28 December 2015

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NCB الأهلي

Saudi Arabia's 2016 Budget Report

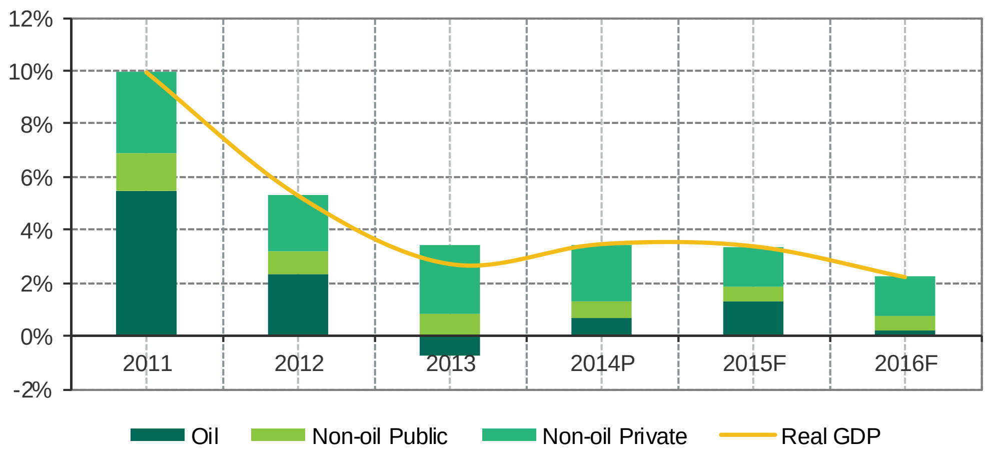
Fiscal Consolidation and Economic Reform

Contents

Highlights and NCB Views

On Monday, 28 December 2015, the Council of Ministers endorsed the government's budget for 2016 and announced the final outcome of fiscal operations and macroeconomic performance for 2015. The highlights are:

- The budget balance recorded the first back-to-back deficit since 2002 due to a sharp decline in oil revenues that was not offset by record non-oil revenues.
- Based on 2010 prices, the Saudi economy registered a moderate growth of 3.4% in 2015 on the back of higher oil production that averaged 10.2 MMBD.
- The deficit was primarily financed from net foreign assets, which decreased by USD84.0 billion, however, currently stands at USD641.2 billion, as the Kingdom continues to hold substantial reserves that will support its defensive oil strategy.
- 2016 budget estimates revenues at SAR513.8 billion and expenditures at SAR840 billion, projecting another deficit. The budget continued to emphasize human capital development, while consolidating the fiscal policy by easing subsidies and enhancing revenue generation through additional fees and taxes.
- Our forecast of USD50/bbl for average Arabian light oil price in 2016 will result in a projected SAR629 billion for total revenues, while expenditures will moderate to SAR897 billion, registering a deficit of SAR268 in 2016.
- As for 2016, we project real GDP growth of 2.3%, the slowest pace since 2009. The oil sector will be a drag especially with no expected increase in crude production that will stabilize around 10.2 MMBD. The non-oil sector will endure the ripple effects of an oil dependant economy and is estimated to grow by 3.5%, which will not suffice to offset the lack of growth in the oil sector.
- The broader international economic environment will remain volatile next year with countries, mostly emerging markets, adjusting to the normalization of US monetary policy by the Federal Reserve.



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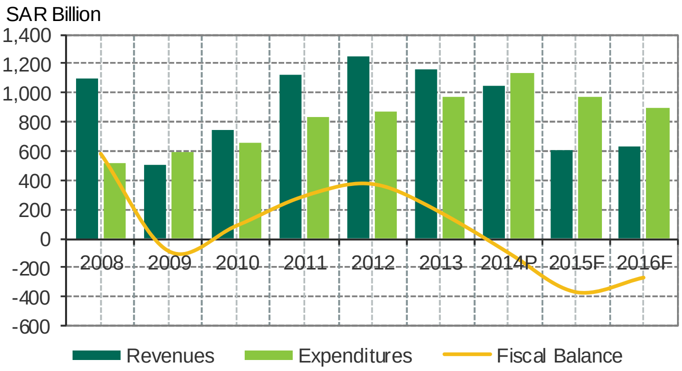
Macroeconomic Indicators	2012	2013	2014	2015P	2016F	Latest	Date
Real Sector							
Average Arab Light Spot (USD/bbl)	110	106	97	51.0	50.0	51.6	11M15
Average Saudi Crude Oil Production (mbd)	9.8	9.6	9.7	10.2	10.2	10.2	11M15
GDP at Current Market Prices (SAR billion)	2752	2791	2798	2450.0	2569.0	-	-
GDP at Current Market Prices (USD billion)	735	745	747	654.2	686.0	-	-
Real GDP Growth Rate, %	5.4%	2.7%	3.5%	3.4%	2.3%	-	-
CPI Inflation (Y/Y % Change, Average)	2.9%	3.5%	2.7%	2.2%	2.7%	2.3%	Nov-15
External Sector							
Trade Balance (USD billion)	247	223	184	63	60	-	-
Current Account Balance (USD billion)	165	135	77	-41	-49	-	-
Current Account/GDP	22%	18%	10%	-6.3%	-7.2%	-	-
Net Foreign Assets with SAMA (USD billion)	648	718	725	640	580	641	Oct-15
Fiscal Sector							
Actual Revenues (SAR billion)	1,247	1,156	1,044	608	629	-	-
Actual Expenditure (SAR billion)	873	976	1,140	975	897	-	-
Overall Budget Balance (SAR billion)	374	180	-96	-367	-268	-	-
Budget Balance/GDP	14%	6%	-3%	-15.0%	-10.4%	-	-
Break-Even Oil Price (USD/bbl)	73.9	82.6	103.6	79.2	69.2	-	-
Financial Sector							
SAR/USD Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	Oct-15
Growth in Broad Money (M3)	13.9%	10.9%	11.9%	6.8%	6.6%	3.9%	Oct-15
Growth in Credit to the Private Sector	16.4%	12.1%	11.9%	6.8%	6.7%	5.5%	Oct-15
Average 3M SAR Deposit Rate	0.9%	1.0%	0.9%	1.0%	1.4%	0.8%	10M15

Source: Reuters, SAMA and NCB

I. Macroeconomic and Fiscal Performance in 2015

The budget balance recorded the first back-to-back deficit since 2002. Revenues tumbled by over 40% on the back of low oil prices, settling at SAR608 billion. Despite pumping record crude to defend market share, the fiscal balance registered a significant deficit of SAR367 billion, 15.0% of GDP. Due to unplanned events such as the royal decrees in 2015 and the war in Yemen, Saudi's expense bill remained near SAR1 trillion mark for the second consecutive year, registering SAR975 billion, a drop of 14.5% over 2014.

Figure (1): Fiscal Balance

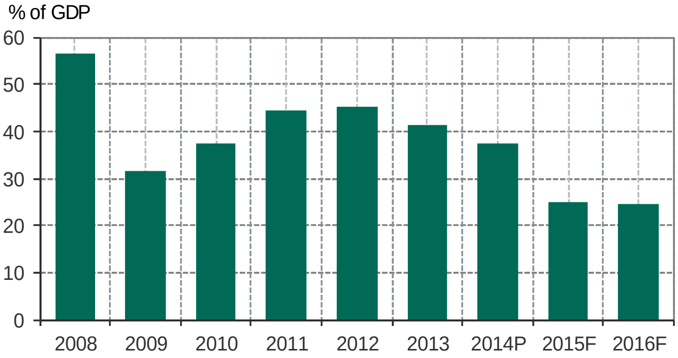


Sources: MOF, SAMA and NCB

Oil revenues reached a 6-year low in contrast to non-oil revenues that posted a record, driven by investment income. OPEC's strategy, led by the Kingdom, to maintain its 30MMBD output target to pressure high-cost producers has resulted in domestic oil revenues dropping by 23% to SAR444.5 billion. The Saudi-led strategy manifested itself in production peaking at 10.6 MMBD in June, which is expected to remain elevated throughout 2016. Conversely, non-oil revenues peaked at SAR163.5 billion, a 36.8% Y/Y gain, with investment income rising by 81% to register SAR37 billion.

The expense bill receded from the SAR1.1 trillion registered in 2014. Despite the sharp declines in oil revenues, the government maintained expenditures near record levels at SAR975 billion, overrunning the budget figure by 13.4%. The budget announcement revealed that the Ministry of Finance has approved 2,650 contracts worth SAR118 billion in new projects this year, a staggering 39.0% Y/Y drop. Additional outlays for ongoing projects will bring the total amount spent on capital expenditures closer to SAR243.8 billion, according to our estimates. Over the previous favorable business cycle, policies to enhance the absorptive capacity and sustainability of the economy has resulted in significant budget overruns, with myriad projects related to employment, infrastructure, education and health implemented. The reduced CAPEX-drive this year underscores the relative elasticity of cutting investment compared to current expenditures whereby salaries and wages comprise more than 40%. Evidently, lower revenues necessitated prioritizing and scaling down projects, a case in point is the King's scholarship program that was extended for the third time and has a 5-year span. This program will be streamlined by selectively accepting applicants for pre-designated jobs in the public sector, thus, matching human development with real government needs.

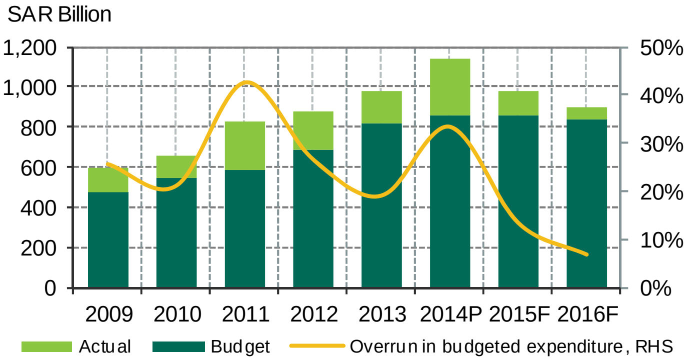
Figure (2): Fiscal Revenues in % of GDP



Sources: MOF, SAMA and NCB

The current account registered a deficit on the back of lower export revenues, albeit the decrease in the import bill. The current account posted a deficit of USD41.4 billion, 6.3% of GDP, the first since 1998. The trade balance posted the third consecutive annual drop, declining by an alarming 65.9% during 2015. Exports were largely affected by the drop in oil prices, with oil exports representing 77% of total exports. Meanwhile, imports registered a contraction of 10% as the stronger dollar coupled with pressured commodity prices reduced the import bill. Past surpluses have facilitated the build-up of reserves, however, a reversal will be in place given our projections of external deficits up until 2019. Accordingly, net foreign assets that fell by USD84.0 billion in 2015YTD to USD641.2 billion is expected to fall further to USD580.4 billion in 2016. Yet, the import coverage ratio will remain at a comfortable level of around 50 months next year. Going forward, we expect the government to slowdown the drawdown process from net foreign assets during the short-term and tilt towards domestic and international bond issuances.

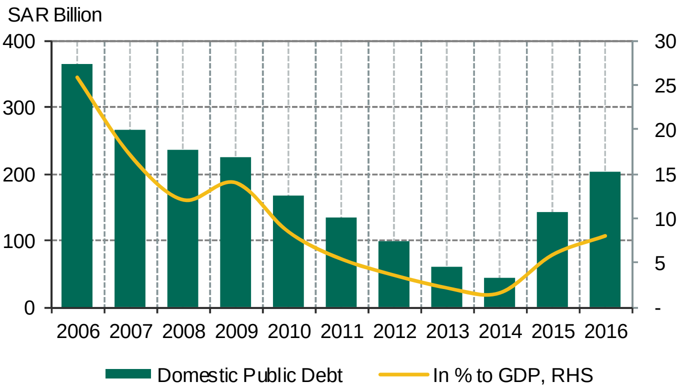
Figure (3): Budgetary Overruns



Sources: MOF, SAMA and NCB

Public domestic debt recorded its first gain since 2002, reaching SAR142 billion at 5.8% of GDP. The unutilized debt capacity was tapped in tandem with net foreign assets to finance the Kingdom's funding shortfall. Saudi publicized bond issuances during the second half of 2015, offering maturities ranging from 5-10 years and yields below 3%. Further issuances are expected next year, which prompted a one notch downgrade by S&P to A+ from Aa3, contrasting with Fitch that affirmed an AA rating albeit with a negative outlook. We believe the capital buffers accumulated prior to the oil collapse will provide stability going forward. SAMA will continue to reduce the stock of T-bills to avoid a crowding-out effect and tighter liquidity amid the rising issuances of bonds. Evidently, T-bills have been reduced by 27.3% during 10M2015 to settle at SAR164.2 billion.

Figure (4): Public Domestic Debt in percent of GDP



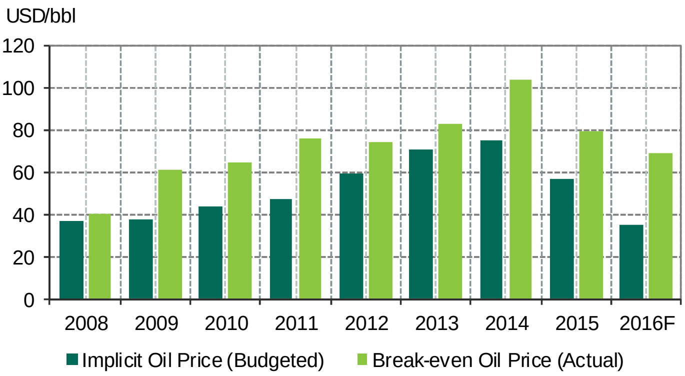
Sources: MOF and SAMA

II. Fiscal Budget Outlook in 2016: Fiscal Consolidation and Economic Reform

The government is adamant in supporting the economy by adopting a fiscal adjustment strategy centered around efficiency and viability. The 2016's budget continues to reflect the government's focus on long-term sustainable development that requires investment in infrastructure, education, health care, and social and economic development projects. As expected, education and training continued to be central to the aforementioned strategy, receiving 22.8% of total allocations, with health accounting for 12.5% of the budget. The 2016 budget release estimates revenues and expenditures at SAR513.8 billion and SAR840 billion, respectively, projecting another deficit given the suppressed oil markets. Based on previous years, we believe that these figures are underestimated, and the government will overrun the budget and record a larger deficit on the back of momentum spending on on-going megaprojects and rising geopolitical challenges. However, in our opinion, actual expenditures will record a decline as the government implements cost control and revenue generating measures to weather the current moderate business cycle.

Oil prices will continue to be the main drag on Saudi's balances. Although the budget press release does not provide oil price and production level assumptions, we believe that both revenues and expenditures are underestimated. Based on announced revenues, government assumed next year's oil prices to average USD35/bbl. With our forecast of USD50/bbl for the Arabian light spot price average and a 10.2 MMBD for oil production average in 2016, we project revenues and expenditures at SAR629.0 billion and SAR897.0 billion, respectively. This would lead to a budget deficit of SAR268.0 billion, or 10.4% of estimated GDP in 2016.

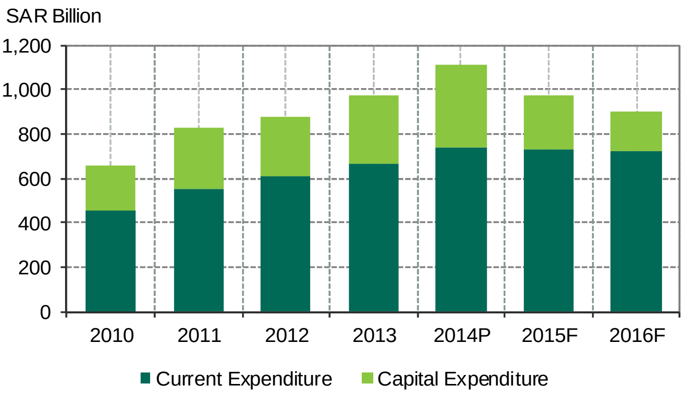
Figure (5): Implicit Budget Oil Price



Sources: NCB

Actual expenditure will overrun the budget, yet, will record an annual decline due to fiscal consolidation. It has become customary to exceed the announced expenditure figures, averaging an overrun of around 25% during past 10-years. Actual expenditures in 2015 are somewhat inflated by the Royal decrees, the lunar 13th-month pay, and the war in Yemen. Ostensibly, we project that 2016 will only record an overrun of 6.8% as the government prioritizes projects, reduce subsidies and as the one-time effect on salaries fade. Out of the budgeted SAR840 billion, SAR657 billion or 78.2% is allocated to current expenditures. The remaining SAR183 billion will be allocated to capital expenditures under a new budget support provision that we believe will be disbursed depending on oil prices. Actual CAPEX is likely to drop by 26.4% to settle at SAR179.4 billion by year's end.

Figure (6): Actual Expenditures



Sources: MOF, SAMA and NCB

Allocations to specialized credit institutions moderated significantly, yet their continuation reflects adamancy to support the economy. According to the budget announcement, SAR49.9 billion will be allocated to specialized credit institutions to finance major industrial projects and support social and human development. The funding will complement private sector credit growth, which recorded an annual 5.5% gain by the end of October 2015. Since the beginning of this year, the Saudi Industrial Development Fund (SIDF) has approved 117 loans, valued at SAR6.2 billion across various industrial areas. The Saudi Credit and Saving Bank also financed 2'400 projects in 2015 worth SAR388 million to support small-scaled private initiatives. Additional measures of finance towards SMEs continue to gain ground, with the Loan Guarantee Program "Kafala" facilitating credit worth around SAR1.6 billion by the end of 2Q2015 to 1'711 establishments. Since inception in 2006, Kafala has granted a total of SAR12.3 billion .

Elevated production levels, record high inventories, and decelerating demand will suppress oil prices to an average of USD50/bbl in 2016. Growth dynamics pertaining to emerging markets, in particular China, and production factors relating to OPEC have underpinned this bearish view. The lack of compliance among OPEC members that produced above the 30MMBD quota for the 18th month in a row will be an important drag, especially that the group lacks a unified front. Saudi, Iraq and Iran are adamant in producing as much as they can. The Kingdom's production peaked at 10.6 MMBD in June, while Iraq has increased output over the year by around 0.7 MMBD, reaching 4.2 MMBD last month. Additionally, lifting the sanctions imposed in July 2012 on Iran is expected to bring an additional 600 thousand barrels a day, which will propel OPEC's production above the 32 MMBD mark. Even though non-OPEC members and high-cost producers will continue to be pressured next year, the anticipated decline in their production will not offset OPEC's over quota strategy. The IEA, EIA and OPEC have forecasted a decline in non-OPEC supply between 250-600 thousand barrels, largely due to the decline in US shale production.

On the demand side, China is expected to have the weakest economic performance since 1990, with growth falling below 7% for 2015 and 2016 despite the myriad attempts to reduce interest rates and reserve requirements coupled with devaluation of the Yuan in order to spur business activity. Furthermore, emerging markets are expected to expand at 4%, the slowest pace since 2010 and well below their ten-year average of 7%. Generally, the three eminent organizations are forecasting oil demand to rise between 1.2 and 1.4 MMBD in 2016, much slower than this year that saw demand grow by as much as 1.8 MMBD, a five-year high. Given these dynamics, we do not expect the market to balance in 2016.

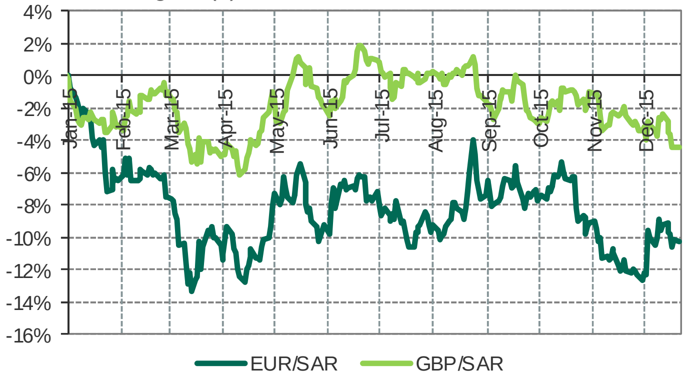
The oversupply will remain a hanging cloud on oil markets containing any upside momentum next year. This will entail a reduction in oil revenues by 3.5% to SAR429 billion despite the elevated levels of production. Aggregate-wise, the Kingdom's total revenues are forecasted to increase by 3.5% to reach SAR629 billion, supported by SAR 200 billion worth of non-oil revenues after the gradual removal of subsidies. Actual expenditures will likely exceed budgeted expenditures by 6.8% to reach SAR897 billion, yet almost half the budget overrun posted in 2015.

(SAR billion)	2015 Actual	2016 Budget	2016 Forecast
Total Revenue	**608**	**514**	**629**
Oil	445	349	429
Non-Oil	164	164	200
Total Expenditure	**975**	**840**	**897**
Current	731	657	718
Capital	244	183	179
Deficit/Surplus	**(367)**	**(326)**	**(268)**

Sources: MOF and NCB

Easing subsidies will underpin inflation that will increase to 2.7% in 2016 despite a stronger USD and weak commodity prices. Commodities are on course to record their fifth annual drop as reflected by the Reuters/Jefferies CRB Index that declined by over 25% YTD. In specific, global food prices have been posting double-digit annual declines this year, with the S&P Goldman Sachs Agriculture Index falling by 11%. This international dynamic had a positive spillover on domestic food prices, the largest component in headline inflation, that averaged around 1.8% in 2015YTD, significantly lower than 2014's 3.3% average. A strengthening greenback, evident from a trade-weighted dollar that appreciated by 9.6% YTD, has been favorably containing imported inflation, which is critical given the heavy local reliance on imports. We do believe, however, that the ripple effects of raising energy and utility prices on industry and higher income consumers will feed into higher prices across the economy, thus, offsetting the positive international dynamics.

Figure (7): SAR vis-à-vis EUR and GBP



Sources: Reuters and NCB

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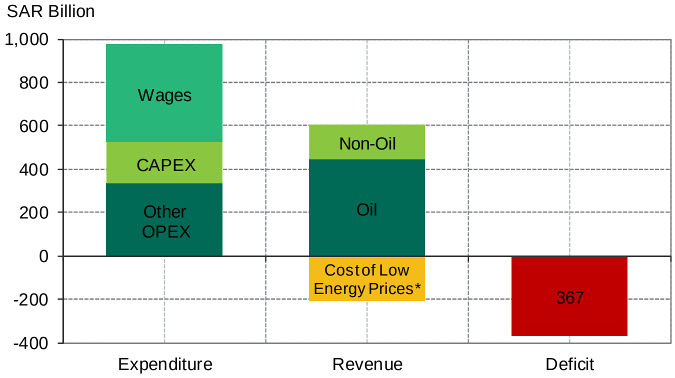
III. Fiscal Response

A new era of fiscal consolidation and adjustment had commenced with this year's budget to avoid a repeat of the 1980s and 1990s. Indeed, the entitlement nature of wages and salaries that constitute more than 30% of total actual expenditures makes it difficult to adjust, but rather contain via the reduction of allowances that have reached around SAR75 billion in 2014 and represent a 24% share of wages and salaries. Additionally, operating expenditures are naturally expected to edge higher necessitated by the SAR1.4 trillion capital expenditure boom during 2008-2014. The inelastic nature of the abovementioned items might explain why the government found it necessary at this juncture of suppressed oil prices to prioritize CAPEX, streamline subsidies as well as diversify the revenue base in order to reduce deficits. The issue of subsidies, notably energy subsidies estimated at around SAR200 billion, has been a widely debated topic, nevertheless, scrapping the "subsidies for all" model towards a more targeted arrangement that reaches lower income groups in real need of government support will be more efficient.

Assertively, the government announced a series of revisions on energy subsidies to increase revenues, enhance environmental awareness, and reduce waste and irrational use while directing and maintaining support to low and middle income segments. Prices on gasoline have returned back to 2006's levels with the 91 and 95 octanes raised by 30 Halalas to SAR0.75/L and SAR0.90/L, respectively. Other fuels which have been heavily subsidized have also been raised such as gas, diesel, and kerosene, yet, they remain substantially lower than their regional and international counterparts. Additionally, the prices of electricity have been adjusted, targeting all industrial & commercial consumption as well as the higher consumption tranches for residential use. Similarly, prices of water have been raised to better target the lower income brackets and enforce conservation of natural resources. The price of feedstock was also raised on energy-intensive industries, notably the ethane feedstock from USD0.75 Mbtu to USD1.75 Mbtu. The extensive nature of reducing/streamlining subsidies will continue over a 5-year time frame, ensuring a gradual rather a shock therapy approach.

On an medium to long-term note, the government will adopt a 5-year privatization plan that will involve a range of sectors and economic activities, which will ensure efficiency and raise non oil revenues. The government had underscored also its full commitment to applying the GCC-wide Value Added Tax. Institutionally, the government had established a debt management unit under the MoF to diversify its debt issuances locally and internationally. 2016 budget, in our opinion, is the start of a new era of fiscal consolidation and reforms that will ensure a sustainable and viable economy.

Figure (8): 2015 Fiscal Breakdown



*Cost of Low Energy Prices: This represents the opportunity cost for Saudi to maintain low prices for domestic consumption.
Sources: NCB

IV. Concluding Remarks

2016 will continue to be a challenging time for policy making. The broader international economic environment will remain volatile next year with countries, mostly emerging markets, adjusting to the normalization of US monetary policy by the Federal Reserve. Asset classes across the board including commodities will be pressured, especially that a stronger dollar will reduce the appeal of commodities as alternative investments. The interest rate environment will adjust upwards, resulting in a tighter and more costly external borrowing.

Looking ahead, over a five-year forecast horizon, a moderation in the business cycle is the most likely outcome, with real GDP expected to average below 3% per annum. Even though the government has been adamant in enhancing the absorptive capacity of the economy and aiming towards diversifying away from hydrocarbons, the oil story remains pivotal and valid, with crude still representing around 80% of fiscal and export revenues. The baseline scenario for the medium-term projects lower oil prices and slower growth in Saudi crude production. Oil markets are expected to remain in a lower range around USD40-80/bbl during 2016-2020, with a bias to the downside, especially that oil lacks strong upside momentum with markets oversupplied. Lower compliance among OPEC members and higher supplies from Iran and Iraq are expected to surpass demand growth emanating from China that will not be able to generate the 40-50% of total incremental oil demand of previous years. However, fiscal reforms and streamlining subsidies will ensure the resilience of government finances by propping up the non-oil revenues.

As for 2016, we project real GDP growth of 2.3%, the slowest pace since 2009. The oil sector will be a drag especially with no expected increase in crude production that will stabilize around 10.2 MMBD. The non-oil sector, which is estimated to moderate around 3.5%, will not be able to offset the lack of growth in the oil sector.

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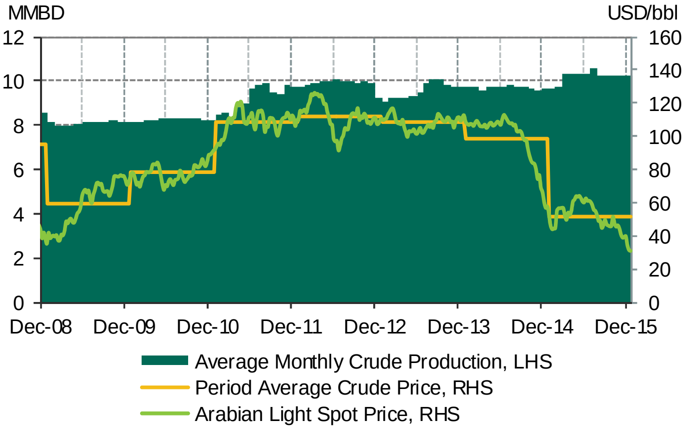
Annex I: Macroeconomic Update

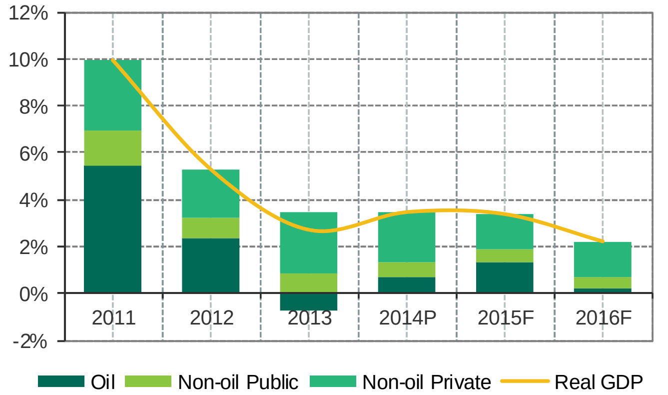
1. Crude oil prices collapsed from an average of USD97/bbl in 2014 to USD51/bbl in 2015YTD while Saudi crude oil production rose from 9.7 million b/d in 2014 to 10.2 million b/d in 2015YTD.

Figure (1): Crude Oil Prices and Production



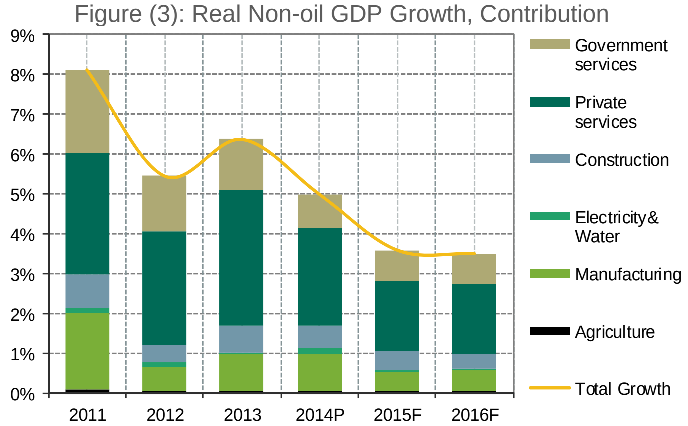
2. However, as the base year has been recently changed to 2010 prices, GDP registered a moderate growth of 3.4%.

Figure (2): Real GDP Growth Contribution



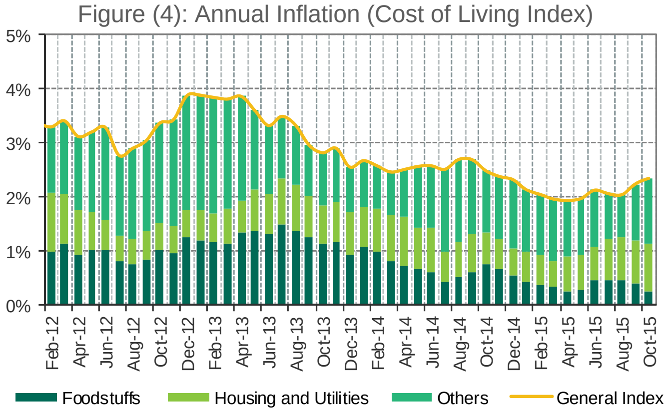
3. Non-oil private GDP moderated around 3.6% in 2015, with growth emanating from construction, trade and manufacturing.

Figure (3): Real Non-oil GDP Growth, Contribution



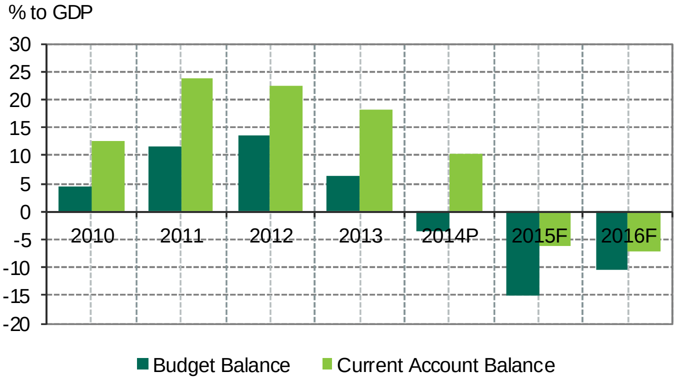
4. Inflation edged lower from 2.7% in 2014 to an average of 2.2% in 2015YTD, on the back of lower imported inflation and weaker commodity prices.

Figure (4): Annual Inflation (Cost of Living Index)



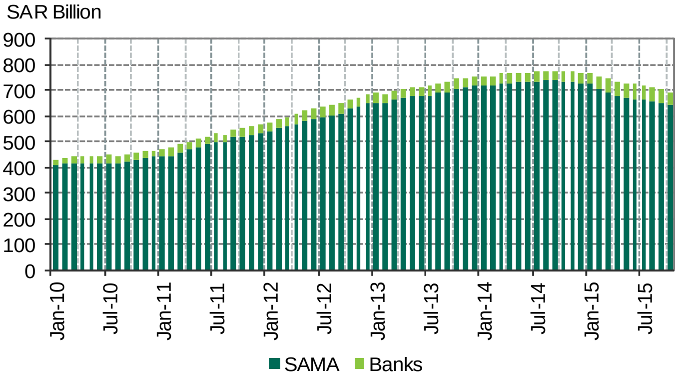
5. The external balance reversed to record a deficit at 6.3% while the fiscal balance contracted to negative 15.0% of GDP in 2015.

Figure (5): Twin Surpluses



6. As such, net foreign assets settled at USD641.2 billion to finance the deficit, after a drawdown of USD84.0 billion.

Figure (6): Net Foreign Assets



Sources: MOF, SAMA, Reuters and NCB

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