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NCB الأهلي

Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- Oil prices are expected to remain rather flat in the coming months despite the OPEC's agreement, as global oil inventory builds will continue, yet at a slower pace in 2017 and 2018 than the 2016 average build of 0.9mb/d.

- In the Eurozone, the outlook remains bearish for the EUR as interest rate differentials are likely to be the main drag for the currency through 2017. Political risks are also expected to remain elevated due to uncertainty surrounding the Brexit aftermath.

- Gold rallied in the first half of the year, peaking in mid-July at USD1'338.3/oz, and began to decline as expectations for the Fed hike intensified.

- The governor of SAMA announced that the liquidity crunch which squeezed local banks in 2016 is over, predicting minimal intervention into the banking system.

- The market will implement a T+2 settlement cycle within the second quarter of 2017 to align with global best practices.

- The resumption of government payments to private sector contractors will continue to ease liquidity conditions as deposits increase. However, as the Fed remains on the path of monetary policy normalization, we expect to see the reverse repo rate rising by an equal measure to preserve the currency peg.

- Low petrochemicals and plastics prices largely contributed to the downturn as they represent around 60% of non-oil exports by value.

View of the Month

Going forward, the expansionary fiscal policy in 2017 will be directed towards projects and initiatives that are viable and relevant to Vision 2030. The annual budget release estimates revenues at SAR692 billion and expenditures at SAR890 billion, higher than last year's budget by 34.7% and 6.0%, respectively.

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Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016P	2017F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/	108.1	110.2	106.4	97.2	50.2	45.0	55.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.5	10.1
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,422.5	2,274.0	2,713.
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	646.9	607.2	724.6
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.5%	1.5%	-0.3%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	4.0%	2.0%
External Sector							
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-53.5	-45.9	-21.7
Current Account Balance/GDP	23.6%	22.4%	18.2%	9.8%	-8.3%	-7.6%	-3.0%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	544.5	505.2
Fiscal Sector (Central Government)							
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	596.9	602.8	702.4
Actual Expenditure, SAR billion	826.7	873.3	976.0	1109.9	969.6	892.1	882.8
Expenditure Overrun, %	42.5%	26.6%	19.0%	29.8%	12.7%	6.2%	-0.8%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-65.5	-372.8	-289.3	-180.3
Budget Balance/GDP	11.6%	13.6%	6.5%	-2.3%	-15.4%	-12.7%	-6.6%
Break-Even Oil Price	75.3	73.9	82.6	100.1	82.1	68.1	69.8
Financial Sector							
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	2.6%	-1.4%	2.3%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	6.6%	4.1%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.5%	3.0%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.9%	1.5%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	160.0	150.0

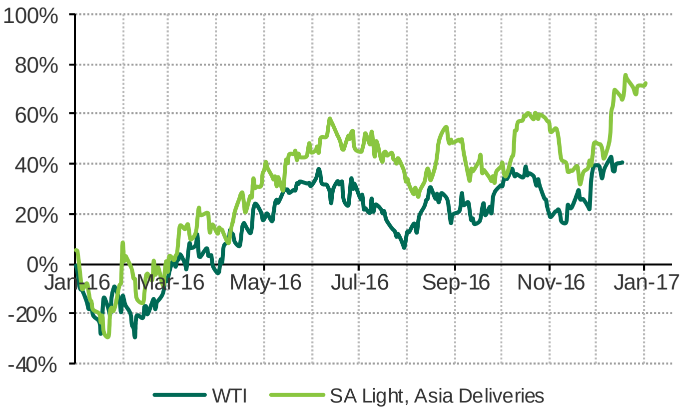
Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
Note: Saudi Economic Review Data, January 2017 Update (Historical and Projections)

Oil Market

Crude Rallies on Fundamental Support

Brent crude oil prices averaged USD53/b in December, rising by USD9/b from November. This rise is largely due to market reactions to the November 30th OPEC agreement to cut production by 1.2mb/d starting in January 2017. However, Oil prices are expected to remain rather flat in the coming months despite the OPEC's agreement, as global oil inventory builds will continue, yet at a slower pace in 2017 and 2018 than the 2016 average build of 0.9mb/d. Global oil markets are expected to be more balanced by mid-2018, with global oil inventories transitioning from moderate builds of 0.4mb/d in 2017 to 0.1mb/d builds in 2018. The persistence of excess global oil supply in the short term, along with the responsiveness of US shale oil production to rising oil prices is expected to limit a substantial upward oil price increase in 2017. In addition, the potential for continued efficiency gains and cost reductions from non-OPEC producers, particularly US shale oil, could result in additional supply that could put downward pressure on prices. Accordingly, Brent crude oil prices are forecast to average USD54/b in 2017.

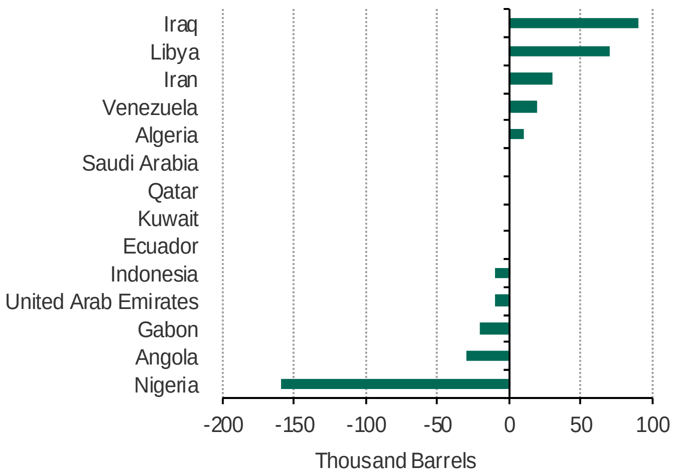
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the supply side, OPEC crude oil production averaged 32.9mb/d in 2016, increasing by 0.8mb/d from 2015, attributed to rising output in Iran, Iraq, and to some extent, in Saudi Arabia. Assuming OPEC members will largely comply to the production targets, OPEC's production is expected to rise by 0.3mb/d in 2017, with Iran and Libya accounting for most of the increase. Oil production is expected to increase in countries not covered by the agreement, particularly Libya. It is also expected that Nigeria's production will increase slightly in 2017. In the US, oil production is estimated to have averaged 8.9mb/d in 2016 and is forecast to average 9.0mb/d in 2017 and 9.3mb/d in 2018, reflecting increases in both federal offshore Gulf of Mexico and shale production. The shale oil is currently the elastic part of the supply chain, as its production rises following any recovery in prices. Therefore, investment spending is expected to increase, with Permian formation accounting for the largest investment share. According to EIA, the well additions in the Permian will increase by over 30% in 2017, which along with increased productivity, should allow production in this formation to increase by 0.35mb/d.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, global consumption of oil averaged 95.6mb/d in 2016, an increase of 1.4m b/d from 2015, driven by non-OECD countries. Global demand is expected to grow be 1.6mb/d in 2017 and 1.5mb/d in 2018. China and India are expected to be the largest contributors to non-OECD oil consumption growth. It is forecast to grow at an average of 0.3mb/d in China and an average of 0.2mb/d in India in 2017. In the Middle East, oil consumption growth is forecast to average 0.3mb/d in 2017, up from 0.1mb/d in 2016. Although Saudi Arabia decreased its use of crude oil for electricity generation in 2016 relying more on natural gas, the expected increased use of natural gas as a petrochemical feedstock in 2017 and 2018 will once again result in an increase of direct crude oil burn for electricity generation.

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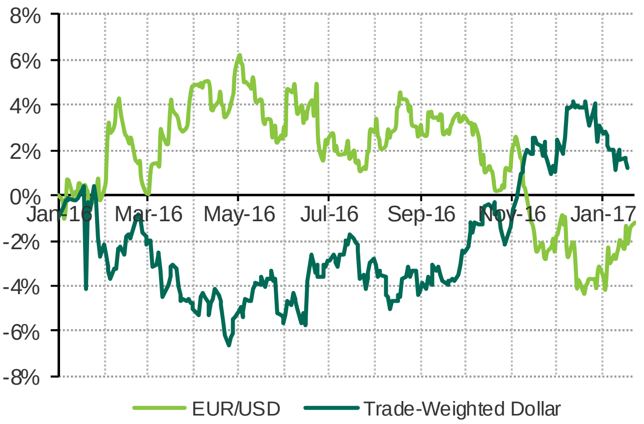
Foreign Exchange
USD Poised to Appreciate in 2017

Persistent perils continue to offer a weaker prospect for the global economy as risks have become more pronounced. The year 2016 was marked by geopolitical shocks; Brexit in the UK, impeachment in Brazil, Japanese and US elections, in addition to an attempted coup in Turkey. The divergence between commodity exporters and importers is widening and softer manufacturing data is indicative of a weaker global demand. On this note, forex direction remains uncertain. The applicability of Trump's pro-growth agenda is unclear yet. However, the Fed's hawkish outlook into 2017 raises the potential for more capital repatriation of US foreign holdings. Preliminary figures for US non-farm payroll stood at 156,000 jobs created in December, bumping unemployment up from the previous month to 4.7%. The US economy has rebounded following the first half of 2016 with output growth averaging 2% Y/Y through 3Q. Consumer spending and housing market improvement were underpinned by a robust job market in which wages posted the biggest gains since 2009. The trade-weighted USD ended 2016 upturning by 3.1% Y/Y, closing at 102.2.

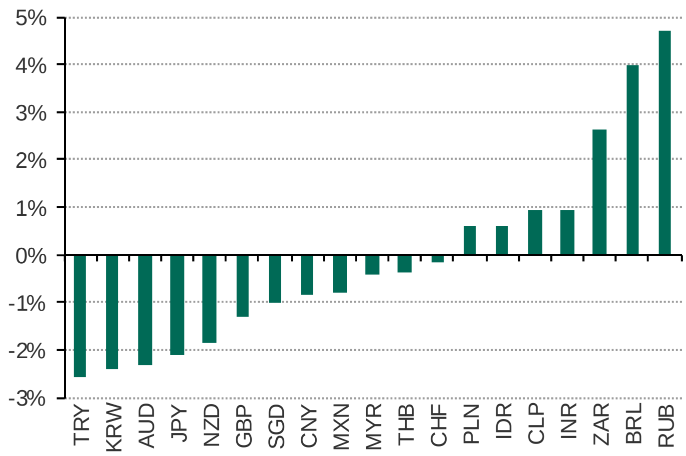
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

In the Eurozone, the outlook remains bearish for the EUR as interest rate differentials are likely to be the main drag for the currency through 2017. Political risks are also expected to remain elevated due to uncertainty surrounding the Brexit aftermath. On the flip side, per capita GDP in the Eurozone managed to return to pre-crisis levels after eight painful years near stagnation. Spain managed to bring unemployment below 20% in 2016 after peaking at 27.2% in 2013. Such success, albeit limited, allows for some hope in depression-stricken countries such as Greece which remains under a debt burden of over 177% of GDP. The hope is that fiscal and monetary discipline will bring about a convergence in the single currency bloc. Moreover, the ECB is expected to increase the TLTRO upper threshold of high rated government bonds in 2017. Business surveys show a notable recovery since August, and consumer confidence ended the year on a high note. The EUR slid by 3.1% Y/Y on year-end standing at USD1.05, and is expected to maintain a downward outlook throughout 2017.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The Chinese yuan remains under weakening pressure against the USD on the back of persistent capital outflows. According to the International Institute of Finance, net capital outflows from China accelerated in the third quarter of 2016 to USD207 billion from USD100 billion the previous quarter and are expected to end the year at around USD540 billion. Furthermore, depreciation pressure is expected to increase in 2017 once individual transfer quotas are reset. On the other hand, the Chinese economy met its growth target at 6.7% for 2016; however, in 2017 growth will likely decelerate as fiscal stimulus fades away and the property market cools off. By the end of December 2016, the renminbi stood at CNY6.9/USD, down by 6.5% Y/Y.

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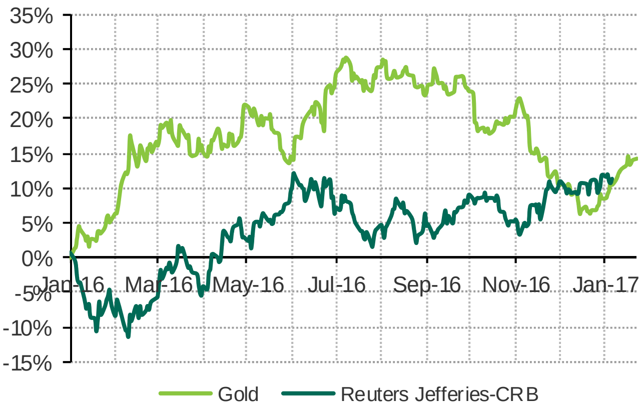
Commodities

Uncertainty Caps Commodities Gains

Commodities surged by 9.3% in 2016 on the back of an improving oil outlook and a substantial improvement in metals. During the second half of the year, agricultural commodities saw a range-bound movement despite ample supply and the absence of drought concerns, building the case for a better outlook in 2017. Multi-year lows are improving global economic conditions, underpinning demand for commodities in 2017; albeit not driving commodity prices substantially higher. According to the World Bank's Global Economic Prospect Report, growth in advanced economies is expected at 1.8% in 2017 on the back of fiscal stimulus although increasing trade protection could hinder their outlook. Emerging and developing economies should pick up to average 4.2% this year, although growth estimates are clouded by uncertainty and upcoming policy direction in major economies. Investment in commodities and commodity stocks could hold back further this year on the back of uncertainty, allowing for an upside market correction.

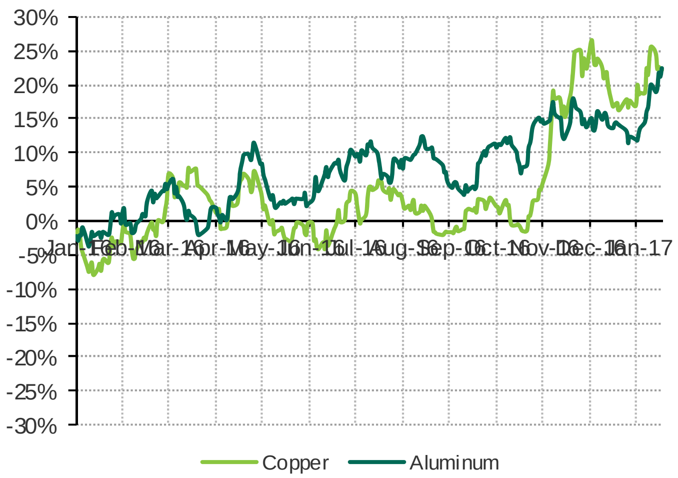
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Metal prices rallied following the win of Trump in the US presidential elections on account of his USD1 trillion infrastructure spending plan. Supply constraints from high-cost smelter closures are also expected to contribute to the rise in 2017. Moreover, China and Philippine governments ordered the closure of nickel and tin mines for environmental violations. In addition, Indonesia announced that it is unlikely to remove or suspend its active ban on Bauxite and nickel ore exports. Despite the bullish trend, however, base metals generally are characterized by excess capacity, especially due to heavy recycling. Copper prices surged 17.7% in 2016, standing at USD5,535/ton. The link between the copper rally and China's growing infra-structure and construction is well established, making it the largest consumer of the red metal in the world. Therefore, we expect the Chinese economic performance in 2017 to directly impact copper prices. Moreover, the rally which started in October on the back of mine closures is adding to the optimism regarding the start of a new commodity cycle. Fundamentals will determine the direction of copper in 2017. The bearish sentiment are aligned with copper futures whereas demand and supply points at an upside pressure emanating from increased stockpiling in China versus additional supply constraints in Latin America and Asia. Aluminum prices also rallied after the US elections, ending the year upturning by 12.3% Y/Y at USD1,693/ton. Key factors that could impact aluminum in 2017 include a potential supply deficit following the Chinese curtailments of high-cost smelters. In addition, Alcoa projects that higher coal prices will likely support prices of alumina as coal is an essential input in aluminum processing.

Chart 6: Base Metals



Source: Thomson Reuters

Spot gold prices gained 8.5% in 2016, closing at USD1'152.2/oz supported by economic and geopolitical uncertainty. Gold rallied in the first half of the year, peaking in mid-July at USD1'338.3/oz, and began to decline as expectations for the Fed hike intensified. The prolonged near-zero interest rate policy aided gold's recovery earlier in the year after gold lost its allure to investors as a safe haven. Moving onto 2017, interest rate differentials will create more demand for the USD which in turn will strengthen the currency, thus unfavorably affecting gold prices downwards. Agricultural commodities were less bearish in 2016 than the previous year. The Goldman Sachs Agriculture index edged up by 2.7% Y/Y on the back of range-bound grain price movement. With limited effect from El-Nino, we expect oversupply to cap any recovery to low single digits in 2017.

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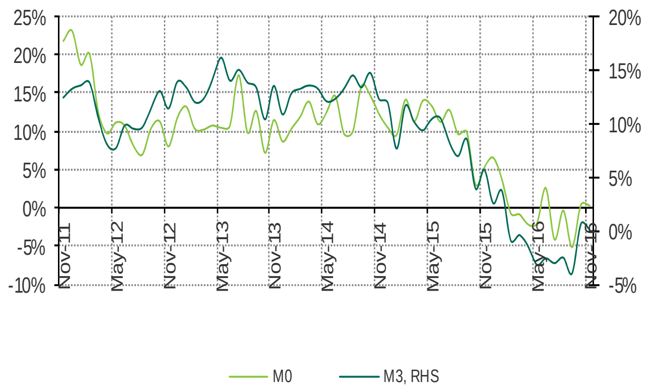
Money & Inflation

Liquidity Improves As Pressure Eases

The Saudi Arabian money supply improved considerably in October from the previous month's contraction of 4% annually. Broad money grew by 0.6% Y/Y, standing at 1.78 trillion. The governor of SAMA announced that the liquidity crunch which squeezed local banks in 2016 is over, predicting minimal intervention into the banking system. Previous efforts included direct cash injections from SAMA, higher repo transactions maturity of up to 90 days, and a lower cap of SAMA bills down to SAR3 billion per week. In addition, the government successfully concluded the largest emerging market bond sale, amounting to USD17.5 billion in October. Current liquidity levels which SAMA deemed to be comfortable will likely be supported by further international borrowings in 2017, alleviating the burden on local banks. SAMA's governor reiterated the agency's open policy towards foreign lenders who wish to obtain a license to operate within the Kingdom.

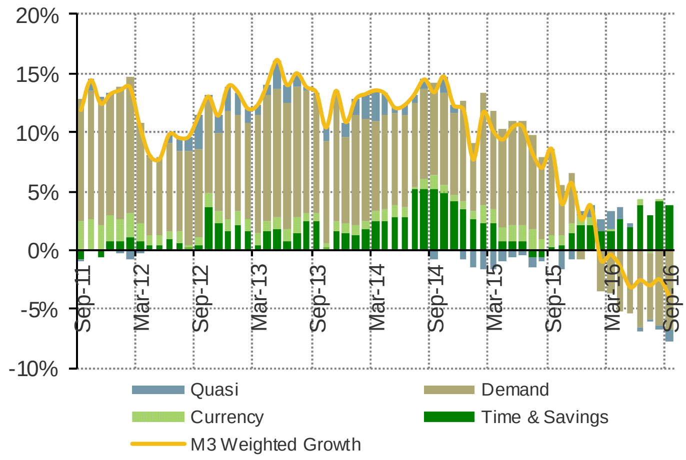
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

Deposit, credit, and liquidity indicators continue to point that the banking system remains to be pressured by the oil plunge albeit the signs of recovery are on the horizon. The monetary base edged up by 0.4% Y/Y to SAR303.8 billion supported by a 12.6% surge in currency outside banks and 21.4% increase in cash in vault. Deposits with SAMA, however, slid by 13.4% on the back of an 86.7% plummet in public institutions' deposits. Bank deposits growth turned positive in October for the first time in 2016 after the government resumed payment to private contractors in which back-payments are worth SAR26.7 billion. However, deposits from government entities is unlikely to expand without higher oil prices. Demand deposits which account for 54% of total bank deposits slid by 5% Y/Y to SAR959.6 billion in its 11th consecutive month of decline. On the other hand, time and saving deposits surged by 23% Y/Y to SAR498 billion in their highest gain in 2016. Quasi monetary deposits stood at SAR152 billion, falling 17% Y/Y on the back of declining foreign currency deposits and outstanding remittances. Government bonds as a share of total bank claims reached 10.6% as bank holdings of government bonds skyrocketed to SAR175.7 billion, up by 145.6% Y/Y. Despite the pressure from rising interest rates as indicated by SAIBOR peaking at 2.38% by the end of October, we note that the rate eased off towards the end of 2016, nearing 2% owing to liquidity pumping. The Kingdom is unlikely to shift away from the current fixed exchange rate regime; therefore, as the Fed continues to normalize monetary policy in the US, we expect to see reverse repo reaching 1% after the next Fed hike.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

The inflationary situation in the Kingdom remains moderate. According to the latest data released by SAMA, the November consumer price index number rose by 2.3% indicating that upward price pressures have subsided. Food and beverages which are the largest by weight at 21.7% of the consumer basket registered a decline of 2.6% Y/Y. On the other hand, Housing and utilities recorded the largest pull of 6.4% Y/Y owing to reduced government subsidies for water and electricity. Moreover, the transport category remains elevated at 7.6% due to a similar effect from energy subsidy cuts.

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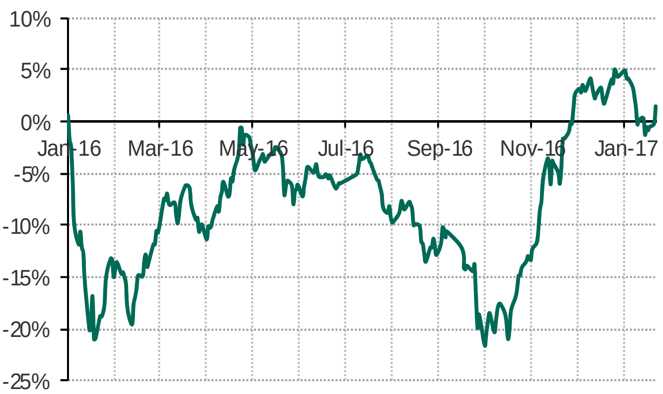
Capital Markets
Equities Endure Volatility

Global equity markets rebounded in 2016 and registered a growth of 5.6% following 2015's decline of 4.3%, according to the MSCI World index. Last year was characterized by extreme volatility as the index dropped to 353.4 in February, only to climb to a peak of 427.5 in December, a 21.0% gain from trough to peak. The populist movement across the US and Europe resulted in the election of Donald Trump as the next president of the United States. While the UK's Brexit referendum brought Theresa May into power and is leading a hard exit from the European Union. Elsewhere in Europe, populist candidates are on the rise in France, Italy, and the Netherlands which has underpinned an uncertain future for the trade bloc. Despite the unfortunate events for the single currency, the depreciation of the Euro attracted investors towards European stocks as other currencies appreciated, namely the US Dollar. Consequently, the Europe STOXX600 recovered most of its 17% losses in 1Q 2016 to register a mere 1.2% drop in 2016 with the German DAX and the French CAC40 gaining 6.9% and 4.9%, respectively. Additionally, the British Pound's drop aided the FTSE's 14.4% rise last year. In the US, the "Trump Effect" drove the DOW and S&P500 toward record highs, growing 13.4% and 9.5%, respectively, as his pro-growth agenda is widely expected to support local businesses through his presidential term.

Chart 9: Tadawul All-Share Index

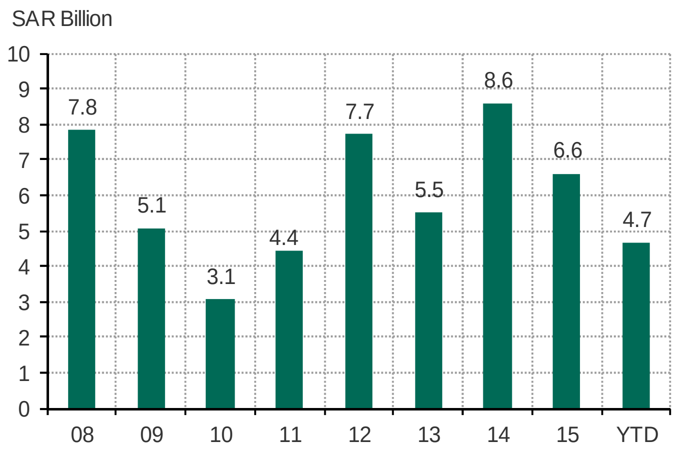


Source: Tadawul

As for the Saudi stock market, Tadawul broke a two-year decline trend by turning from a bear market into a bullish one towards the end of last year. In the beginning of the year, the oil market continued to pressure the Saudi economy. In turn, the government continued with plans towards fiscal consolidation and economic reform which reduced the investment sentiment towards the equity market. However, as OPEC agreed upon a 5% cut in production, complemented with a 558'000 barrel production cut from non-OPEC producers, and as the Saudi financial market overcame a liquidity crunch, Tadawul managed to record a gain of 4.3% in 2016.

The best performing sectors were the energy, petrochemical, and real estate as they registered annual gains of 41.0%, 25.0%, and 21.5%, respectively. While the worst performing sectors were the hotel, media, and retail as they declined by 44.0%, 23.5%, and 18.5%, respectively on an annual basis. As risk levels have increased over the past years, liquidity levels in the stock market declined rapidly. In 2016, the average daily traded value reached SAR4.6 billion, 29.8% below 2015's SAR6.6 billion and 45.8% below 2014's average of SAR8.6 billion. As for the primary market, a total of three companies turned public with a total value of SAR2.8 billion, increasing total market capitalization by 0.54% to reach SAR1'681.95 billion last year.

Chart 10: Average Daily Traded Value



Source: Tadawul

The Capital Market Authority and Tadawul have been steadily progressing towards the inclusion of the Saudi equity index into MSCI indices. Regulations for QFI trading have been readjusted ahead of schedule to attract foreign investment. Additionally, the market will implement a T+2 settlement cycle within the second quarter of 2017 to align with global best practices. Tadawul had also announced a parallel market, Nomu, which aims to diversify capital markets domestically and provide an alternative funding source for local businesses. Listing requirements are less stringent as the minimum market cap was reduced to SAR10 million from SAR100 million, leaner financial disclosure deadlines, and lowering the minimum offering share to 20% from 30% in Tadawul. The new market will provide small and medium businesses a pathway to the main market as a transition is possible within two years. Given the recent liquidity shortages in the domestic financial market, Nomu will become a viable alternative as five companies have already been granted approval for listing.

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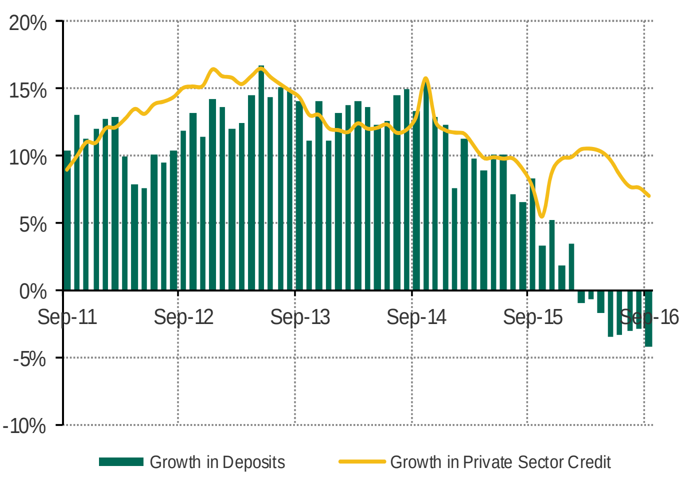
Loans Market

SAIBOR to Return Back to Nominal Levels

The gap between credit and deposits will continue to gauge liquidity pressures in the Saudi banking system. However, signs of recovery have been observed following the USD17.5 billion sovereign bond sale in October which reduced the burden on local banks. Deposits from government entities are still dwindling, but the boost from time and savings deposits nudged total deposits up by 0.5% Y/Y. This resulted from the government's deferred payments to the private sector which increased its deposits by 3.4% Y/Y. Demand deposits which account for 54% of total deposits fell by 5.4% Y/Y on the back of a 6.3% annualized decline in deposits by businesses and individuals. Bank holdings of SAMA bills reached the lowest levels since December 2007 at SAR33.3 billion as SAMA capped its bill issuance to SAR 3 billion per week to ward off the negative effects of liquidity tightness.

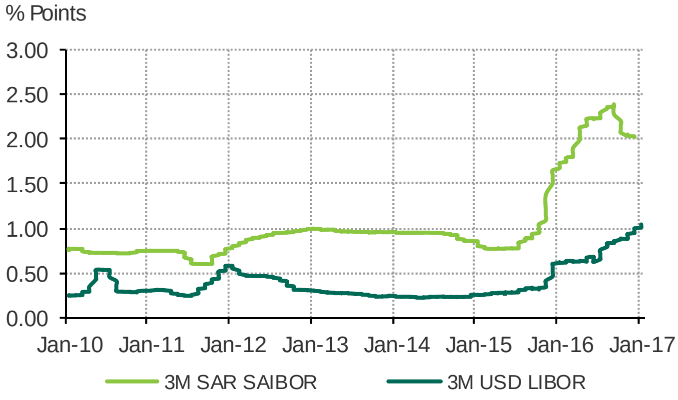
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

Total bank credit to public and private sector reached SAR1.43 trillion in October, with a 6.2% Y/Y upturn in private sector credit, the slowest rate since 2011. On the other hand, credit to the public sector surged by 31.4% Y/Y to SAR51.3 billion which is the fastest growth in three years, while government bond holdings in Saudi banks rose by 145.6% Y/Y to SAR175.7 billion. Although overall deposits are likely to be a drag on credit growth, the loans-to-deposit ratio (L/D) eased in October to 89.1% as a sign of decreasing liquidity strain. Furthermore, the Saudi Interbank Offered Rate (SAIBOR) has notably fallen after the international bond sale to around 2%. By maturity, medium-term bank credit surged the most by around 19.5% Y/Y, accounting for 18.6% of total credit followed by long term credit which grew by 6.9% Y/Y accounting for 30% of total credit. Short-term credit recorded the lowest growth since January 2015 at 5.6% Y/Y.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

The resumption of government payments to private sector contractors will continue to ease liquidity conditions as deposits increase. However, as the Fed remains on the path of monetary policy normalization, we expect to see the reverse repo rate rising by an equal measure to preserve the currency peg. Currently, the reverse repo rate stands at 75 bps, and higher borrowing costs will require additional stimulus amid government spending cuts. The Kingdom is planning to further tap into international debt markets seeking as much as USD15 billion to fund government spending plans. The key metric for consumer demand remains the point-of sale transactions which inched up by 1.4% Y/Y returning to positive territory for the first time since June. Nevertheless, as the improvement in the depositary base is more concentrated in time and savings deposits, we doubt that it will reflect positively on point of sale transactions in the coming months.

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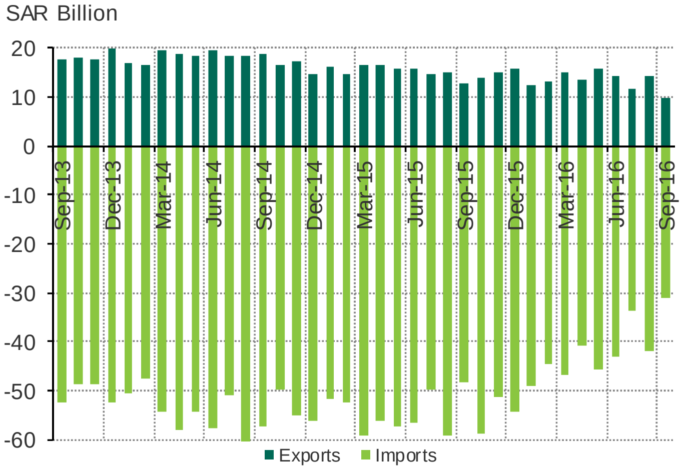
External Trade

Non-oil Exports to Remain Weak

In the third quarter, Saudi non-oil exports dropped 11% Y/Y with a value of SAR41.3 billion which highlights the declining revenues compared to the second quarter's SAR45.3 billion. Low petrochemicals and plastics prices largely contributed to the downturn as they represent around 60% of non-oil exports by value. Ongoing fiscal reforms helped narrow down the current account deficit currently standing at 5.2% of GDP compared to 8.7% in 2015. In the month of September, non-oil trade in the Kingdom resumed declines on the back of lower demand from China, low commodity prices, and a stronger USD. Non-oil exports tumbled 35.9% Y/Y in their largest annualized decline this year.

Chart 13: Saudi Non-Oil Trade Balance

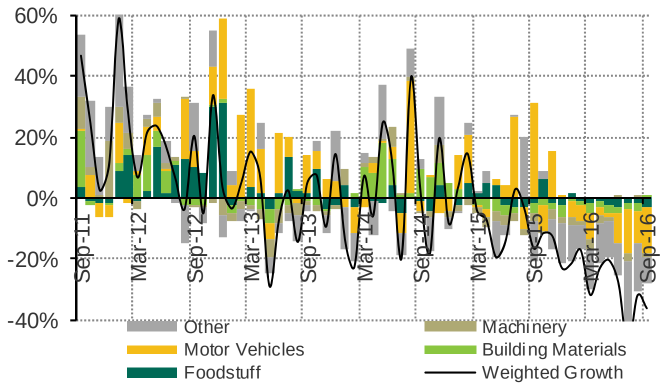


Sources: SAMA and NCB

Exports of plastics stood at SAR3.4 billion during the month falling by 21.2% Y/Y. Chemical products recorded SAR2.4 billion, tumbling by 34.7% Y/Y. Base metals which account for 7.4% of total non-oil exports registered a hefty decline by 34.7% Y/Y with a value of SAR0.7 billion. By export destination, the UAE accounts for 15.8% in value terms amounting to SAR1.6 billion. Compared to last year, exports to the UAE nose-dove by 26.6% Y/Y, likely affected by lower re-exports to China. Non-oil exports to China were valued around SAR0.9 billion tumbling by 28.6% Y/Y. The value of non-oil exports to Kuwait surpassed Singapore and India, recording SAR0.6 billion by surging 47.4% Y/Y.

On the import side, machinery and electrical equipment, the single category which makes up around 23.6% of imports in value terms, tumbled by 41% to SAR7.3 billion. Imports of vehicles which are considered the second largest group of imports, valued at SAR6 billion, declined by 34.5% Y/Y. Imports of chemical products fell by 39.3% Y/Y to SAR2.6 billion. By country of origin, imports from the US accounted for 17% of all imports by value at SAR5.3 billion, around 16.6% below last year's figure. Imports from China came second at SAR4.5 billion, tumbling by 27.8% Y/Y. Furthermore, imports from the UAE fell by 27.8% compared to the same month last year, standing at SAR1.8 billion.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

Settled letters of credit (LCs) for the month of October totaled SAR13.8 billion, falling for the 12th consecutive month on a Y/Y basis. Compared to last year, settled LCs declined by 30.3% on the back of declining imports of motor vehicles, machinery, and building materials. LCs for motor vehicles were valued at SAR2.6 billion 53.2% Y/Y whereas imports of machinery fell by 16.2% Y/Y to SAR0.9 billion followed by building materials which declined by 8.1% at SAR1.4 billion. We expect the downward trend to continue due to the government's fiscal consolidation efforts. Low global inflation will also impact the value of key LC categories such as foodstuff which have been down-trending since July as food grain LCs were down by 32.8% Y/Y compared to last year, valued at SAR0.7 billion in October.

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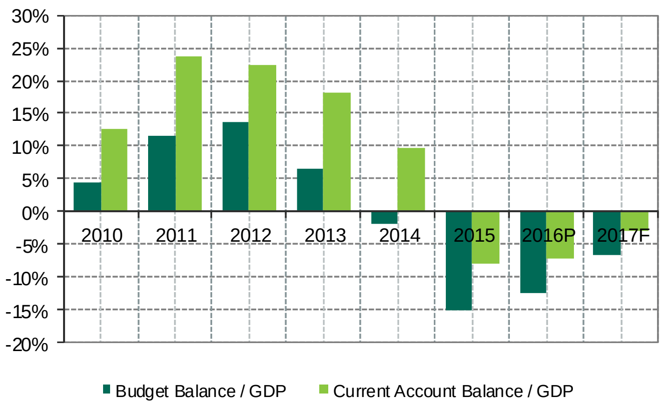
NCB الأهلي

Special Focus:

Saudi Beyond 2016

The budget announcement for 2016 was the first contractionary fiscal policy since 2002 as the government tried to consolidate in the face of plummeting oil revenues. The oil market collapse since 2014 had underscored the necessity to steer away from hydrocarbon dependency towards a diversified economy, which was later on adopted by the government as a strategy in the form of Saudi Vision 2030. Despite, prices for Arab Light spot declining by 20.3% in 2016, the government was able to reduce the budget deficit by 18.7% to reach SAR297 billion through fiscal consolidation and economic reforms. Total expenditures were contained to SAR825 billion, saving SAR80 billion through the newly established Spending Rationalization Office. Reduced oil revenues and geopolitical challenges that underpinned military spending have offset the substantial growth in non-oil revenues which registered a record high at SAR199 billion, a 20.0% Y/Y increase, driven by SAMA's investment income that rose by 75.7% to SAR62.2 billion. In 2016, revenues fell by 13.8% to reach SAR528 billion, yet higher than the budgeted revenues of SAR514 billion by 2.8%. The government maintained a two pronged strategy of covering the funding gap via drawing down reserves and debt issuances as net foreign assets fell by USD78.5 billion to USD531.3 billion by end of November and debt levels reached 12.3% of GDP by the end of last year.

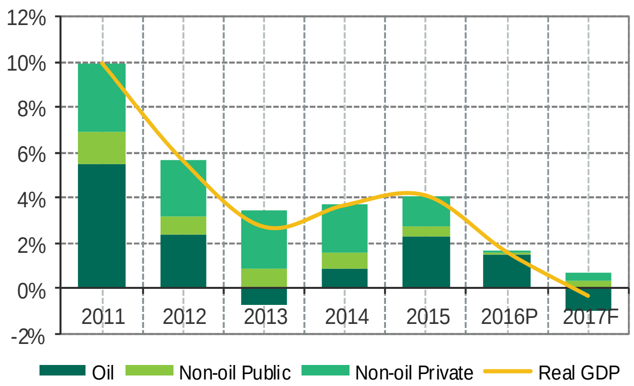
Chart 15: Twin Balances



Source: MOF, SAMA, and NCB

Going forward, the expansionary fiscal policy in 2017 will be directed towards projects and initiatives that are viable and relevant to Vision 2030. The annual budget release estimates revenues at SAR692 billion and expenditures at SAR890 billion, higher than last year's budget by 34.7% and 6.0%, respectively. In our opinion, oil prices will average USD55/bbl for the Arabian light spot price and production will average 10.05 MMBD. The expected rebound in oil prices will raise oil revenues to SAR483.6 billion, a gain of 47.0% despite the reduction in oil production following OPEC's agreement. As for non-oil revenues, we believe 2017 will register SAR218.9 billion through higher investment income, white land taxes, and increased fees and tariffs. However, the increase in actual expenditures by 7% Y/Y to SAR882.8 billion will slightly offset gains on the revenue side which is expected to reach SAR702.5 billion this year. We do believe that downside risks emanating from geopolitical uncertainties, global macroeconomic conditions, and domestic liquidity concerns will constitute the main challenges and we project the Saudi economy will contract by 1.0% in real terms as the Kingdom bore the brunt of OPEC's agreed upon cut.

Chart 16: Saudi Economic Growth



Sources: MOF, SAMA, and NCB

It seems the government had realized that the high frequency of policy changes has impacted sentiment, and as such the Fiscal Balance Program 2020 was revealed along with the budget release. Business and consumer confidence declined as Saudi faced economic and geopolitical challenges, although, adopting a gradual and transparent fiscal plan is expected to improve domestic and international sentiment. The program's main themes revolve around rationalization of government expenditure, further reduction of subsides, and increasing non-oil revenues. Moreover, SAR100 billion worth of capital expenditure projects were deemed unnecessary out of a total SAR220 billion, a further SAR1.2 trillion projects will be reviewed in the second phase. Meanwhile, energy and water prices are planned to be raised to reference prices. Saudis will receive direct cash grants according to their income levels in order to reduce the impact of higher prices through a targeted household allowance program. Additional non-oil revenue from an expat levy and a 5% VAT in 2018 will generate an expected SAR423 billion, cumulatively by 2020.

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