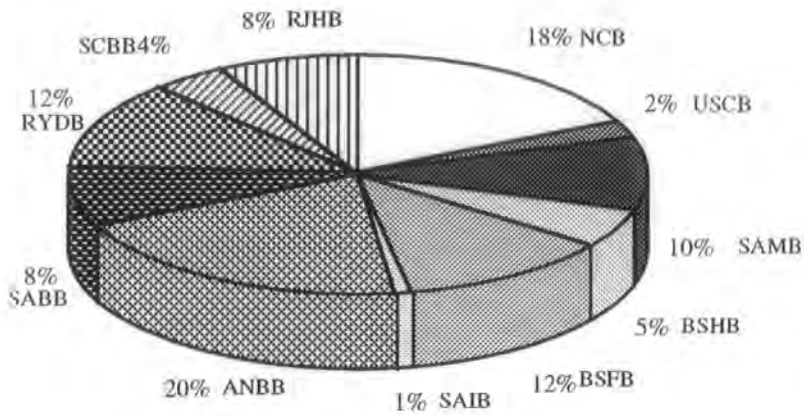
- 1 - Determine the customer service needs.
- 2 - Improve transaction efficiency by the bank to cover 65 percent of all transactions.
- 3 - Improve the image of the bank.

It was recognised that such goals could be achieved by improving the ATM machines, installing interactive ATM's, introducing more foreign exchange machines, having more point of sale, installing smart phones and, introducing Window's based P.C technology. The customers in this case can get access to such services as the provision of complementary credit cards, debit cards and smart cards.

The division has been given a budget of \$7.5 million as a total target investment in automation. By the end of 1994, a target of 179 ATM was set, 50 percent of which should be off-site. By the end of 1995, the anticipated increase of the Master Card holders was raised to 35,000 person, and the holders of Visa cards to 40,000 persons. In addition to this, the division plans to install a 24 hour information desk, as well as ensure that 50 percent of the staff obtain a minimum of one week training.

It is the responsibility of this department to extend the overseas capability of its ATM cards and to reach a target of 315 machines by the end of 1995. This step will increase the ATM's capacity from 500,000 transactions in 1994 to over 1.5 million transactions by the end of 1995, and would reduce the use of NCB's customers of other bank's machines from

Figure 11.6: % Share of Installed POS Terminals by Saudi Banks (1994-95)



Source: "SPAN Report". January, 1994., Volume i., No. 1., p. 1.

300,000 in 1994 to 270,000 by the end of 1995. The bank plans to impose a charge on NCB customers who use other bank's ATMs.³³ The alternative would be to negotiate reciprocal free use with the other banks.

The division has also started a special programme to educate customers on how to use and obtain greater benefit from their ATM cards. Such benefits include reducing problems associated with credit card fraud, statement delivery, collateral control, excess checking and fees collection. The division is keen to become innovative through introducing "mobile bank", the first "supermarket" branch and a full telephone banking system.

In the areas of improving the bank's image, the electronic division believed that it was necessary for the bank to resolve the responsibility for its ATMs by its departments. These ATMs are the responsibility of many departments in the bank, which as a result has led to a lack of efficient installations and servicing. Therefore, it was found necessary that total control and management of ATMs be in the hands of the electronic banking department. An installation, purchasing, maintenance and centralised group should be formed to service all machines in terms of cash and supplies, especially the off-site locations.

The department has also made plans for the future role of its ATMs which will include the following: full statements, product information, saving account information, services information, cheque cashing, loan application, cheque deposits, NCB card only, traveller cheques, fast cash transfers, coupons including (air tickets) and draft issuing.

11.9.2 Private Banking Business Division

The bank established a new division to deal with private clients at high net worth. This new division has three regional offices. All types of banking and non banking products and services are available. Such services include the NCB's services in addition to some personal services such as cash home delivery, traveller's cheque and drafts, airline reservations and many other services. The existing position of this division has been measured by the bank and found to be serving at present only rich local clients, who are also served by the Riyadh Bank and Al-Rajhi. The Saudi American Bank was found to be serving the super rich clients on an international level, along with international banks. According to the 1995 budget and planning documents of the NCB, the division is now capturing more local clients and was successfully increasing its share in the private banking market. It is therefore expected, according to these documents, that the division will be able to continue its trend in dominating the local segment of the market, and it is predicted that by the beginning of 1996 financial year, its client base will be concentrated more towards the highly local super rich category along with the Arab National Bank and Al-Rajhi. Other local banks such as the Saudi American Bank, Riyadh Bank and Saudi British Bank are also expected to increase their client base among the super rich and international segment, at the expense of foreign banks.³⁴

However, the most important goal for this new department according to its manager, is "to build a good relationship between the bank and its clients, improve the bank image, be innovative and avoid all the mistakes that the other banks have made".³⁵ This division measures its performance by the increase in number of customer served. The number of its staff and clients is reported to have increased significantly. According to the manager of the private banking division, "the number of its clients in 1993 was 305, and this figure increased to 346 clients in 1994, and hopefully will increase by a further 18 clients by the end of 1995. The division has not lost any of its clients so far."³⁶ This information is contradictory to what has been reported in the previous chapter. In a special report on the NCB, the manager was reported to have said that "the division's relationship officers are handling 400 accounts."³⁷ Such inaccuracy might not help the bank improve the division's position and may even affect the bank's overall image.

In September 1994, the division had 10 relationship managers, but by January 1995 the division increased the number of its relationship managers to 13, while the total number of staff was 33 members.³⁸

11.9.3 Islamic Business Division

In the restructuring process of the bank, the Islamic Investment Unit has been upgraded to a full division and acts as any other division and promotes its services in the market. An SWOT analysis by the bank concluded that the Islamic business division must take advantage of the owner's commitment to adopt and maintain Islamic banking principles. According to Channon, D.F (1993), the SWOT is a "plan which should explicitly assess the bank's relative strength and weaknesses for specific factors such as market share, service quality and relative cost. The plan should also assess threats to and opportunities for the achievement and objectives on the basis of the environment and market assumptions and relative competitive strength."³⁹ The division is committed to making its message very clear by increasing customer awareness and obtaining recognition through promotion and strong marketing, by improving the location and appearance of those branches dealing with Islamic business operations, by training and development of the staff and by competing with Al-Rajhi in the Saudi market. Therefore, the division is very keen to establish a Sharia board, to improve the quality of services, and to automate all branches and introduce investment accounts.

The Islamic business division estimated other competitors portfolio structure to be as follows: Al-Rajhi SR 22 billion of deposits, Faisal Islamic bank SR 7 billion of deposits, Al-Baraka SR 4 billion of deposits, Islamic Investment Company SR 4 billion of deposits. Therefore, in order to compete strongly with such giants, the Islamic Investment Division in the NCB, will take advantage of the poor service quality in this section, low expertise for corporate investments, poor level of technology, limited range of Islamic banking services, weak Islamic image, limited Islamic branches, the absence of local outlets and access to retail market.⁴⁰

The range of services in the Islamic business division are classified into several profitable and non profitable types of businesses or accounts, namely retail, corporate mid-market, high net-worth individual accounts and non-profitable institutions. These

types of business have sometimes similar accounts such as the current account, general investment account, investment funds, personal morabaha, mudaraba, musharaka, leasing, istisna' (Manufacturing by order) and letters of credits and guarantees.⁴¹

The IBD has indicated that the division has increased its profitability from SR 16 million in 1993 to SR 75.3 million in 1994, an increase of 368 percent. The value of the current accounts of the IBD have increased by 23.7 percent to SR 1.59 billion. The volume of musharaka investment has grown by 11.5 percent. The volume of modharaba grown by 9 percent; while the personal modharaba increased by 8.2 percent, the commercial modharaba has increased by 8.5 percent. The ijara (Lease) business has increased by 8.5 percent, and istisna' by 9.2 percent. The bank has increased its fees and commissions by 38 percent to reach SR 3 million.

According to an internal document produced by the NCB's Islamic Business Division, the division is expected to generate a high level of income due to its involvement in a new ventures through financing more projects and better utilisation of liquidity at higher market rates. The division is planning to open two new branches this year, while 14 branches have already been reorganised, relocated in better areas and converted to deal with only Islamic business services.

One of the goals of the division is to increase the number of Saudi Arabian staff by 5 percent, raising the percent of local nationals from 60 percent in 1994 to 75 percent by the end of 1995. The management of the division is in constant touch with its staff through intensive meeting and training programs. In fact, the management was able to schedule 50 site visits by the headquarter staff to branches.

The head of the division is totally convinced that such a division must also be innovative, which is one of the new aims of the bank as a whole. It is therefore, planning to introduce four new Islamic products during 1995, and to enhance the quality of its employees through conducting continuous training courses and seminars, and quarterly workshops for each of its branches in business planning, budget reviews and recent developments. The division also participates in conferences and seminars in the field of Islamic business, economics and finance.

According to the division's budget for 1995, total revenue should increase by 93

percent over 1994's revenues. The net revenue is expected to grow by 375 percent. The division's balance sheet indicates an increase of 20.5 percent, most of it in finance and investment activities.

The Islamic business division manager has encountered many difficulties in trying to achieve the bank's objective, and making its vision real. He says " the division was given the worst performing branches and have had to turn them to profitable ones. The Islamic business division has the full authority to control its branches in the way it sees fit, and some success was achieved although limited. Many lose making branches were transferred into profit making ones. Overall, the Islamic business division was able to achieve profits of more than SR 8 million in the year up until mid 1994, compared to a total loss of SR 17 million for the same period in 1993."⁴²

The division is determined in providing the necessary training for most of the division's staff, mainly in the area of new Islamic investment instruments. According to the manager of the division, 27 branches deal only with Islamic business operations. It is expected that six more branches will be transformed by the end of 1995. The division is also working on developing a different accounting system, which is expected to match its main business activities. The division also liaises with high calibre financial institutions to develop new types of Islamic instruments. However, according to internal sources in the bank, many of the people who are involved in the Islamic finance have limited practical knowledge of Islamic banking and investment, but nevertheless they are well versed in the academic field.

11.9.4 Al-Sager Project

The Al-Sager (The Hawk) project is another new and ambitious strategic step for the new management. The purpose of Al-Sager project is to reorganise the bank operations. This is to be achieved by concentrating on front-line retail and customer services and the improvement of systems for better financial control. Al-Sager involves setting up three regional processing centres, one in Jeddah, another in Riyadh and the third in Dammam. It is hoped that centralising some of the bank operations, mainly processing, will enable the bank to concentrate on the front line services and ensure consistency through the three regional processing centres.⁴³

The executive manager of Al-Sager project stated in an interview that "if letter of credits are being processed out of 230 branches, then it is likely that we will have very inconsistent quality." He then adds that "if you form a unit of 15-20 people, they will develop a level of expertise which over time would provide excellent delivery of these services."⁴⁴ The purpose, however, of such central processing is to cut cost, improve the quality of services through specialised staff who would be able to deliver better and quicker services through their centralised centers rather than making such service widely spread over all the bank's branches and having it in the hands of non-professionals.

The Al-Sager project is still in its first phase, therefore, and it would be difficult to pass judgment before results materialise. The project is directly linked to the advanced technology introduced in the bank. Several places were chosen to launch and experiment with this programme, including the main branches in (Palestine Square) Jeddah, Abaha and Al-Khobar. The bank is also running several seminars on the project, inviting branch managers from all three regions to advance their knowledge with the latest development on the project as well as other changes in the bank, in order to transfer this knowledge on to their staff and customers.

11.9.5 Other Changes Introduced to the NCB

The NCB has been very dynamic in the last three years. In October 1992, a new brokerage service was formally launched by the investment management division. Sheikh Mohammed introduced this new brokerage service which enables the buying and selling of Wall Street shares and United States government financial securities.⁴⁵

At the end of 1992, the bank launched more than 65 training programs covering around 1,276 trainees.⁴⁶ In 1993 the bank was able to complete 127 training programme which trained over 1,670 employees. It is the intention of the management is to introduce more technical courses to cope with its reform process. In 1994, the bank introduced four more investment funds, including one for dealing in Saudi Arabian shares. In total, the bank is now managing 19 investment funds, and of these 12 funds are open to the public and seven funds are private. The funds cover several investment areas. According to a well planned source in the bank, the total amount invested in these funds exceeds 10 billion Saudi riyals (\$2.7 Billion) and involves around 22,000 investors.⁴⁷

11.9.6 Going Public?

The owners of the bank have totally ruled out the possibility of making the bank a public company. Nevertheless, perhaps once the NCB regains its premium place in Middle Eastern banking, it would then be to the owners advantage to sell part of the bank off to the general public. In two years time the position of the bank should have been completely changed, and then there is a possibility of going public.⁴⁸

11.10 Reaction on Newly Introduced Changes in the NCB

The NCB's reform process has show that the bank is seriously thinking of its future. A substantial improvement has been recorded in its performance. The bank has been able to become more successful and is still trying hard to improve its image. Such achievements in its competitive capability and image is reported to have attracted praise from local and international concerns. Some analysts are reported to have predicted that the bank would have a solid foundation and operations after 1997/98.⁴⁹ Capital Intelligence, an independent financial rating agency, gave the bank a single "A" long term rating and classified the NCB as a strong bank with no cause for concern. One report commented that "assessment indicates that the dark clouds that hung over the bank in the late 1980's and early 1990's have dispersed." The bank's move to publish its audited qualified financial statements for the unreported years between 1987 and 1989, as well as its results for 1991 and 1992, have relieved the tension and the uncertainty which was surrounding the bank's image in the market. The credit problem that the bank has suffered in the past, and which contributed to its financial troubles, is not a matter of concern any more. The bank's Chairman of Credit Policy Committee, is reported to have said that "as the bank is controlling its credit policy wisely and gradually, there is no more uncontrolled credit extension".⁵⁰

11.11 Conclusion

The NCB has now reached a turning point. The previously discussed studies indicate that the bank is at a critical stage in its evolution. On the one hand NCB, is clearly a dominant force in terms of market penetration and share - especially in the corporate banking sector, however, on the other hand there is evidence, particularly in relation to bank switching and

image, which poses a threat to NCB's dominance, primarily from the Saudi American Bank.

The bank's image and customer satisfaction survey for corporate clients showed that NCB has 44 percent of the market for corporate lending in the Kingdom, followed by the Saudi American Bank and Al-Rajhi, who together control 31 percent. Nevertheless, it is worth noting that from this survey that it was also discovered that NCB's position with reference to its high net-worth individuals is weaker than that of the Saudi American Bank, Al-Rajhi and the Saudi British Bank. Due to this result, the private banking division of the bank has now directed its efforts to capturing a greater percentage of this market segment.

It is apparent that the NCB's strong market position stems from a number of factors, of which the most important are: its reputation as a solid, reliable and substantial bank, and its time-honoured presence in the Kingdom. Its considerable branch network, its perceived wide range of services, for both retail and, to a lesser extent, corporate clients, also reinforce the bank's position. More importantly, its customers are as satisfied with it as those banking with other banks.

The role of the bank's staff in the whole process is obviously critical. The staff survey indicated that whilst, on the whole, employees are satisfied with working for NCB, a number of areas could be improved. Although satisfied, many feel the job does not meet their initial expectations. Specific areas of employee concerns were: management attitude and fairness, inadequate training opportunities or facilities, and lack of necessary technology to enable them to deliver a top quality service. Obviously, the company needs to address these issues through relevant procedures, training and investment. A further staff-related issue that may be more difficult to fully resolve is that many employees do not seem to be particularly career-oriented and seem to derive little satisfaction from the intrinsic nature of their work. Therefore, there is a need to replace what appears to be a slightly low key, complacent atmosphere in the bank, with one which is more aggressive and challenging.

Hence, a number of worrying conclusions emerged from these studies. These weaknesses need to be addressed by the NCB management, if the bank is to retain and even enhance its dominant position. For instance, compared to some other banks, the Saudi American in particularly, the NCB's image is somewhat old-fashioned, characterised by

perceptions of being bureaucratic, relatively inefficient, and slightly behind on the use of modern technology. This image profile is undoubtedly associated with the fact that the average age of the bank's customers is significantly older than that of the major competitor's customers, Saudi American Bank. SAMBA not only has, on average, younger retail clients, but it also has a modern and more dynamic image. This situation will unquestionably cause many problems for the bank in future. If SAMBA continues to capture a much larger share of the new/younger customers, then in time it could control a larger portion of the market, especially when SAMBA is more aggressive in its advertising i.e. generating much higher advertising awareness than the NCB.

Therefore, the NCB needs to urgently persuade the market that, whilst maintaining its solid banking reputation, it can also deliver efficient, up to date, technologically-driven services which are equal to those of its competitors. This implies improving both the substance of these elements in terms of more automation, high technology products, better trained and more efficient staff to deliver the products, as well as higher profile communications, to put the message across to customers. The bank's first step towards rectifying this situation was to introduce a new electronic banking system.

Notes:

- (1) Most information mentioned in this chapter was obtained either through interviews or material obtained privately from the NCB on several trips made to Saudi Arabia.
- (2) Edgar, H. F. Organisation Development and Change New York: West Publishing Company, 1980, pp. 65-66.
- (3) Kanter, Rosabeth Moss.; Stein, B.A. and Jick, T. D. The Challenge of organisational Change: How companies Experience it and Leaders Guide it New York: The Free Press, 1992, p. 24.
- (4) Ibid., pp.33-35. Another example is the technological development in the broadcasting business. See foot note for more ideas. The broadcasting organisations in the United States of America which was until very recent years dominated by only three major net works namely: CBS, NBC, and ABC. Nowadays, because of the cable and satellite facility broadcasting technique, there are numerous networks including the CNN (1980) and Fox Broadcasting (1990).
- (5) Hempel, George H.; Simonson, Donald G. and Coleman, Alan B. Bank Management: Text and Cases Canada: John Wiley and Sons, 4th edition, 1994, pp. 18-21.
- (6) Ibid., p. 721.
- (7) Canals, Jordi. Competitive Strategies in European Banking Oxford: Clarendon Press, 1994, p. 36
- (8) Ibid., pp. 36-39.
- (9) Special interview with Sheikh Mohamed Bin Mahfouz, General manager of the NCB and Chief executive for the management committee.
- (10) Ausrat Al-Bank Al-Ahly (NCB Family) An internal publication produced by the central public relations of the NCB. Issue No. 24, September 1993, pp. 4-5.
- (11) "Report on Bank Image and Customer Satisfaction Survey (Corporate and High Net-Worth Individuals) in Saudi Arabia." Prepared for the NCB, Central Marketing. By AQMD/MEMRB International, September, 1993, p.21.
- (12) Ibid., p. 25.
- (13) Jakson, David J. and Borgatta, Edger F., Factor Analysis and measurement in Sociological Research London: SAGE Publication, 1981, pp. 11-13. See also King, P. An Easy Guide to Factor Analysis London: Routledge, 1994.
- (14) Jakson and Borgatta, op. cit., 1981, p. 29.
- (15) "Report on Bank Image and Customer Satisfaction Survey (Corporate and High Net-Worth Individuals) in Saudi Arabia". Prepared for the NCB, Central Marketing. By AQMD/MEMRB International, September, 1993.
- (16) Ibid., p. 25. In fact the data refers more to a better image of some of the other banks which might have deliberately ignored by the report, and if this is the case this would mean two possibilities; one is that the company which was responsible for conducting this market survey was not subjective in its judgment or two it has only reporting what it would keep the NCB happy.
- (17) "Report on Staff Attitude Study in Saudi Arabia". Prepared for the NCB, Central Marketing. By: AQMD/MEMRB International, September, 1993, p. 5.
- (18) Ausrat Al-Bank Al-Ahly (NCB Family) An internal publication produced by the central public relation of the NCB. September 1993, Issue No. 25.
- (19) Core transactions are as follows; encashment of cheque drawn on own A/C at same

branch, encashment of cheque drawn on another city branch, encashment of cheque drawn on another branch in a different city, A/C to A/C transfer to another branch, issuance of draft in local currency, issuance of draft in foreign currency, selling foreign currency travellers cheques to customers, purchasing foreign currency travellers cheques from customers, deposit cash for credit to A/C at the same branch, deposit cash for credit to A/C at another branch, cheque deposit and clearing cheque drawn on another branch, cheque deposit and clearing cheque drawn on another branch in a different city, cheque deposit and clearing cheque drawn on another bank, selling foreign currency bank notes to customers, purchasing foreign currency bank notes from customers, issuance of cheque book, requesting and receiving monthly statement, requesting and receiving statement on demand and response to account inquires.

The non-core transactions were; obtaining a counter cheque, telex transfer to A/C at another branch, telex transfer to A/C at another bank, application for certification of a cheque, opening of bank account, issuance of ATM card (PIN number), processing stop-payments on cheques and returned cheques processing/advising. See "Customer Service Monitor - Mystery Shopper", Period: October 1993 - January 1994, A Report Prepared for the NCB - Central Marketing, by: AQMD/MEMRB-International. p. 2.

- (20) Ibid., p. 2.
- (21) Ibid., p. 5.
- (22) Ibid., pp. 4-10., "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February - May 1994, A Report Prepared for the NCB - Central Marketing, by: AQMD/MEMRB International., p. 13. "Customer Service Monitor - Mystery Shopper", Period: June-September 1994, A Report Prepared for the NCB - Central Marketing, by: AQMD/MEMRB International., p. 15.
- (23) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: October 1993 - January 1994., p. 11. and "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February-May 1994, p. 13.
- (24) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: October 1993 - January 1994., p. 11.
- (25) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February - May 1994, p. 12.
- (26) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: October 1993 - January 1994, p. 10. "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February - May 1994, p. 12. "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: June - September 1994, p. 15.
- (27) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: October 1993 - January 1994, p. 11. "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February - May 1994, p. 13. "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: June - September 1994, p. 15.
- (28) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: October 1993 - January 1994, p. 9.
- (29) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: February - May 1994, p. 12.
- (30) "Customer Service Monitor - Mystery Shopper", AQMD/MEMRB International. Period: June - September 1994, p. 14.

- (31) "SPAN Report". January, 1994., Volume I., No. 1., p. 1.
- (32) Ibid. pp. 2-3
- (33) Special Document on Electronic Banking in the NCB. Electronic Banking Division - NCB.
- (34) Special Report on "The Perceptual Map of the Competitive Role of the Private Banking Division in the NCB", Special Report, Private Banking Division: NCB.
- (35) Interview with the manager of the Private Banking Division of the NCB took place in Jeddah, February, 1995.
- (36) Ibid.
- (37) Middle East Economic Digest, Vol. 38, No. 39, 30th September, 1994, p. 7.
- (38) Ibid., and the interview with the manager of the Private Banking Division of the NCB.
- (39) Derek F. Channon. Bank Strategic Management and Marketing. London: John Wiley, 1993, p.9
- (40) Special Document on the Islamic Business Division of the NCB, Islamic Business Division, NCB.
- (41) Special Interview with the manager of the Islamic Business Division of the NCB took place in Jeddah, February, 1995.
- (42) Ausrat Al-Bank Al-Ahly (NCB Family). *op. cit.*, Issue No. 30, January, 1995, p.75 and pp. 80-82.
- (43) Ibid., pp. 80-82.
- (44) Ibid., pp. 80-82 and Middle East Economic Digest, Vol. 38, No. 39, 30th September, 1994, p.2.
- (45) Ausrat Al-Bank Al-Ahly (NCB Family), *op. cit.*, Issue No. 22, January, 1993.
- (46) Ibid., April-July, 1993. Issue No. 23., p. 27.
- (47) Special interview with the manager of the Corporate division of the NCB.
- (48) Ausrat Al-Bank Al-Ahly (NCB Family), *op. cit.*, Issue No.30, September, 1994, p.3.
- (49) Middle East Economic Digest, *op. cit.*, p. 3.
- (50) Ibid., p. 3.

Chapter Twelve

Conclusion and Recommendations

Financial intermediaries in Saudi Arabia have developed from being quite rudimentary to organisations equipped with the most sophisticated and advanced banking technology. However, they have not been allowed to take up the role expected of intermediaries in a developing economy. The main cause of this was the Saudi Arabian government's income from oil, which allowed the Kingdom to commit itself to vast development expenditure to ensure that the country was steered towards industrialisation and ultimately greater independence from oil. It was, therefore, its policy to provide funding to projects that would help the Kingdom achieve its goal of greater self reliance. This meant that financial intermediaries were crowded out. However, when the government activity was curtailed due to the fall in oil prices, financial intermediaries would play a more important role.

The study revealed that the Saudi Arabian government did not rely on monetary policy to achieve its goals. It tended to place much emphasis on expenditure policy; this was evident from its budgetary plans that were created to work around its development plans. As long as the economic development objectives were met the government was willing to bear inflation and would ease the pressure of inflation on lower income earners in its society by subsidising staple food. However, in its drive towards self reliance it had not looked into the opportunity costs of developing the agricultural sector, for instance, it has perhaps over spent on this sector, when it would have been much cheaper to import. The study points out to the fact that perhaps Saudi Arabia is not seeing what it has become. Today Saudi Arabia is seen as a service economy, still largely dependent on crude oil, despite its attempts to diversify.

An insight into the background of the NCB, the oldest and largest financial intermediary in Saudi Arabia, was given by its founder Sheikh Salem Bin Mahfouz, who managed to rise from "rags to riches" through his foresight and hard work. The thesis explained the important role played by Sheikh Mahfouz in the informal market, as both a moneylender and moneychanger. His role in government finance was also significant when oil was still undiscovered.

The study of the NCB's financial statements revealed that the bank was very much affected by the swings and booms in the economy. Hence, as oil revenue increased, the economy boomed, and the multiplier effect meant that people prospered, as did the NCB with the increase in its deposits. The NCB had high levels of liquidity during the peak of development spending, which meant that funds were not utilised. In fact, the bank started to invest large sums abroad, which revealed the lack of investment opportunities in the Kingdom. The development agencies set up by the government were all encompassing, making it very difficult for the banks to compete in lending. Another obstacle to lending was the fact no collateral would be taken against the loan, because of the Sharia Law. This meant that the bank would follow discretionary methods of lending.

Due to the fall in oil prices during the recessionary period in the mid 1980's the government could no longer solely finance the development process, thus banks became more involved. Unfortunately, many were too eager and ended up with much bad debt, the NCB being one of them. This made the bank cautious again and the gap between lending and deposits expanded from SR 3.8 billion in 1980 to SR 5.1 billion in 1992, which reflected both the lack of investment opportunity and market distrust.

The study of the NCB's performance in relation to the economy provided evidence that the bank has not been a source of funds for development, as there was indication that revenue from oil was the vital element. The study revealed that investments were dependent on government spending, however, on occasion the NCB's loans would complement government expenditure, especially for working capital purposes. It was found that the bank's trade loans and the Kingdom's imports were related, but only to a limited degree, and there were indications that loans were used for consumer goods inventories as opposed to development inputs. The study revealed that capital goods imports were largely dependent on government spending. Bank lending was not used to finance private consumption, but it did finance businesses stocks of these items.

The study has shown that the banking sector is playing a marginal role in financing the development process. However, due to the last Gulf war, the Saudi government was forced to commit much of its funds for military purposes. Income from oil has fallen with the price of oil hovering between \$14 to \$20 per barrel. Much of the country's foreign reserves were used for the war efforts and all this has left no choice to the government except to turn to its financial intermediaries for help. The Saudi government recently issued development bonds in order to finance the development process through commercial banks.

The study showed that the Saudi Arabian financial system has not experienced significant financial deepening, a process that is arguably necessary to insure the long term success of development. The ratio of financial liquidity to aggregate GDP and non oil GDP was calculated and it was found that in both cases the ratio was rising, but relatively slowly. A more rapid rise will only happen if the banks are given the chance to actively be employed in the funding of investment. However, this will only be possible if the government development agencies are brought in line with commercial bank rates as far as lending are concerned. The government does not have to worry about what projects are funded, it can actively inform banks about its development plans i.e. in which areas of the economy should the banks direct their lending policy. However, as was revealed in the research, the Saudi Arabian money supply and the circulation of notes has expanded indicating monetisation. The results also showed that Saudi Arabians are relying more on bank deposits for their financial activities. The financial system has also experienced financial widening due to the effort of SAMA and the financial intermediaries. This will inevitably facilitate the move towards financial deepening. Secondary markets have also been created by SAMA but are still at an embryonic stage.

The literature survey in chapter two stressed the importance of reform to the financial system, especially for its intermediaries. The NCB appears to have taken this up on its own accord providing a healthier bank with a managerial objective that should equip

it well for the future. But it is up to SAMA to ensure that financial intermediaries in the Kingdom are forced to improve on their performance in order to ensure that they can handle the challenge of development ahead of them.

Commercial banks are likely to continue to be the predominant organisations in the formal financial market in Saudi Arabia. It is, therefore, of vital importance that they are made more efficient through the enhancement of their managerial organisations and by ensuring constant competition between them. Managers in commercial banks must be better trained to apply caution in their lending policies. In order to be more aggressive in loan recovery, they need to develop more refined information systems, and they must ensure that their staff are trained to high levels. In the meantime, the government must try to develop other forms of financial intermediaries, especially those that are equipped to provide long-term loans. The government must also encourage the development of a secondary market and follow all the steps necessary to ensure greater financial deepening as the country has only really been exposed to financial widening. In order to achieve financial deepening the government must liberalise the financial system by eliminating gradually all forms of financial repression. This must all be supervised by government regulations since finance often evolves rapidly. The commercial banks must try to provide market information promptly in order to facilitate market activities. Many changes are needed in order to establish a solid foundation for an efficient financial system to be more instrumental in the long-term development of the country.

The time has come for Saudi Arabia to liberalise its financial system especially that now it is unable to maintain the country's economic development from its own efforts. In order for financial liberalisation to succeed in the Kingdom the government must step back after it has done the following: Firstly, the removal of interest rate ceilings, hence ending financial repression. This may also imply delinking the riyal from the US\$, and allowing it to float freely.

The second step towards liberalisation would be to allow the entry of new banks into

the Saudi market regardless of the fact that they are foreign banks. This would increase competition and also bring in foreign financing. Naturally Saudi Arabia should not allow any bank to operate, only those who are well established in the world's financial markets. The third step would be to reduce reserve requirements as this would free up much needed financing that banks can lend to investors for development purposes. The final point, and in relation to the previous one is that the government must not impose direct controls on bank lending, rather it should be allowed to flow freely.

Furthermore, much of the experience of developing countries shows that financial liberalisation must be carried out simultaneously with macroeconomic reform, and that countries that have tried to liberalise their financial system prior to making macroeconomic reforms have been faced with volatile capital flows, rising interest rates and organisational mayhem. In addition, financial liberalisation will not be able to truly flourish unless the government undertakes the reorganisation of the non performing or failed banks and businesses in the economy by controlling and managing them to ensure their success once more. Naturally the control of the banks must be left to SAMA, and as the central bank it must be allowed to have full control of the financial system. Saudi Arabia in a way is lucky in that there is no short term political gain in manipulating the economy. The ruling family is there to stay and therefore they can afford to take a long term view freed from any other ulterior political motive such as the need to win elections.

Appendix A
The National Commercial Bank and
The Saudi Arabian Economy

The main objective of this appendix is to discuss the relationship between the performance of the NCB and its effect on the Saudi economy. Did the NCB play an active role in the economic development of Saudi Arabia? Or did it merely complement the government and its development agencies in the development process, participating whenever given the opportunity? Were the Saudi Arabian government's expenditure plans and its effort in setting up its infrastructure so all-embracing that it completely crowded out the NCB and the financial sector?

Neo-classical economists argue that if markets are left to do as they please then they would operate efficiently. The financial liberalisation theory is a typical example of the neo-classical ideology. Its advocates suggest that if credit markets are left to operate freely with no government intervention, then it follows that investment and savings will be equal. Interest rate ceilings will result in disequilibrium. In Saudi Arabia the government did not intervene in the market by setting interest rates or dictating to commercial banks in which form they should make their loans. In fact, one could argue that the commercial banks in Saudi Arabia were left in a *laissez faire* state. What the Saudi Arabian government did instead was to develop its own financial agencies, agencies that competed with commercial banks. These government agencies competed with an unfair advantage however, as they were not subject to the same commercial discipline as the banks.

The theory of financial development argues the importance of the mobilisation of saving for investment. This leads to the second argument of whether the NCB is mobilising its deposits for investment purposes, or financial trade, or even lending to the public? Is the NCB playing its true role as a financial intermediary i.e. lending to the business that would reap the best investment opportunities for the Kingdom's development, or is it perhaps applying a discriminate lending policy by lending to the people it knows best, even though the former scenario would have ensured a better return on investment.

Another point to examine is whether or not the increase in government expenditure has led to an increase in demand deposit of the NCB. The implication of this is, as economic conditions improve, the household financial position also improves. Multiplier (or leakage) effects mean that an increase in the household income will lead to an increase in their propensity to save, and this will be mirrored in the NCB's customer deposits.

Hence, households are more concerned with saving and are, therefore, becoming part of the financial system. As demand deposits expand and the different elements in the money supply increase, this means an increase in the ratio of bank deposits to GDP, resulting in financial deepening.

Although there are several means of obtaining data, the data included in this research has been obtained directly from the management and staff of the NCB. In return, complete confidentiality was assured that the data will only be used for the purpose of this research. The other type of data which were utilised here were the data obtained from SAMA on the Saudi economy. This is published both yearly and quarterly and is made available to the public. All the figures for the seven categories were deflated using the consumer price index to eliminate the effect of inflation. The deflator used in this process was that reported by the International Monetary Fund in its yearly financial statistics reports for Saudi Arabia. As a result the analysis became more reliable, as real values were used, and the risk of bias that may result from inflation is greatly reduced.

There are two major sources for the data used in the analysis in this appendix. The first is the NCB's lending power and the level of customer deposits. The second is Saudi Arabia's macroeconomic variables. The NCB's figures relate to three major fields; loans and advances to the private sector; customer deposits and letters of credit. The second set of figures, reflecting the economic performance of the Kingdom, include investment, government expenditure, private consumption and imports.

Due to the strong financial position of the government of Saudi Arabia for much of the 1970s and early 1980s as a result of substantial oil revenues, the state is not heavily dependent on the banking sector as a source of finance. Its fortunes were therefore independent of those of the private sector. That does not mean there is no relationship between the NCB and the macroeconomy. In the past the prosperity of the private sector has depended on government spending levels, but the dependence was one way. However, the latest development in the Saudi Arabian economy over the last two years, shows that the government has started to rely more on commercial banks to finance public projects. This is contrary to the position in the 1970s and much of the 1980s. This appendix explores the performance of the NCB in this macroeconomic context. It goes further to decipher the

effects of the performance of the Saudi Arabian economy on the NCB.

Figure A.1

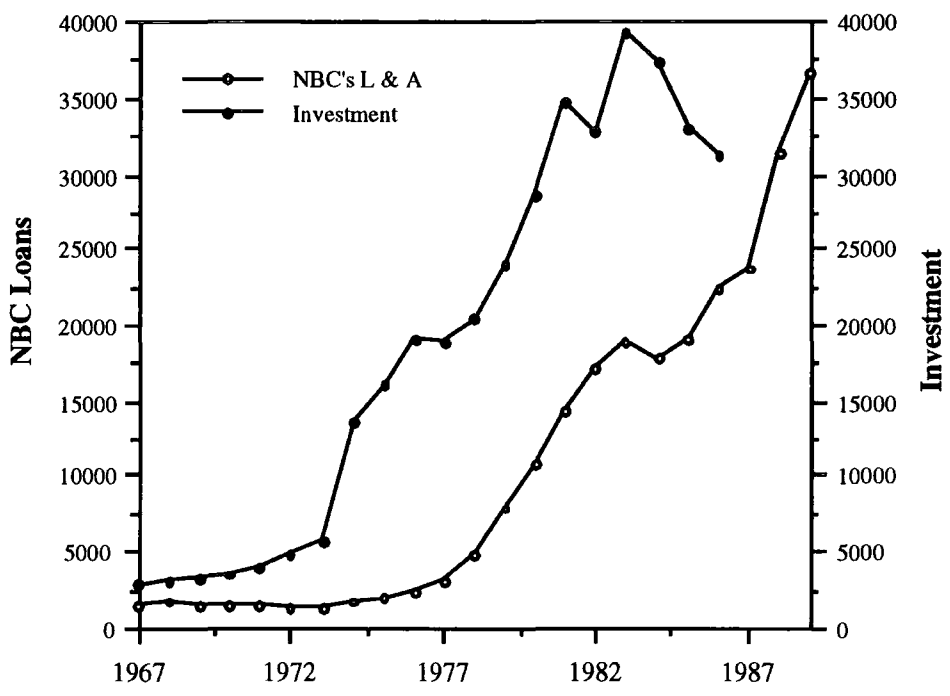


Figure A.1 examines the relationship between investment in Saudi Arabia and loans and advances given to private sector by the NCB. It is quite possible, theoretically, for government development projects to encourage loans and advances from private banks. Government projects might be given to contractors who in turn subcontract them to others, and both might seek finance from private banks. It is apparent from the diagram that the NCB's loans and advances do not explain the variations of aggregate investment. This is not surprising since in a country mainly dependent on income from oil, such as, Saudi Arabia (the biggest oil exporter and oil reserve holder in the world), it is not surprising that most investment is not financed by commercial banks. NCB's loans and advances are more likely to be dependent on state investment since government contracts are given to the private sector and the private sector in turn look to private banks to finance such contracts, since investment expenditure may induce future borrowing. Hence, although the government development agencies fund the majority of projects initially it may be that after the work is started the investors are forced to turn to financial intermediaries; i.e. suggesting that when the funds allocated to the project are used up, it becomes necessary to borrow in order to ensure the completion of the project or for working capital purposes. This is reflected in the upward trend of both variables. However, as investments decrease

loans and advances continue to rise emphasizing the growing importance of bank lending in the Kingdom. As government investments in the country decrease, private investors take on a more dominant role within the economy.

Figure A.2

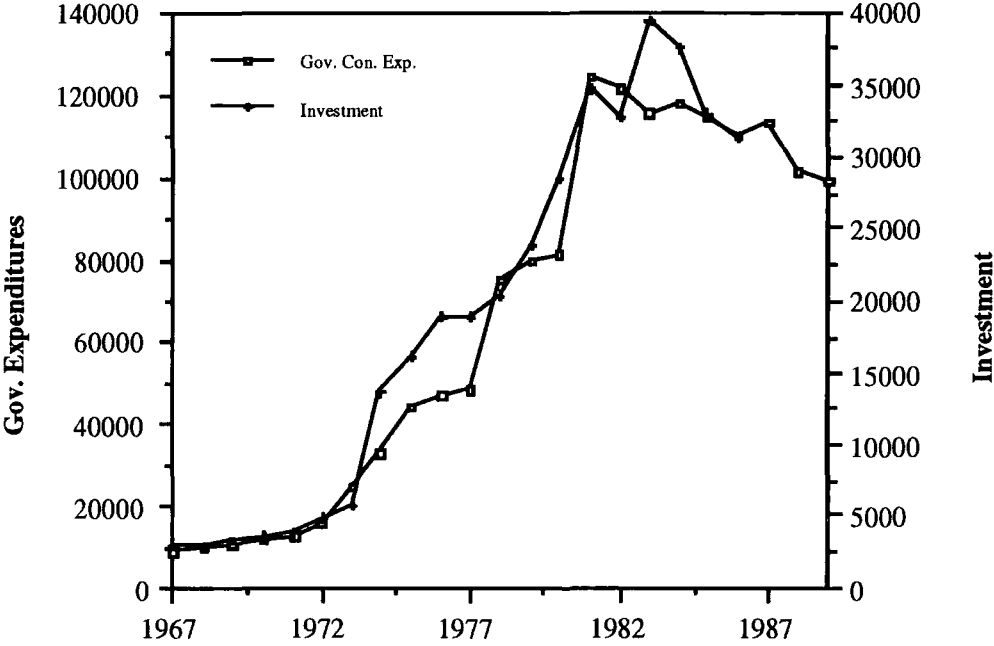
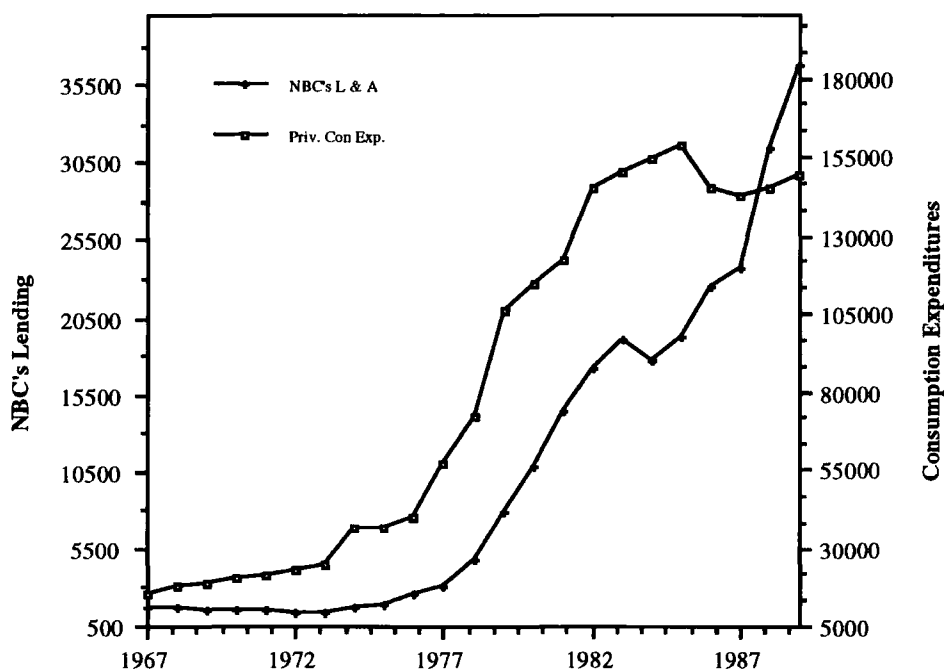


Figure A.2 examines the relationship between investment and government expenditure. The objective of the figure is to show the degree of dependence of investment on government expenditure. Due to the financial position of the Saudi government, and the extent of public sector spending in the last two decades, it is not surprising to find a positive relationship between investment and government expenditure. In fact, it is apparent that the two variables reflect each other which suggests that the banking sector was playing a marginal role in financing the development process. This is not surprising since government development agencies have played a significant role in investments in the Kingdom, to the extent that they even deprived private banks of business opportunities.

Figure A.3 looks at the extent to which people in Saudi Arabia finance their consumption through borrowing from banks. The figure shows an increase in both variables, which is probably due to the economic prosperity in the region. Evidence from the NCB suggests that people in Saudi Arabia generally do not like to borrow for personal

consumption reasons. This is divergent to the pattern of consumer behaviour in some Western countries. Another reason could be the Islamic *Sharia* law which forbids borrowing if it carries interest. Due to the the Islamic laws, banks do not like to give personal loans, as they cannot take any kind of collateral, or indeed action against the borrower if he decides not to pay back the loan. In many cases it is often difficult to get a personal bank loan if one is not a large account holder in the bank which will guarantee the loan. Also the high income level enjoyed by many people in Saudi Arabia means that there is little demand for borrowing.

Figure A.3



The figure shows that even though both variables are increasing they do not reflect each other with the actual yearly trends. Hence, it is apparent that people in Saudi Arabia do not use loans from banks for consumption purposes.

Figure A.4 presents the relationship between imports and the NCB's loans and advance. Here again the trend is an upward one, but it is apparent that there is not a strong link. This basically means that the loans and advances given by the NCB are not used for financing imports. If bank loans are not used for imports, and, as discussed earlier, are not used for investment or personal consumption, this leaves very limited commercial opportunities for these funds to be used.

Figure A.4

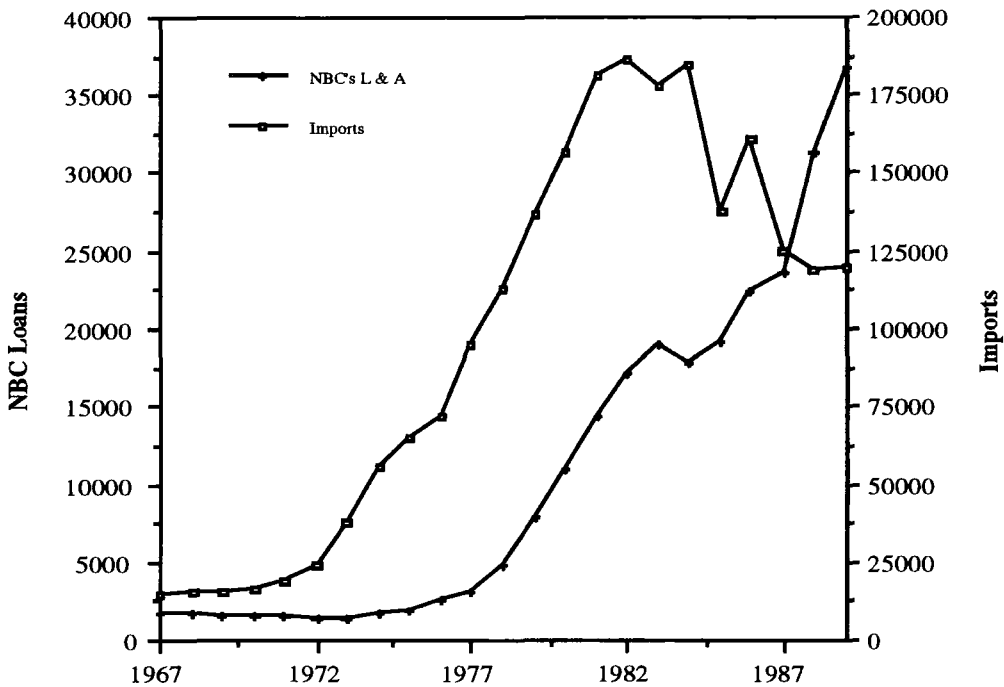


Figure A.5 examines the possibility of customers using their deposits for import purposes. It is clear that the NCB's customers do not use their personal savings to finance their imports. Figure A.6 shows the relation between loans in the form of letters of credit from the NCB and imports. Generally speaking commodities or goods are selected and, then letters of credit arranged by buyers. This implies letter of credit determine the level of imports. Sometimes letters of credit are not used or goods do not arrive on time. This means the variations in imports do not necessarily respond in a given period to the variations of letter of credit. What is apparent from the figure is that letters of credits are not determined by the size of imports in Saudi Arabia even though the relationship is positive. Furthermore, due to the tendency of the merchants to have substantial cash balances in Saudi Arabia, one might expect that they are less dependent on letters of credit to import. They might deal with their suppliers directly without involving banks. However, looking at both figures A.5 and A.6 simultaneously it is apparent that demand deposits are less likely to be used for import purposes and letters of credit are the main contributor. This means that the NCB should have made better use of these deposited funds, preferably in the form of domestic financing which would help in the development process.

Figure A.5

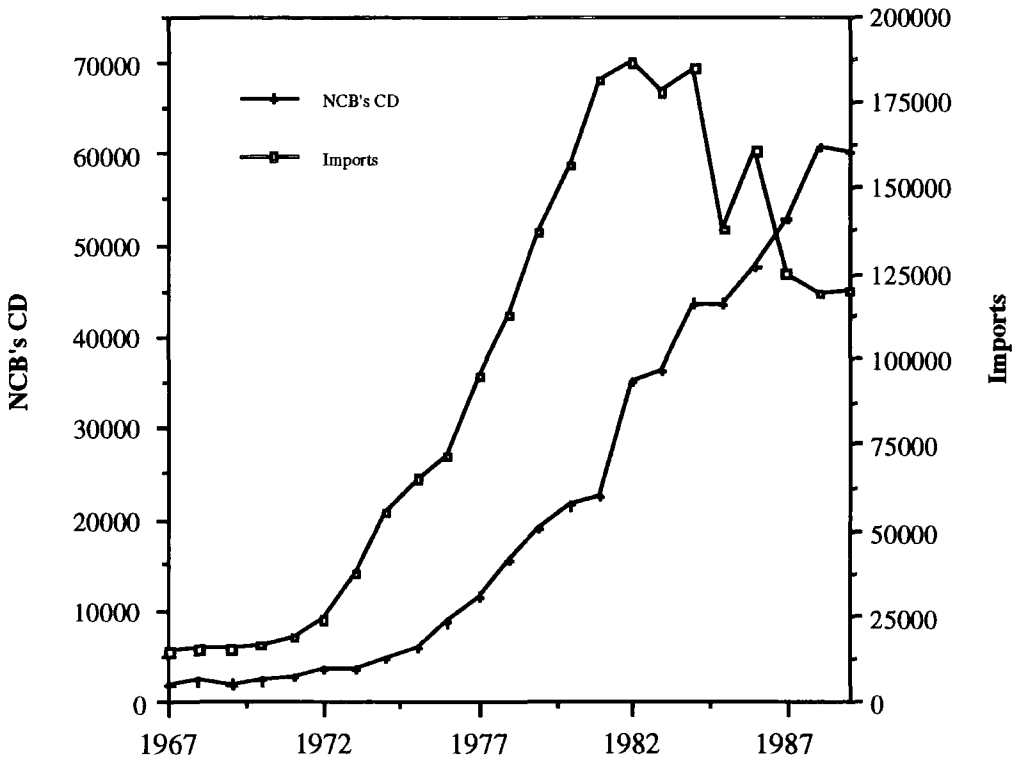


Figure A.6

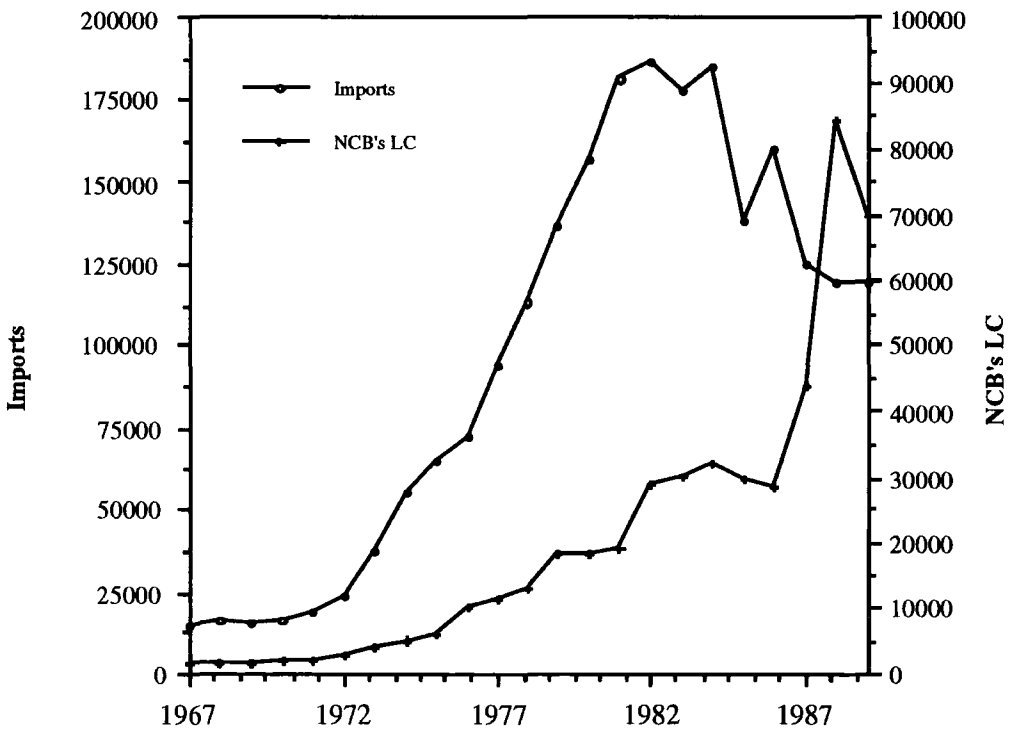
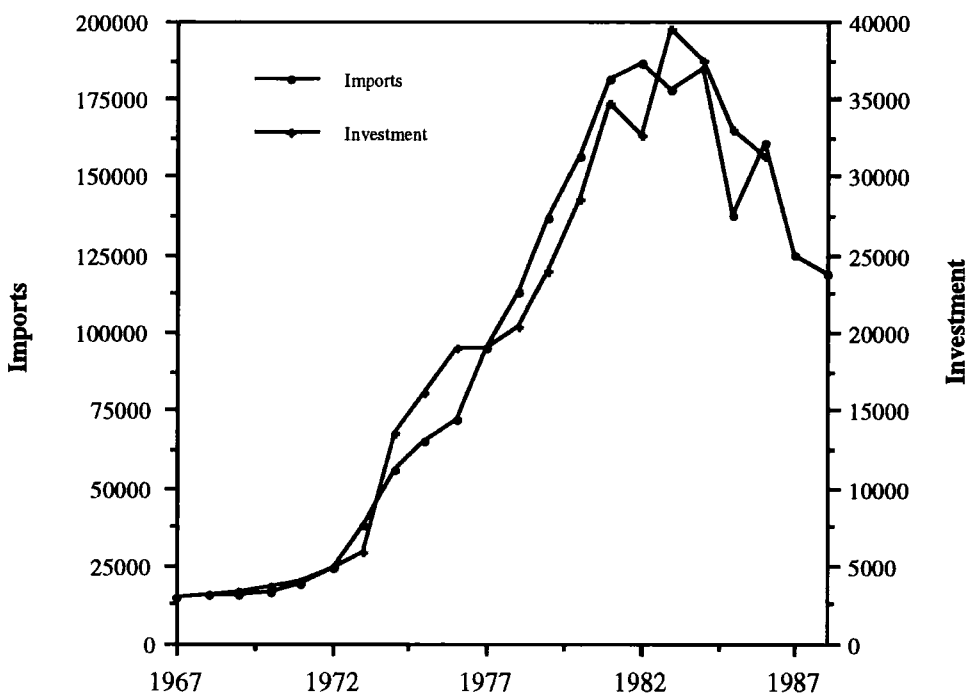


Figure A.7 examines the relationship between imports and investments. Generally, imports tend to increase when investments increase in any of the economic sectors. For example, if investments were directed toward the manufacturing sector, this means an increase in imports of raw materials and machinery. If it is directed towards the construction sector, it means more imports of steel, cement and household utilities. As a result of such investments, importers may borrow to finance their imports. In fact, the higher the investment, the higher will be the level of imports, and the higher the level of imports, the less likely will be loans by banks. It is apparent from comparing figures A7 with figure A4 that it is investment that determines imports as opposed to loans and advances.

Figure A.7



The last group of figures are concerned with the behaviour of customer deposits in relation to government expenditure, consumption and investment. It is clear that the increase in government expenditure tends to improve economic conditions and subsequently improves the financial position of bank customers. This means an increase in consumer income would lead to an increase in the propensity to save. This mirrors the increase in customer deposits in commercial banks. This will eventually cause a multiplier

effect on the economy. If this is found to be true in Saudi Arabia, it means that people are becoming more conscious of saving and trying to become part of the financial system. And it would then be up to the financial intermediaries to harness this saving for development purposes. Due to the strong role of the Saudi government in the economy during recent decades, it might be expected that customer deposits are positively related to the government consumption expenditure.

The purpose of figure A.8 is to show the relationship between the behaviour of customer deposits and government expenditure, and to see the extent to which customer deposits are responsive to government expenditure. It could be that such a relationship cannot be explained directly as the improvement of customer deposits does not only depend on government expenditure. It also depends on the increase in individual income which could be a result of the improvement in many other factors in the country. The figure shows a positive relationship between government expenditure and customer deposits.

Figure A.8

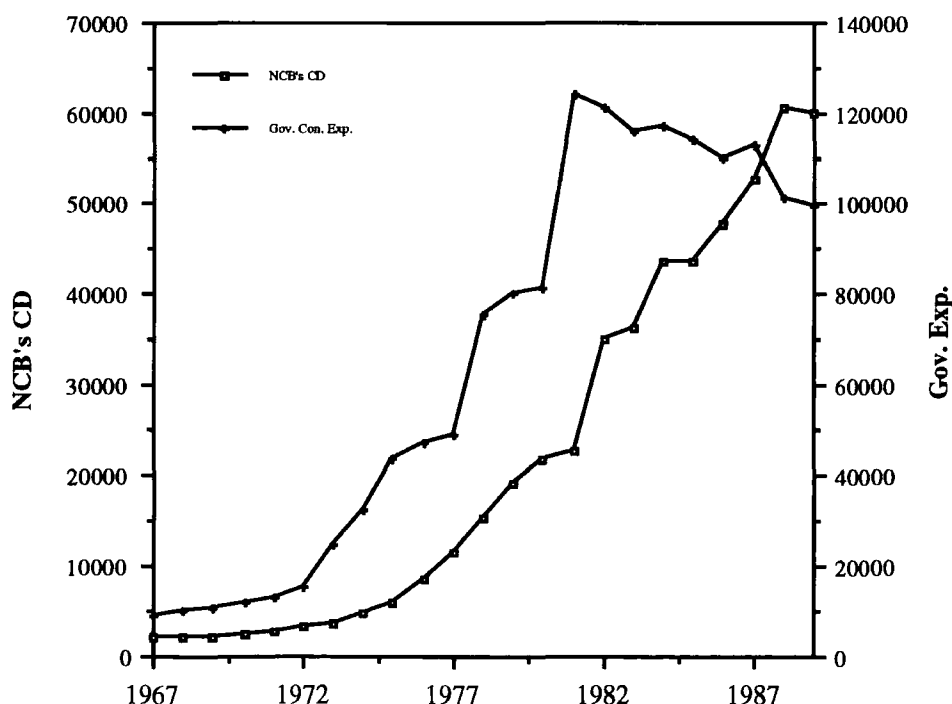
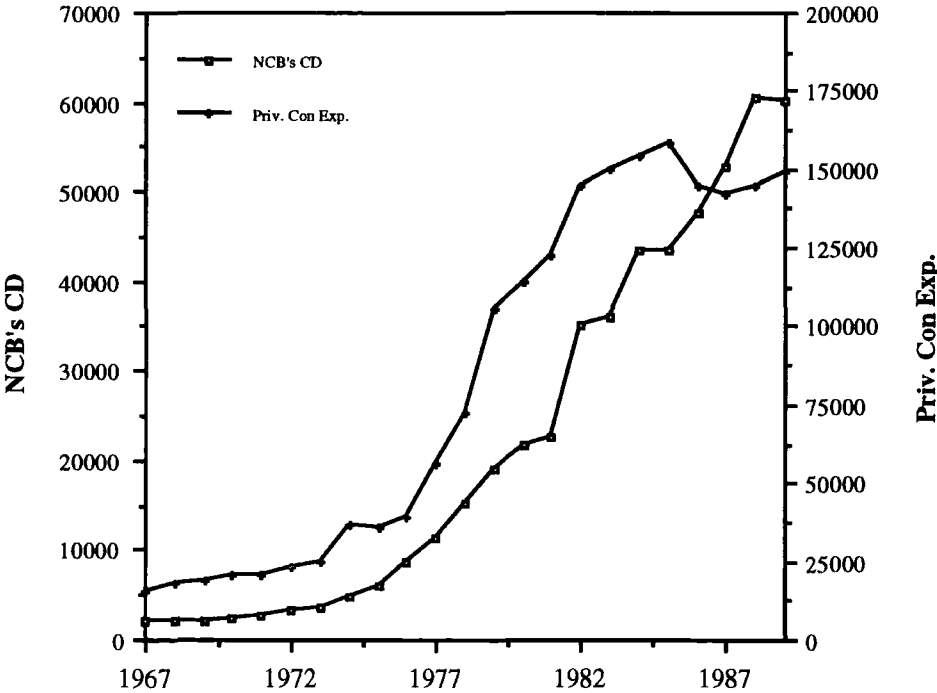


Figure A.9 examines the effect of private consumption expenditure on customer deposits. Theoretically, the increase in income may lead to both higher saving or higher spending or some kind of "trade-off" between saving and consumption. However, when the economy is doing well, as was the case in Saudi Arabia for much of the period under review, one would expect to find that there is plenty of money for both saving and consuming. The implication is that there is no real trade-off between consumption and savings in the case of Saudi Arabia. Hence, it is not necessary for the Saudi Arabian people to sacrifice their ability to consume in order to build up savings or vice versa. The parallel relationship between customer deposits and private consumption expenditure confirms the ability of those who bank in Saudi Arabia to spend and save at the same time. This is due to the strong financial position of bank customers in Saudi Arabia. However, it is worth noting that in Saudi Arabia until recently it was not possible to acquire goods on hire purchase; this basically meant that households needed to save in order to purchase the more expensive luxuries in life. The figure indicates that households in Saudi Arabia save for future consumption; in fact one could suggest the very near future, as the results suggest that the demand deposits are used as a substitute for cash, which implies that the Saudi economy is still cash based.

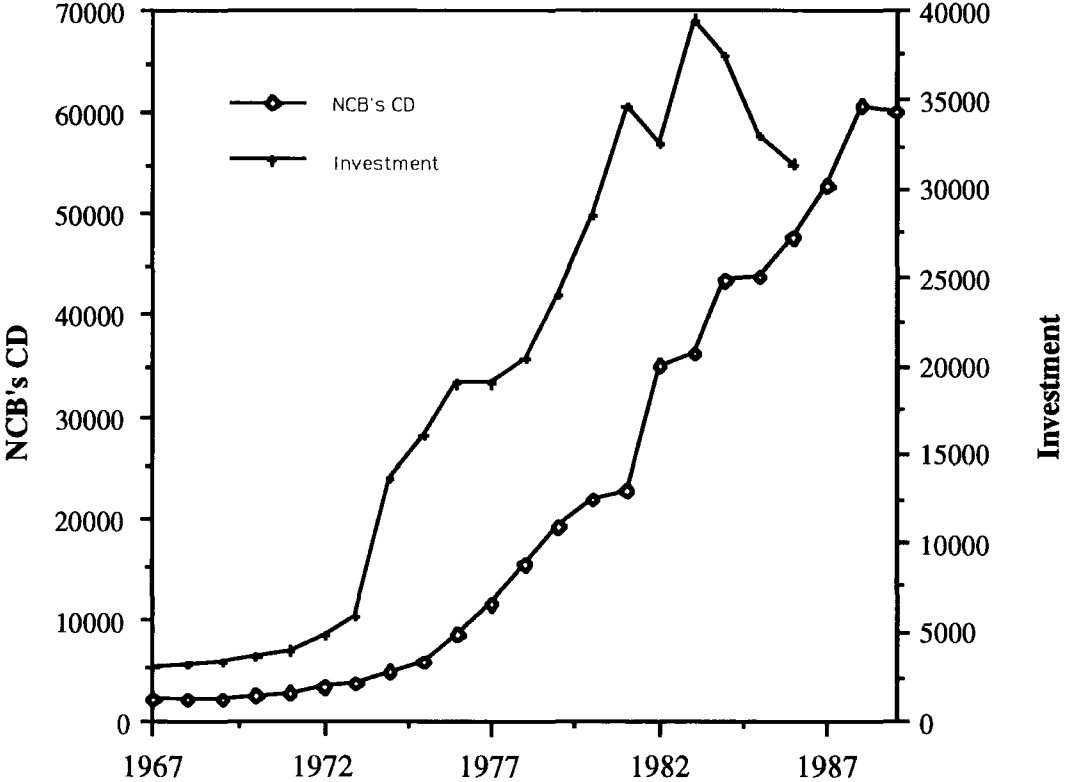
Figure A.9



Continuing the above investment is introduced as an explanatory variable for customer deposits. Some investment spending goes on imported capital items but the majority finds its way into salaries in Saudi Arabia, boosting customer deposits. It is apparent that there is a trade-off between investment and customer deposits as investments in Saudi Arabia are more dependent on the government rather than private sector or finance from private banks. Figure A.10 shows that increases in investments are accompanied by increases in customer deposits, but have each gone its own way since the decline in the income from oil which has forced the government to reduce its investments.

It was the objective of this appendix to measure and evaluate the financial performance of the NCB and relationship with the performance of the Saudi economy. To achieve such a goal, data were collected from both the bank and SAMA's annual reports. Data were manipulated and organised for transformation into figures.

Figure A.10



The relationship between the loans and advances of the NCB and investment in Saudi Arabia was looked at. The figure shows that investment in Saudi Arabia is not dependent on finance from private banks. This result was expected since the government's

income from oil was large for much of the period, and it financed most investments itself, leaving little room for commercial banks like the NCB. However, it was expected that loans and advances would have an effect on investment after a time lag, which most likely implies that the investors turn to commercial banks later on for finance, most probably for the working capital

Figure A.3 showed how the government used its oil revenues for investment in the Kingdom. This meant that commercial banks are crowded out by the government and are not really participating in the country's developing programs.

With reference to the idea of whether or not households in Saudi Arabia are using loans from banks to finance their consumption expenditure, it was found that they do not generally do so. This merely reflects the Sharia's position towards lending, unlike in the West, where many household items are often bought on credit or bank loans and then paid for in installments. It was also found that there was no real relationship between government expenditure and loans and advances by the bank.

With respect to the effect of loans from banks in the form of letters of credit on imports, it was found that there is no real relationship between them. It is also suggested that, due to the cash holdings of the Saudi merchants and businessmen generally, it could be the case that those people do not use banking facilities intensively such as letters of credit for import purposes. Another reason is that a large amount of imports were financed through the government for its construction projects, especially in the 1970's to mid 1980's, when the infrastructure was established.

It was also unclear from the figures whether depositors with the NCB were using their liquidity to finance imports. It may be that merchants and businesses build up their deposits in anticipation of the need to make import payments, the lagging suggesting that merchants think a long time ahead.

Examining investment and loans by private banks in relation to imports showed a strong association between the variables. The figures suggest that the higher the investments, the higher the level of imports, and the lower will be the loans from banks,

which meant that finance is obtained elsewhere, namely from the government, or by drawing down customer deposits.

It was found that there was a positive relationship between government expenditure and customer deposits, suggesting that the higher the government expenditure, the higher are the customer deposits. The positive relationship between customer deposits and private consumption expenditure confirms the general expectation regarding the ability of those who bank in Saudi Arabia to spend and save at the same time. It was found also that any increase in the customer deposits is accompanied by an increase in both investment and government expenditure.

From all this, one can conclude that the NCB's clients are still cash oriented, and seem to use their demand deposits as a substitute for cash. It also shows that they both save and spend and do not borrow to finance their private consumption. The implication of this is that clients may call up their money at any time making it difficult for the bank to lend even on a short term basis. Perhaps this is one of the reasons why the NCB is highly liquid. What is also apparent is that instruments such as letters of credit are not used much, at least not by NCB clients. The bank should try to find a way to increase its business customers' use of such facilities. It could also encourage investment by looking at the possibilities on their own merit, as opposed to merely being concerned with the status of those seeking funding.

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