Macroeconomic outlook

Saudi Arabia: government spending and reforms to stimulate non-oil activity

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Overview and outlook

- **Growth is forecast to slow from 1.4% in 2016 to 0.5% in 2017 due primarily to a contraction in oil sector activity (-0.3% y/y) as the kingdom complies with its OPEC crude production cut agreement.**
- **Non-oil growth to accelerate from -0.1% y/y in 2016 to 1.1% y/y in 2017 as the government adopts a moderately expansive fiscal stance and rolls out its Vision 2030 reform agenda.**
- **The fiscal deficit should halve to -8.0% of GDP in 2017 on higher oil/non-oil revenues and relative fiscal restraint.**
- **The fiscal deficit will continue to be financed by a combination of debt issuance and reserve drawdowns; public debt should peak in 2018 at around 24% of GDP.**

Responding to the oil price downturn, the Saudi government has embarked on a radical and ambitious plan to transform the kingdom's entire economy, restructure its finances and ultimately wean it off its oil dependency. The Saudi Vision 2030 and its associated tactical programs, now provide the basis upon which economic growth and development will be benchmarked. Public expenditures and investment will be redirected towards localizing industries, training Saudis and raising economic competitiveness. Fiscal reform is taking place through expenditure rationalization, non-oil revenue enhancements and privatization of state entities, so that by 2020 the kingdom would achieve a balanced budget. Fuel and utility prices have been hiked, taxes are about to be introduced, including a VAT in 2018, while the authorities unveil a private sector stimulus package. That package is to include a housing and household allowance program to mitigate the burden on low income families.

The risks and challenges are immense; the most pressing is the need to stabilize the oil price at a level high enough to kick-start growth in the non-oil economy directly, through government spending and investment in SR 1.4 trillion ($373 billion) worth of outstanding capital projects, and indirectly, through enhanced banking sector liquidity and lending. Consumer activity and confidence should rebound.

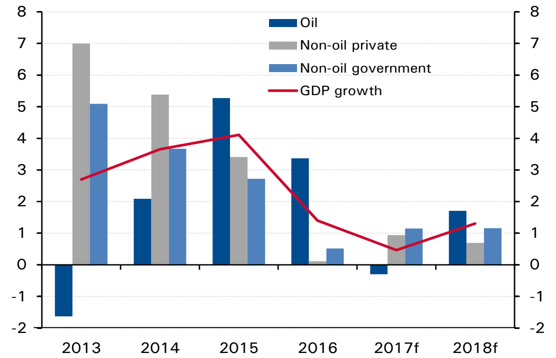
Key economic indicators

		2015	2016	2017f	2018f
Real GDP growth	% y/y	4.1	1.4	0.5	1.3
Oil	% y/y	5.3	3.4	-0.3	1.7
Non-oil	% y/y	3.2	-0.1	1.1	1.0
Inflation	% y/y	2.2	3.5	1.4	2.1
Fiscal balance	% of GDP	-15.0	-16.8	-8.0	-3.7
Public debt	% of GDP	5.8	13.2	17.7	24.3

Sources: Official sources and NBK estimates

Chart 1: Real GDP growth

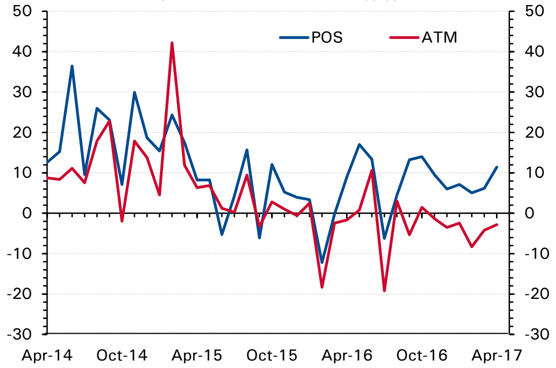
(% y/y)



Source: General Authority for Statistics (GASTAT), NBK estimates

Chart 2: ATM and POS transactions growth

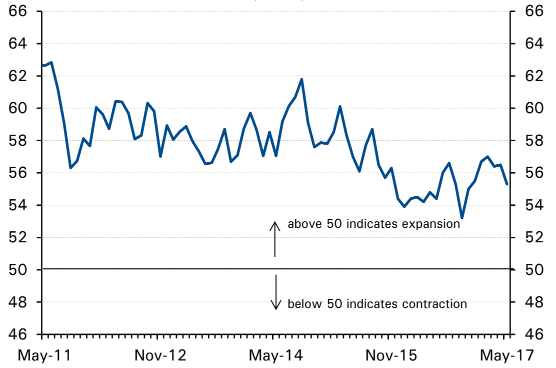
(value of transactions, % y/y)



Source: Saudi Arabian Monetary Agency (SAMA)

Chart 3: Purchasing Managers' Index (PMI)

(index)



Source: Emirates NBD/Markit

Real GDP growth to slow in 2017 on oil sector contraction, but non-oil sector activity expected to rebound

Saudi economic growth is projected to slow further from last year's 1.4% to 0.5% y/y in 2017. Behind the outlook are a contraction in oil sector activity, by -0.3% y/y, in line with Saudi Arabia's commitment to OPEC's cuts, and continued weakness in the non-oil private sector. Private sector growth fell to a 26-year low of 0.1% last year, following two years of relative fiscal austerity and low business confidence triggered by the oil price downturn.

This year, however, non-oil activity is expected to rise by 1.1% y/y, thanks to moderately expansive government fiscal policy, including the launch of specific housing and private sector stimulus packages, and a rebound in consumer, manufacturing and construction activity. The consumer sector should get a welcome boost from the recent reinstatement of public sector bonuses and allowances.

The private sector stimulus package, which is worth SR 200 billion ($53.3 billion), aims to boost private sector GDP by 2020 through efficiency enhancements to high energy and labor-intensive industries. The government is also committed to improving the localization of industries such as oil/gas and defence.

Moreover, the non-oil manufacturing sector is expected to benefit from the full operation of major petrochemical projects such as the $20 billion Sadara petrochemical complex and the $500 million Rabigh expansion project. The direct effects of these and ancillary projects should lead to the creation of thousands of jobs, providing a welcome boost to Saudi employment levels.

Nevertheless, the retail and consumer sector remains a weak spot. The latest metrics, such as point of sale (POS) and ATM transactions, private sector credit growth and the Purchasing Managers' Index (PMI) show improving but subdued activity. (Charts 2, 3 and 10.). The roll out of the second round of the government's subsidy cuts this year, along with the implementation of excise taxes on tobacco and sugary products, and the VAT in 2018, will undoubtedly squeeze consumer finances, although the government has moved to mitigate the adverse effects on lower income families via the introduction of the Household Allowance Program.

Deflation unlikely to last beyond 1H17, after which energy price hikes, excise taxes and VAT (in 2018) will push prices up

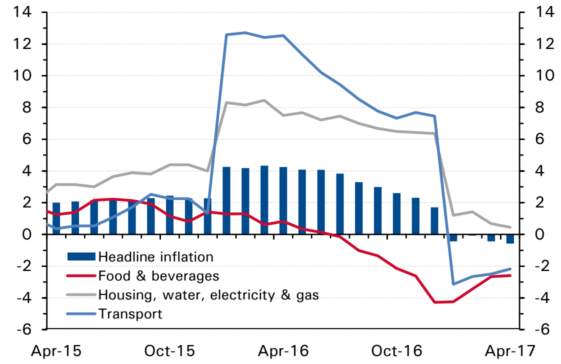
Inflation has been in negative territory since the start of the year, falling to -0.6% y/y in April. (Chart 4.) The downward trend is due to a combination of weak consumer demand, still soft international food prices and lingering base effects relating to last year's subsidy cuts. As a further reflection of anemic demand, real estate prices have also been trending downwards, falling by around 10% y/y. (Chart 5.) Going forward, however, it is more likely that inflation will pick up once the government's second round of energy subsidy cuts are instituted and after the authorities roll out their planned excise taxes on tobacco and sugary products by the middle of the year. The introduction of the VAT in 2018, at a rate of 5%, will also impact consumer prices, and propel the headline inflation rate towards 2.1% in 2018 from a projected 1.4% in 2017.

Fiscal deficit to narrow in 2017-2018 on higher oil prices and fiscal reforms…

Saudi Arabia's 2-year-old budget deficit is likely to extend into 2017 and 2018. The deficit should narrow, however, from last year's high of -16.8%

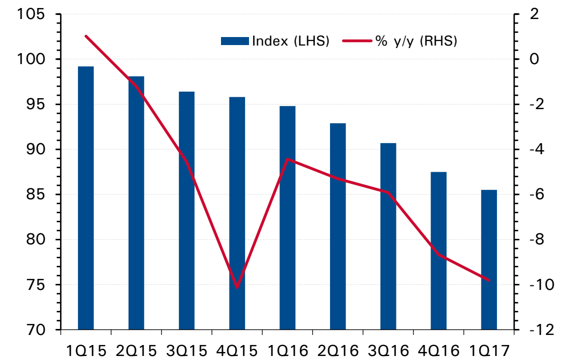
Chart 4: Consumer price inflation

(% y/y)



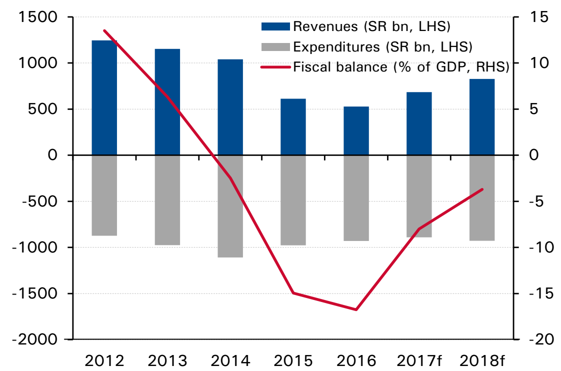
Source: GASTAT

Chart 5: Real estate price index



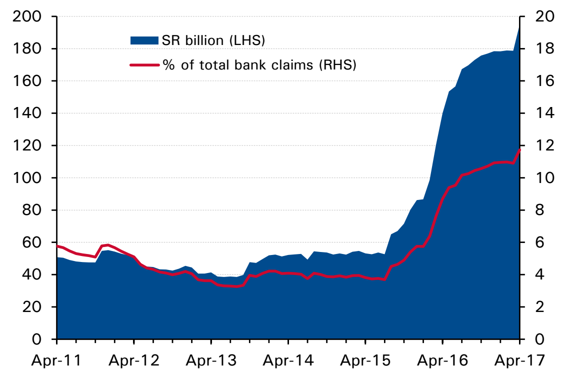
Source: GASTAT

Chart 6: Fiscal balance



Source: SAMA, NBK estimates

Chart 7: Banks' holdings of government bonds



Source: SAMA

of GDP to -8% of GDP in 2017, and to -3.7% of GDP in 2018. (Chart 6.)

The expectation of higher oil prices during the next two years (Brent to average $55/bbl in 2017 and $60/bbl in 2018) and continued fiscal restraint as well new reforms stipulated in the National Transformation Program (NTP) and Vision 2030 documents are behind the improved outlook.

Indeed, judging by recent data for 1Q17, which showed the fiscal deficit halving to SR -26.2 billion ($7 billion) from the pro-rata 1Q17 budget estimate of SR 50 billion ($13 billion), the government appears to have carried through into 2017 some of the fiscal restraint and spending rationalization programs it introduced in 2016. In 1Q17, revenues increased by 72% y/y while expenditures contracted by -3% y/y.

Based on full year figures for 2016, total expenditures were cut by 16% from 2014's historically high level of SR 1,110 billion ($296 billion) to SR 930 billion ($248 billion). Capital expenditures were curtailed by scrapping or deprioritizing non-essential infrastructure projects. Fuel and utility subsidies were cut. Public sector bonuses and allowances were cancelled. (The latter were reinstated in April by royal decree, however).

The second round of fuel and utility subsidy cuts is expected this year as the government pushes ahead with its phased plan to link all fuel, water and electricity prices to international market-based prices by 2020. The estimated savings to the government are in the region of SR 209 billion ($55 billion) by 2020, or around 8.7% of 2016 GDP, as detailed in the government's Fiscal Balance Program (FBP).

The FBP targets a balanced budget by 2020. This it aims to do by improving the efficiency of spending, under the auspices of the newly-established Bureau of Spending Rationalization (BOSP), and by broadening the non-oil revenue base. In the former, the adoption of best practice across government ministries in terms of improving contracting and procurement practices, for example, should lead to cumulative savings of around SR 70 billion ($18 billion) by 2020 and SR 21.4 billion ($4.8 billion) in recurrent annual savings after that. The introduction of a VAT in 2018 plus a host of other taxes and fees (expat levy, 'sin taxes'...) should net the Saudi treasury an additional SR 152 billion ($40 billion) in revenues by 2020. The introduction of VAT could generate about SR 22 billion ($5.8 billion) next year, or 1.5% of non-oil GDP. The authorities hope that by 2020 more than 50% of the kingdom's total revenues will be generated independently of oil—up from 37.7% in 2016.

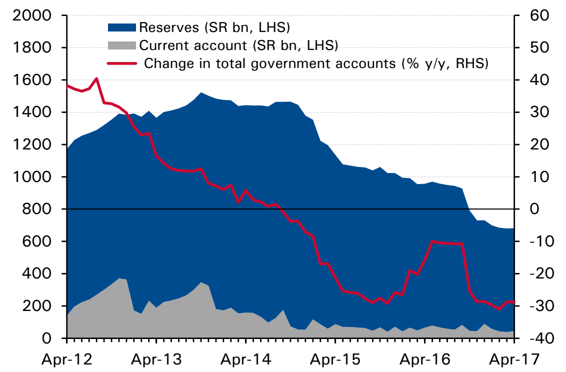
...but government spending expected to increase after 2 years of fiscal restraint

With the above in mind, the government has, nevertheless, adopted an expansionary budget this year (notwithstanding the SR 105 billion in back payments to contractors in late 2016), raising its spending by an estimated 8% as it attempts to soften the impact of continued austerity on consumer spending and to stimulate the non-oil economy. Indeed, this partly explains the reinstatement of previously cancelled state allowances and bonus payments in April 2017.

Fiscal deficit to continue to be financed by a combination of debt issuance and reserve drawdowns

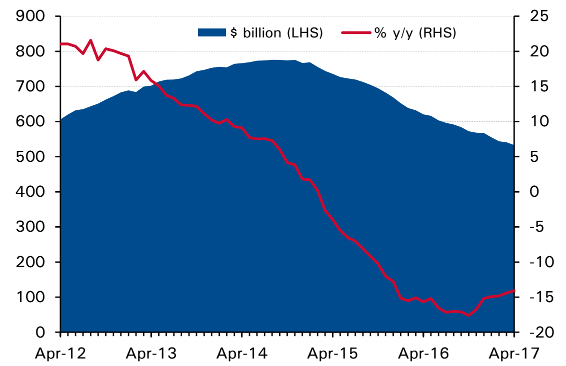
According to the authorities, at least SR 120 billion ($32 billion) in debt will be issued in 2017, equating to about 60% of 2017's deficit. More than half of that will be domestic debt sales (SR 70 billion) and the remainder international issuance. The authorities hope to capitalize on the highly successful sale in October 2016 of $17.5 billion in sovereign bonds,

Chart 8: Government accounts at SAMA



Source: SAMA

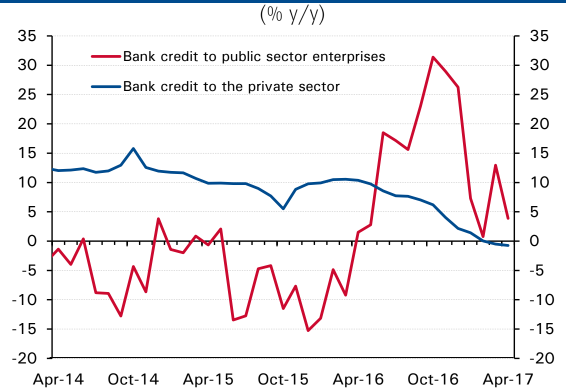
Chart 9: Net foreign assets



Source: SAMA

Chart 10: Bank credit growth

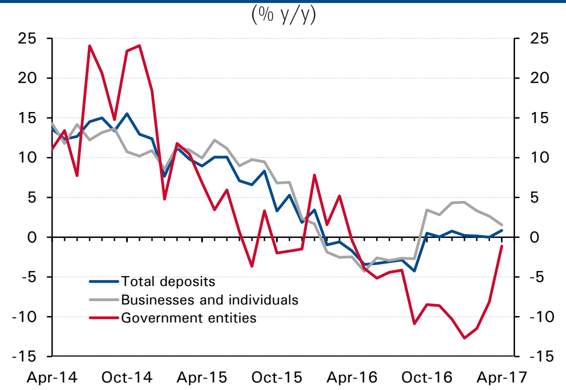
(% y/y)



Source: SAMA

Chart 11: Bank deposit growth

(% y/y)



Source: SAMA

a record for an emerging market, as well as the more recent sovereign sukuk issuance of $9 billion. Banks' holdings of government bonds have, consequently, skyrocketed from a low of SR 38.5 billion ($10.3 billion) in 2013 to almost SR 190 billion ($52 billion) in April of this year; bonds account for almost 11.7% of total banks' claims. (Chart 7.)

Debt issuance should ease the pressure on the government's accounts at SAMA (current account and government reserves), which declined by SR 293 billion, or 28.6%, in 2016—an average monthly drawdown of around SR 24.4 billion ($6.5 billion). According to SAMA's April bulletin, SR 44.6 billion ($11.9 billion) was withdrawn from the government's current account in the first 4 months of 2017, SR 26.2 billion of which was required to cover the government's first quarter fiscal deficit. (Charts 8 & 9.) The remainder appears to have been placed in the banking system, perhaps to improve liquidity or in anticipation of further spending outlays.

Public debt (gross) is forecast to rise from last year's 13.2% of GDP to an estimated 17.7% of GDP this year and peak at around 24.3% of GDP in 2018. (Chart 9.) These levels are low by international standards and the authorities' own stated objective of a maximum permissible debt-to-GDP ceiling of 30% by 2020.

Credit and deposit growth remain lackluster, acting as a brake on economic growth

Both total and private sector bank credit growth turned negative in March, for the first time since December 2009. (Chart 10.) The contraction in credit to the private sector, by -0.8% y/y in April, is particularly worrisome, given how important the sector is to the success of the Saudi Vision 2030. Lending to the construction, commercial and services sectors remains especially weak, and consumer loan growth in 1Q17, at -0.3% y/y, was the lowest since the financial crisis.

Bank deposit growth is also struggling at the moment, even though it has rebounded slightly from last September's low of -4.3% y/y. Growth was 0.9% y/y April. (Chart 11.) We are yet to see, however, evidence of an improvement in the deposit base of banks resulting from higher oil prices, the government's repayments to contractors, or even last October's sovereign bond sale. 6 months on and deposit levels are barely any higher. Commercial banks' deposits with SAMA, on the other hand, have increased to SR 235 billion ($62.6 billion), suggesting perhaps that banks have been shuttling off some of their excess deposits into reserves at the central bank. (Chart 12.)

Further monetary tightening on the cards but, improved liquidity affords the authorities room for maneuver

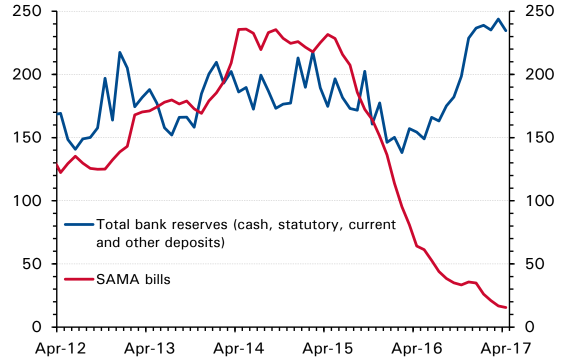
Following the US Fed's lead, SAMA raised its key interest rate, the reverse repo, for the second time this year, by 25 bps from 1.0% to 1.25% in June. The repo rate, however, remains at 2.0%. (Chart 13.) One further 25 bps rate hike may be on the cards during the second half of the year. This would further raise the cost of borrowing in the kingdom at a time of subdued consumer activity, anemic credit growth and low inflation, and should thus require the authorities to take a more considered approach.

Nevertheless, the authorities would seem to have room for maneuver: interbank rates (3-month SIBOR) have fallen by a sizeable 66 bps from their October 2016 high of 2.38% to around 1.72% as liquidity constraints have eased following the sovereign international bond sale. (Chart 14.) Also, pressure on the Saudi riyal in the forwards markets has dropped significantly. (Chart 15.)

Market perceptions of Saudi sovereign risk also seem to be moderating—

Chart 12: Bank reserves and holdings of SAMA bills

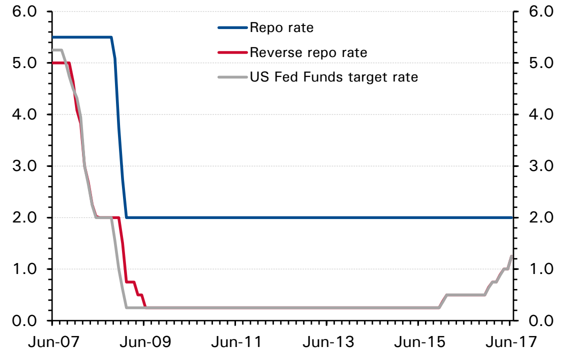
(SR billion)



Source: SAMA

Chart 13: Key interest rates

(%)



Source: Thomson Reuters Datastream

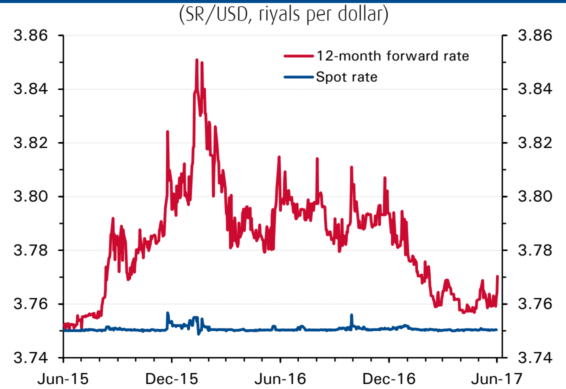
Chart 14: Interbank rates

(%, 3-month SIBOR)

Source: Thomson Reuters Datastream

Chart 15: Saudi riyal 12-month forward rate

(SR/USD, riyals per dollar)



Source: Thomson Reuters Datastream

and this comes despite Fitch's recent ratings downgrade of Saudi's long term foreign and local currency ratings to A+ from AA-.

Oil price weakness and a spate of downward revisions to Saudi economic prospects continue to weigh on market sentiment

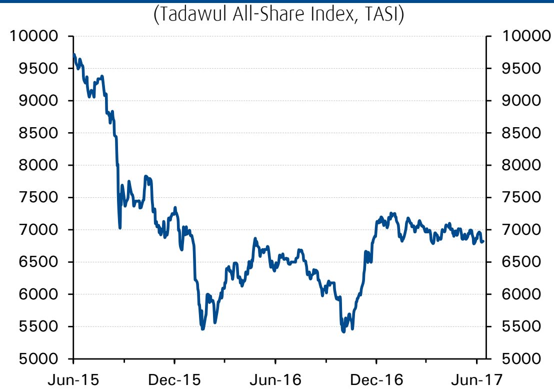
Halfway into the year and the main Saudi stock index, the Tadawul All-Share Index (TASI), remains down by more than 5% year-to-date at around 6,822. (Chart 17.) The bourse continues to suffer from weak sentiment despite better-than-expected corporate and bank profits in 1Q17 and despite the king's reinstatement of state allowances in late April. The retreat in oil prices, the IMF's downward revision to Saudi growth and Fitch's debt rating downgrade all appear to have cast a long shadow over the index.

Nevertheless, the Saudi bourse, in conjunction with the regulatory authorities (CMA), continues to press ahead with reforming and modernizing the stock market in order to bring it up to international standards and increase its appeal to foreign investors. New measures introduced recently include: short selling, a first for the middle east; a two-day trade settlement cycle (T+2); new regulations for REITs; and less stringent restrictions on investments by qualified foreign investors (QFI), whereby the AUM requirement has been reduced from $5 billion to $1 billion and the single stock ownership limit of QFIs raised from 5% to 10%. The authorities hope that such measures will help the bourse gain inclusion in emerging market indices such as the MSCI EM Index and the FTSE Global Equity Index. The MSCI is expected to decide on whether the kingdom is on its review list next month, while the FTSE decision is expected in September.

Then there are the preparations for arguably the showpiece event in the realization of the Saudi Vision 2030: the part-privatization of Saudi Aramco. Up to 5% of the energy giant is expected to be publicly listed either next year or in 2019, generating at least $45 billion in proceeds (based on an Aramco valuation of $900 billion) for the kingdom's newly designated SWF, the Public Investment Fund (PIF). According to Prince Mohammed Bin Salman, 50-70% of the proceeds of the Aramco sale will be invested in local industries such as mining, entertainment and defense; a total of SR 500 billion ($133 billion) will be invested within 3 years of the Aramco IPO.

Chart 16: Stock exchange index

(Tadawul All-Share Index, TASI)



Source: Thomson Reuters Datastream

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