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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

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Executive Summary

- Even though non-OPEC members and high-cost producers will continue to be pressured this year, the anticipated decline in their production will not offset OPEC's over quota strategy.

- Despite inflation remaining below the Fed's longer run objective of 2%, the solid improvements in the labor market ensure that household spending, and business fixed investment will continue to foster growth and nudge inflation up in the medium term.

- Precious metals continue to underperform pressured by the USD's appreciation and the Federal Reserve's interest rate hike increasing the greenback's investment appeal.

- The government's newly unveiled fiscal reforms include programs aimed towards conserving government spending, namely through wages and benefits which accounted for half the budget of 2015. We expect the government cutbacks and debt consolidation measures to hit consumers, albeit with a lag, especially with the fuel and utility subsidies being lifted.

- A strong positive correlation of 0.86 has been witnessed between oil prices and Tadawul's main index which resulted in a 17.1% drop during 2015 for the latter. The second consecutive annual drop underscores the immaturity of the market which is gradually developing albeit at a slow rate.

- The interest rate situation is mirroring the Fed as on the 16th of December, SAMA raised the reverse repo rate by 25bps to 50bps from 25bps, keeping the repo rate at 200bps. By the end of 2015, the Saudi Interbank Offered Rate surged to the highest level since January 2009 at 1.55%.

- In the month of October, non-oil trade maintained a declining trend on the exports side whereas imports remained supported by internal demand.

View of the Month

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 more than 70% of fiscal and export revenues.

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Macroeconomic Indicators

	2011	2012	2013	2014P	2015F	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	50.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.2
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,449.6	2,346.6
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	654.1	626.6
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.4%	2.1%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	2.7%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.5	76.9	-41.3	-47.4
Current Account Balance/GDP	23.6%	22.4%	18.2%	10.2%	-6.3%	-7.6%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	640.2	580.4
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1044.4	608.0	629.1
Actual Expenditure, SAR billion	826.7	873.3	976.0	1140.0	975.0	897.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	33.3%	13.4%	6.8%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-95.6	-367.0	-267.9
Budget Balance/GDP	11.6%	13.6%	6.5%	-3.4%	-15.0%	-11.4%
Break-Even Oil Price	75.3	73.9	82.6	103.6	79.2	69.2
Financial Sector						
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	6.8%	6.6%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	6.8%	5.2%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	1.0%	1.4%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.3%	0.4%	0.7%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	69.5	60.0	70.0

Sources: Thomson Reuters, SAMA, and NCB

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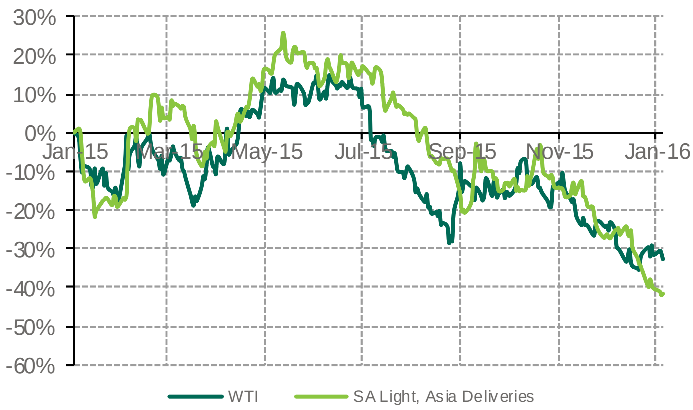
Oil Market

The Oversupply Theme will Remain in 2016

Elevated production levels, decelerating demand, and record high inventories 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 in November. Additionally, lifting the sanctions imposed in July 2012 on Iran is expected to bring an additional 500 thousand barrels a day during 1H2016, which will keep OPEC's production above the 32 MMBD mark.

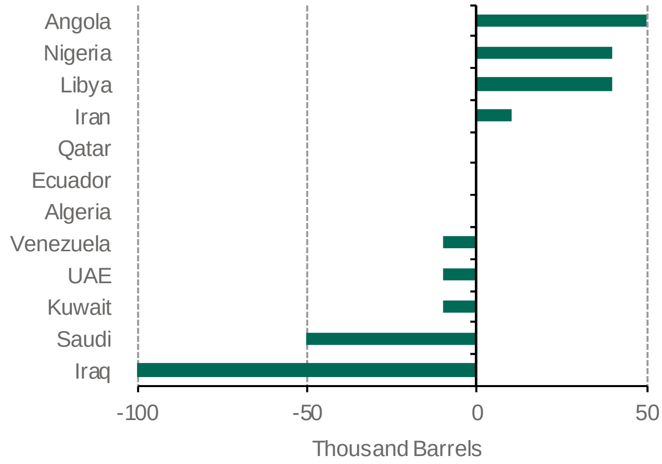
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

Even though non-OPEC members and high-cost producers will continue to be pressured this 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 400-600 thousand barrels a day, the first annual decrease since 2008, largely due to the steeper decline in US shale production. The EIA predicted in its latest report that companies operating in US shale formations will reduce production by a record 570 thousand barrels a day, which underscores the challenging environment even after slashing capital spending, laying off workers and focusing on the most productive areas.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

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, reserve requirements and devalue 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 last year that saw demand grow by as much as 1.8 MMBD, a five-year high. The record US and global crude oil inventories will also continue to weigh on oil markets. The end of year US crude oil inventory at 487.4 MMbbls is 27% more than the level recorded in 2014, which was 388 MMbbls, and is also at an 80-year high for this time of year. Additionally, the OECD's commercial total oil inventories rose to around 2.971 billion barrels, near a record level that is equivalent to 60 days of consumption and above the five-year average. Given these aforementioned dynamics, we do not expect the market to balance in 2016.

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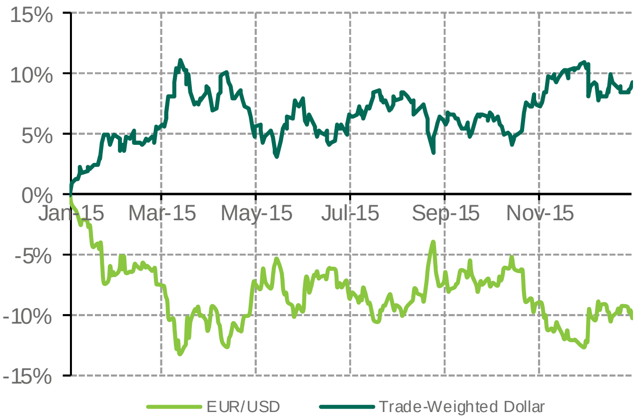
Foreign Exchange

Financial Markets React to Fed Lift-off

The Federal Open Market Committee (FOMC)'s meeting in December rattled financial markets with its announcement of the first interest rate hike in seven years, ending a protracted era of easy money. Meanwhile, emerging markets struggle as capital repatriation and USD strengthening continues to damage investment prospects and demand for their local currencies. China's industrial production continues to contract placing pressure on real GDP outlook. In addition, the country's transition towards a more consumer-based and services economy is becoming evident with the rapid growth in the service sector. The Euro recovery is still on track with several economic indicators defying low expectations. Save headwinds from political uncertainty in Greece and unknown extent of the Volkswagen emissions scandal in Germany, the Euro area's business and industrial sentiment proved stronger than expected. With the holiday season upon us, European data risk will be fairly sparse and we expect no surprise ECB action.

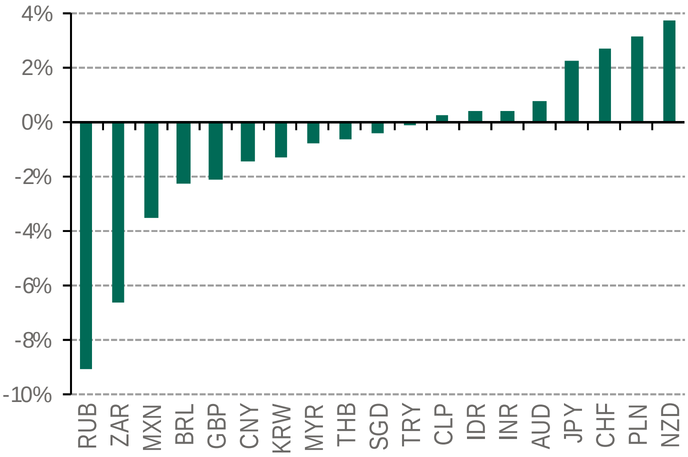
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

The onslaught of the Great Recession took its toll on the US, taking the world's largest economy eight years to fully recover. Today, the Fed's tone grew more confident over the US economy's ability to withstand a normal monetary policy once more. The FOMC announced in its December meeting that it will raise its federal funds rate by 25bps, pushing the upper bound up to 0.5% while the lower bound stands at 0.25%. Despite inflation remaining below the Fed's longer run objective of 2%, the solid improvements in the labor market ensure that household spending, and business fixed investment will continue to foster growth and nudge inflation up in the medium term. The greenback rallied following the hike announcement, ending 2015 up by 9.3% Y/Y closing the DXY index at 98.6. Moreover, 3Q US growth was revised to 2% down from 2.1%, beating Reuters' forecast of 1.9%. Solid job gains, and low gas prices pushed consumer spending, underscoring resilience despite a raft of global headwinds. That being said, the risk of a spillover effect was anchored by the Fed which confirmed that its policy will remain accommodative to counteract any potential drag on the recovery.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The euro initially reacted to the Fed hike announcement by falling 10.5% YTD to USD1.08. However, despite the negative impact the dollar strengthening has on its major peers, the European single currency remained afloat compared to November and March levels in which the EUR nose-dove to as low as USD1.05. Optimism finds its way in the prospects of the European Union as Spain posted 3Q growth figures of 3.4% Y/Y, the highest since 4Q2007. The serious structural reforms made by the Spanish government proved fruitful as the jobless rate in Spain decreased to the lowest level since 2Q2011, recording 21.2%. The Eurozone's unemployment rate is also at a four-year-low of 10.7%, indicating an ongoing overall economic recovery. The EUR ended 2015 down by 10.2% Y/Y at USD1.08.

Global manufacturing has been weakening since early 2014, driven by a slowdown in the BRIC countries. In contrast with the manufacturing activity in Europe, the China Caixin Manufacturing PMI posted 48.6 in November, recording the ninth consecutive contraction. Following the Fed rate hike decision, the Chinese yuan tumbled to its lowest levels this year, ending the year standing at 6.47, marking a 4.4% YTD decline.

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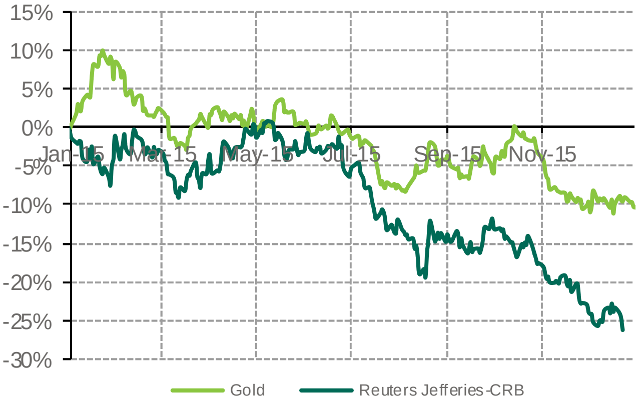
Commodities

Weakening to Persist Through 2016

The year 2015 was not commodity-friendly by any standard, starting from the oil plunge, to metals and food grains. Although some speculators believe that the worst is over, the bear market is yet to find any positive drivers for 2016. Global demand is still lackluster, and supply is ample, making it hard to speculate any strong coordinated demand acceleration next year. In addition, China's move towards advancing the value chain in order to compete with South Korea and Japan rather than low-cost producers such as Indonesia and Vietnam. This will boost the country's reliance on growth from the service sector, and decrease its reliance on growth from manufacturing as the latter is directly correlated with the demand on base metals. The two-speed nature of the economy whereby there is a booming service sector and a stagnating industrial sector adds to uncertainty among commodity investors. In addition, miners are finding new ways to reduce production costs preventing a supply push. Precious metals continue to underperform pressured by the USD's appreciation and the Federal Reserve's interest rate hike increasing the greenback's investment appeal. Food grains yield which reached record highs during the commodity super-cycle continue to offset any upward price pressure induced by weather or drought concerns. Overall, the commodity market is expected to remain in a massive supply glut throughout 2016. As indicated by the Reuters-Jeffries CRB index which plummeted 23.4% Y/Y on December, standing at 176.1, commodities reached their collective lows by year-end, exacerbated by the Fed rate hike.

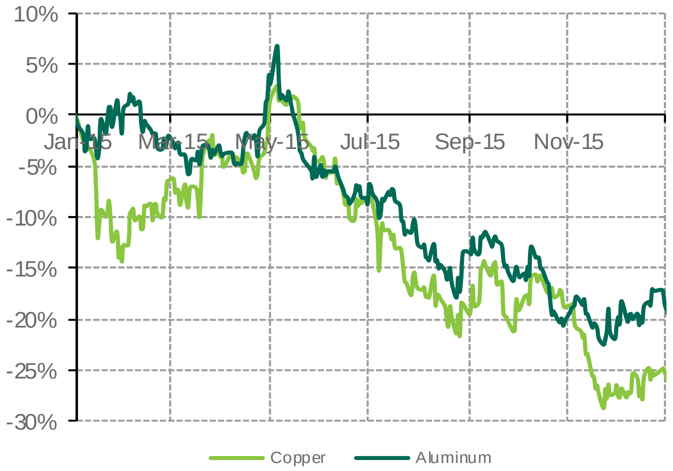
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

The London Metal Exchange (LME) copper collapsed to a six-year-low of USD4,490/ton on November 23rd on the back of continued USD appreciation, recording a 28.7% YTD slide. Meanwhile, the People's Bank of China is moving forward with its currency liberalization, allowing the CNY to depreciate to new lows, hurting the purchasing power of the Chinese national currency. LME aluminum moved in tandem with copper reaching its lowest price point also on the 23rd of November, trading at USD1,345.5/ton. The prospects of base metals remain low as they are heavily dependent on the performance of China's manufacturing sector. Gold prices reacted negatively to the Fed's interest rate hike, touching a six year-low of USD1,061.7/oz by the end of December, losing 10.4% from year start. Bear traders speculate that gold prices could potentially fall below USD1,000/oz in response to the second Fed rate hike giving a dismal outlook to the precious metal.

Chart 6: Base Metals



Source: Thomson Reuters

The Goldman Sachs/ S&P agriculture index ended the year at a double-digit YTD decline of around 12.1% after expected adverse effects of El-Nino did not materialize. The US Department of Agriculture notes that trade expectations are neutral as US corn ending stocks came at 1.78 billion bushels as demand numbers were revised lower by 50 million bushels. The lift of the Argentine corn export tax in December adds to the vulnerability of corn prices for a downside correction. Towards the end of December, corn futures delivered on March 2016 moderated compared to November, standing at 381.7 cents/bushel, sliding 9.3% YTD. As for wheat, the global market is extremely oversold, and the downside seems limited. On the 31st of December, wheat futures hit year-low levels of 470 cents/bushel, sliding by 24.1% YTD.

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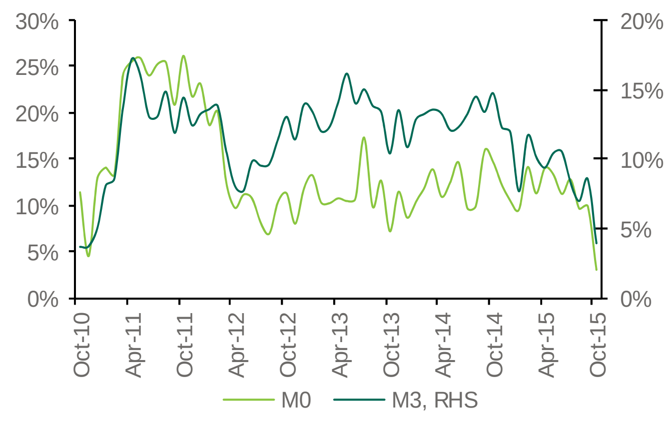
Money & Inflation

Money Supply at a Five-Year-Low

Saudi Arabia continued to be adamant on its expansionary policies throughout 2015 despite the collapse in oil prices that started in the second half of the previous year. Internal dynamics remained sound and growth in money supply and demand kept the economy humming, albeit at a decelerating pace. Until mid-2015, the annualized growth in broad money supply averaged 10%, reflecting the strength of the Saudi monetary system in the face of the oil crisis tapping into the massive foreign reserves. However, as the government began issuing bonds to local banks in the second half of the year, liquidity concerns began to surface as government deposits declined to multi year lows, in turn, negatively affecting the growth of broad money supply. In addition, the government is expected to clamp down on spending on the back of lower oil prices which will trickle-down in the form of declining bank deposits.

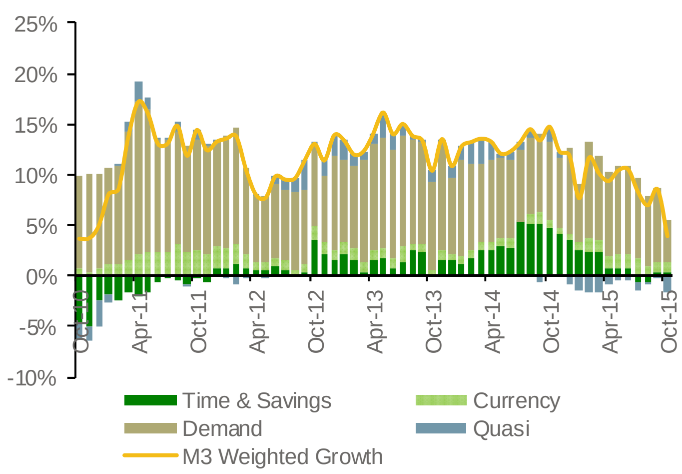
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

In the month of October, broad money supply (M3) recorded the lowest annualized growth in five years, upturning by just 3.9% at SAR1.77 trillion. The moderation in cash in vault which grew by 7.9% marking the first single-digit growth in two years, in addition to the sharp 84.8% decline in public financial institutions' deposits affected the bottom-line growth of the monetary base (M0) which moderated to 3% Y/Y at SAR302.7 billion. Demand deposits which account for 57.2% of the M3 money supply logged a 9-year low annualized growth rate of 7.7%, reaching SAR1.013 trillion. Time and saving deposits which account for 22.8% of M3 at SAR403.8 billion returned to positive territory since September, posting 1.6% Y/Y growth. Quasi monetary deposits which account for 10.4% of M3 tumbled the most since March, losing 13% Y/Y at SAR184.1 billion.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

Price levels in the Kingdom remained moderate as low commodity and energy prices dampened the upside potential for inflation. The general consumer price index recorded an upturn of 2.4% Y/Y in October, mainly driven by housing and utilities which rose by 4.3% Y/Y. Inflation drags came from food and beverages which inched up by 1.5% compared to the same month last year. The end of the commodity super-cycle resulted in a huge supply glut of various commodities which, in addition to the strengthening US dollar, are decreasing imported inflation. Restaurants and hotels recorded the seventh consecutive decline in price level by -1.9% Y/Y while clothing and footwear marked the largest gains of 5.2% Y/Y. The number point of sale (POS) transactions witnessed a surge to an all-time record of 204.2 thousand transaction while sales jumped to the highest levels since April, recording SAR14.1 billion. The government's newly unveiled fiscal reforms include programs aimed towards conserving government spending, namely through wages and benefits which accounted for half the budget of 2015. We expect the government cutbacks and debt consolidation measures to hit consumers, albeit with a lag, especially with the fuel and utility subsidies being lifted.

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Capital Markets

A Rocky Year for Tadawul

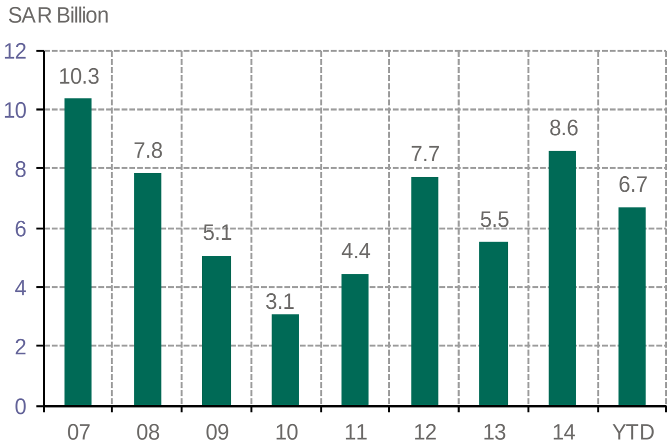
The focal topic of 2015 was the collapse of oil markets as Saudi and the GCC led OPEC to continue producing above the 30MMBD quota to maintain market share against high cost oil producers, namely the US. Given Saudi's revenues are mainly sourced from oil, the economy was in the eye of the storm, yet the government endured and remained on path with its strategy. Domestic oil production peaked at 10.6MMBD, which increased the average production of 2015 to 10.2MMBD, up from 9.7MMBD in 2014. The oversupply in oil markets coupled with faltering global demand pressured prices to record an average of USD51/bbl for brent. This directly affected the Kingdom's economy and, in particular, the stock market. A strong positive correlation of 0.86 has been witnessed between oil prices and Tadawul's main index which resulted in a 17.1% drop during 2015 for the latter. The second consecutive annual drop underscores the immaturity of the market which is gradually developing albeit at a slow rate. Opening the market for qualified financial institutions (QFI) failed to provide the much needed stability as trading by non-institutions remains high at levels above 80%. After six months of trading, QFIs hold a mere 0.09% of shares in Tadawul while noting their maximum exposure is 10% of market capitalization. The appeal for foreign investors is likely weak given the current economic situation of the Saudi economy. Trading activity, gauged by the average daily traded volumes, declined by 22.9% annually last year to settle at SAR6.6 billion.

Chart 9: Tadawul All-Share Index

Source: Tadawul

Earlier in 2015, a Royal Decree worth an estimated SAR100 billion, including a 2-month bonus salary pay, lifted stock prices to as high as 9'834.49. However, systematic risks weighed on investor outlooks as the collapse in oil prices had rippled through government expenditures and private sector performance. On the final trading hours of 2015, Tadawul closed at 6'911.76, a few days after a budget release that has been nervously anticipated. The deterioration of oil prices coupled with assertive geopolitical strategy undermined stock prices. The largest losses were recorded by the cement sub-index which declined by 33.9% Y/Y. The construction and petrochemical sub-indices registered the second and third largest annual drops at 30.0% and 27.5%, respectively. Despite the aforementioned, the speculative nature of the domestic market was apparent in the 56.7% Y/Y gain recorded in the media sub-index, due to rumors lifting prices prior to a large ownership shift in the sector's Saudi Research and Marketing Group stock. Also, the transport and insurance sectors managed to gain 9.2% Y/Y and 2.0% Y/Y, respectively.

Chart 10: Average Daily Traded Value



Source: Tadawul

In December, the primary market concluded the last initial public offering (IPO) for the financial year of 2015. Alandalus Property Company offered 21 million shares, 8.4 million shares for individuals and the remaining for institutions. At a price of SAR18, the company was hoping to raise SAR151.2 million from the individuals alone. The appetite for IPOs remains healthy as the individuals oversubscribed their share by 469%, raising SAR709.7 million. Economic conditions made it difficult for companies to turn public as the total value of IPOs reached SAR4.2 billion, a significant drop from SAR25.2 billion. However, the government's intent of privatizing a range of sectors and economic activities will boost the primary market in 2016, a case in point is GACA's recent announcement of privatizing 3 airports in 2016 and beyond.

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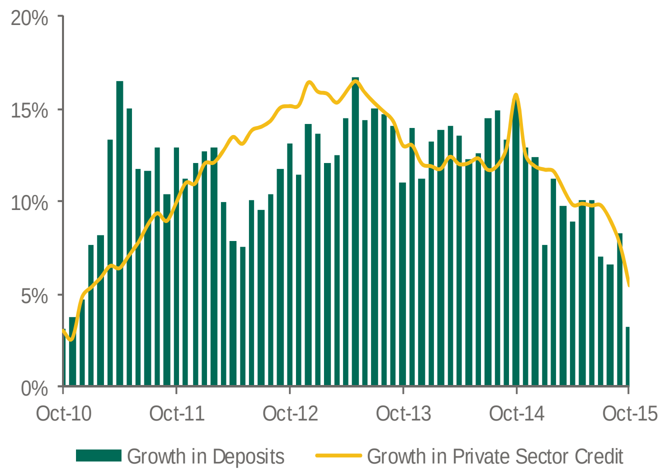
Loans Market

Credit Growth on a Decelerating Phase

The Kingdom's direction towards more responsible public spending is expected to affect almost every sector in the economy, including the banking sector. Throughout 10M2015, outstanding total credit extended by Saudi banks continued to grow to new records, reaching SAR1.34 trillion. However, the annualized growth rate has shown a consistent deceleration in bank lending, allowing growth in total credit to sit at 4.9% Y/Y by the end of October. Fresh bank credit year-to-October reached SAR90.9 billion, around 42.5% less than the level of the same period last year. Countercyclical government spending in the past years helped the private sector maintain high profitability in the aftermath of the global financial crisis. This pushed private sector companies to pursue expansive strategies which in turn propelled private sector credit to record-high double digits. However, given that the Saudi economy remains relatively undiversified, the recent developments in the oil market have turned the business cycle, prompting the government to reduce spending, issue local debt, consequently reducing bank deposits. The fiscal squeeze which is credit negative for Saudi banks will dampen credit growth and moderate the flow of deposits. In the month of October, the annualized growth in private sector credit was 5.5%, met with a 3.3% Y/Y growth in deposits.

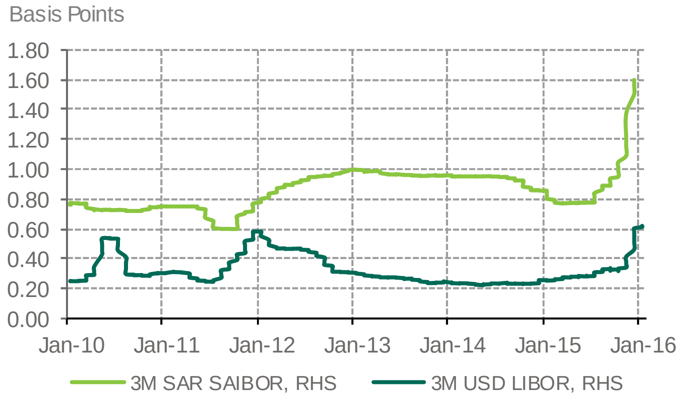
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

Demand deposits which represent the bulk of Saudi bank deposits by around 63.3% grew by 7.7% compared to last year. Meanwhile, interest-bearing time and savings deposits which represent 25.2% of total bank deposits edged up by 1.6% Y/Y. Despite the slowdown in deposits which will likely trigger some weakening in bank lending next year, the adequate capital buffers and strong profitability of Saudi banks will likely offset the overall impact of tighter funding conditions. Excess reserve ratio in Saudi banks stood at 24.8%, the lowest since October 2008, while the annualized growth in total banks assets is at a seven-year-low of 2.9%. Saudi banks' holdings of short-term SAMA bills saw the largest decline on an annual basis since the Financial Crisis of 28% at SAR164.2 billion in favor of government bonds. The government's issuance of development bonds in the second half of 2015 led banks' holdings to surge by 33.2% Y/Y in October, reaching the highest level since January 2010 at SAR71.5 billion. Moreover, analysis of bank loans by maturity began to show a shift back towards short-term loans which regained 52.1% of total loans. Medium and long-term loans began to decelerate from double-digit growth since April this year, ending October with an allocation of 16.6% and 31.3%, respectively. That being said, capacity utilization represented in the loans/deposits ratio stands at the highest level since February 2009 of 83.8%, indicating a faster pace of dwindling deposits relative to loans.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

The interest rate situation is mirroring the Fed as on the 16th of December, SAMA raised the reverse repo rate by 25bps to 50bps from 25bps, keeping the repo rate at 200bps. By the end of 2015, the Saudi Interbank Offered Rate surged to the highest level since January 2009 at 1.55%. We expect to see some moderation going forward mainly driven by higher cost of funds and a liquidity squeeze. Nevertheless, Saudi banks' stable funding structure which is based primarily on non-interest-bearing deposits, in addition to ample liquidity buffers will render the effect of more costly capital market funds limited.

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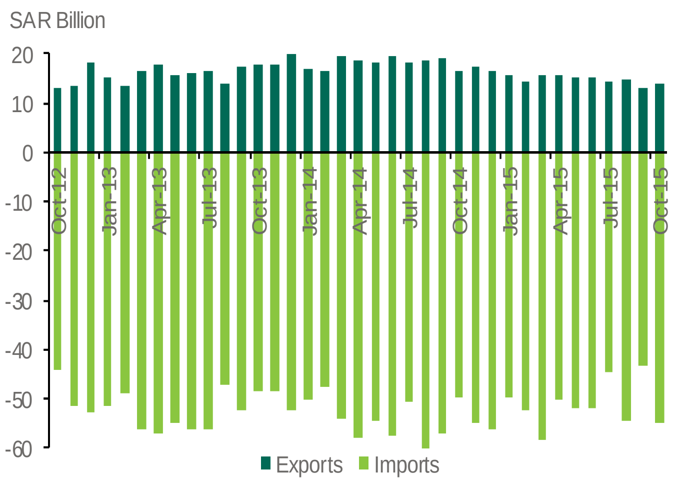
External Trade

Trade Gap Widens on Weak Commodities

Amid continued global supply glut in the oil market, more emphasis is placed on the non-oil sector as a source of growth going forward. The sharp fall in oil prices during 2015 led the Council of Economic and Development Affairs to adopt new strategies aimed at rationalizing expenditure and structurally reforming the economy and the financial system. Although at SAR163.5 billion, the non-oil sector will hardly plug in the expenditure gap coming from the oil's shortfall, it is expected to cover up around 48% of the income drop in 2015. The private sector will likely have a larger contribution to GDP as a result, and thus, an increased dependence on non-oil exports. In the month of October, non-oil trade maintained a declining trend on the exports side whereas imports remained supported by internal demand. In value terms, non-oil exports reached SAR13.8 billion in October compared to SAR16.6 billion during the same month last year, sliding by 16.6% Y/Y. Imports on the other hand marked an upturn of 10.4% on a Y/Y basis after posting a total of SAR54.8 billion. By weight, however, total non-oil exports during the month weighed 4.1 million tons, edging down by 0.2% Y/Y, whereas imports weighed 6.2 million tons, declining by almost 8% compared to last year.

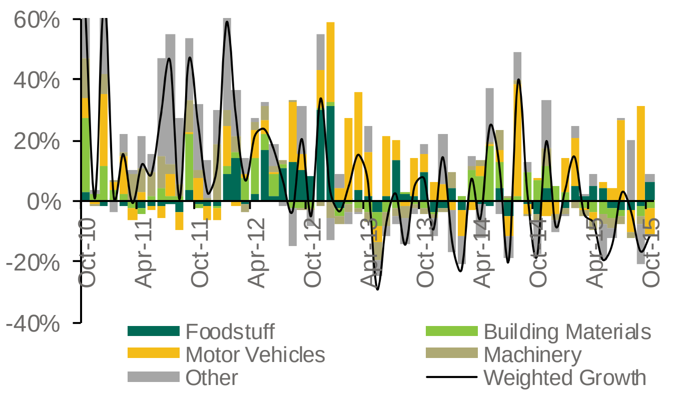
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB

By composition, plastics accounted for 34.5% of October's non-oil exports, valued at SAR4.8 billion, followed by petrochemicals representing 28.2% at SAR4 billion. Compared to last year, exports of plastics plummeted by 18.3%, while exports of petrochemicals experienced a sharper dip of 31.8%. Exports of base metals which account for 8.2% of total non-oil exports at SAR1.1 billion experienced a 10.5% Y/Y downturn. The top export destinations during the month were the UAE, China and India. Each respectively accounting for 11.5%, 9.4% and 5.9%. In contrast to the rest of export destinations, non-oil exports to the UAE amounted to SAR1.6 billion, inching up by 1.9%Y/Y. On the other hand, exports to China tumbled 39.9% Y/Y after posting SAR1.3 billion. Exports to India recorded SAR0.8 billion, falling short of last year's figure by 25.3%.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

On the import side, machinery and electrical equipment accounted for the largest share of the import bill at SAR14.8 billion, about 27% of the total. Compared to the same month last year, imports of machinery and equipment surged by 19%, contributing largely to bottom line growth of imports. Imports of transport equipment which account for 21% of total imports marked the largest annualized upturn at SAR11.5 billion, rising by 26.8%. In contrast, imports of base metals dwindled 17.9% Y/Y, posting SAR5 billion. The top countries of origin were the US, China and Germany, each accounting respectively for 15.2%, 14.2% and 6.1%. Imports from the US were valued at SAR8.3 billion, surging by 23.3% Y/Y. Imports from China also witnessed a sizeable annualized upturn of 17.1%, leaving Germany as the only country with receding imports by 20.1% Y/Y at SAR3.4 billion.

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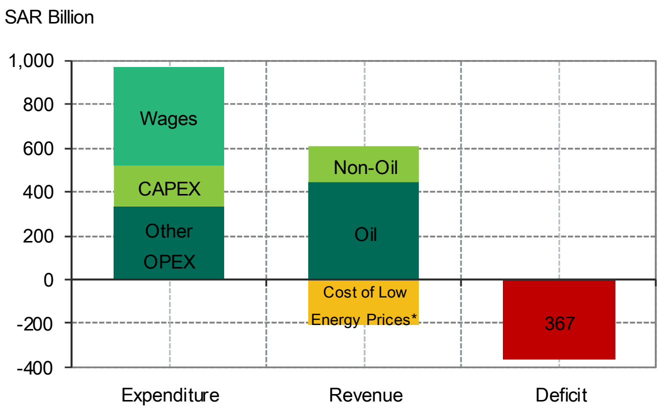
Special Focus:
Fiscal Consolidation and Economic Reform

A new era of fiscal consolidation and adjustment had commenced with this year's budget to avoid a repeat of the 1980s and 1990s. 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. The Saudi-led strategy manifested itself in production peaking at 10.6 MMBD in June, which resulted in domestic oil revenues dropping by 23% to SAR444.5 billion. Conversely, non-oil revenues peaked at SAR163.5 billion, a 28.9% Y/Y gain, with investment income rising by 69.3% to register SAR37 billion. 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. During 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.

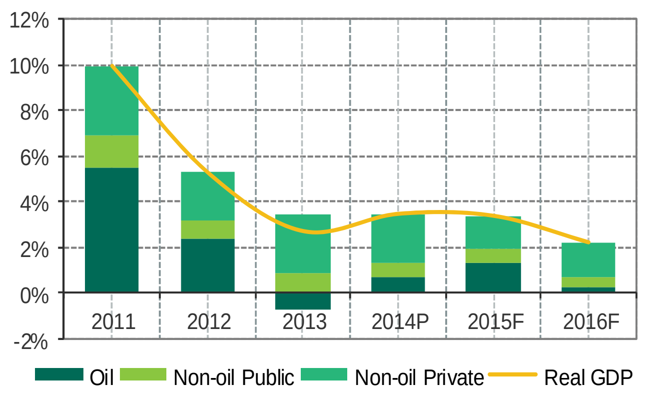
Chart 15: 2015 Fiscal Breakdown



Source: MoF and NCB

The government is adamant in supporting the economy by adopting a fiscal adjustment strategy centered around efficiency and viability. The 2016 budget release estimates revenues and expenditures at SAR513.8 billion and SAR840 billion, respectively. 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 11.4% of estimated GDP in 2016. Actual expenditure in 2015 is 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. Oil prices will continue to be the main drag on Saudi's balances as elevated production levels, record high inventories, and decelerating demand will suppress oil prices to an average of USD50/bbl in 2016.

Chart 16: Saudi Economic Growth



Sources: NCB

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 more than 70% 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 non-oil revenues.

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