Macroeconomic outlook

Saudi Arabia: Economic activity slows as fiscal consolidation proceeds apace

> Omar Al-Nakib
Senior Economist
+965 2259 5360, omarnakib@nbk.com

Overview and outlook

- **Growth is forecast to slow from 3.5% in 2015 to 1.2% in 2016 amid greater fiscal restraint and slower consumer activity.**
- **Inflation is expected to rise to 3.6% in 2016 following fuel and utility price hikes but moderate thereafter.**
- **The fiscal deficit should narrow to -12.1% of GDP in 2016 from -15.3% of GDP in 2015 as the authorities' fiscal consolidation proceeds.**
- **Debt is replacing government reserves as the main source of deficit financing, with rising domestic and international bond issuance.**
- **Liquidity appears to be improving following government repayments to contractors and thanks to the sovereign bond sale.**
- **TASI turned positive in mid-Dec on renewed optimism following the international bond sale and OPEC's output deal, which boosted oil prices.**

More than two years into the oil price downturn and Saudi economic growth has slowed significantly. Public investment has been pared back, credit growth has slowed and liquidity has tightened amid reduced deposit flows and rising debt issuance. Facing the prospect of widening fiscal deficits, the authorities have cut back on spending and embarked on a bold and ambitious program of fiscal consolidation. They froze public sector salaries and benefits, cut fuel and utility subsidies, scaled down public investment projects and raised non-oil revenues via tax hikes and privatization programs. These and other measures form part of the government's new strategic blueprint for economic restructuring, diversification and fiscal sustainability: the Saudi Vision 2030. Looking ahead, we see the authorities delivering on some of their goals, economic growth resuming, albeit, modestly, in 2018, helped by higher oil prices and by a recovery in consumer and investor confidence.

Real growth to slow in 2016 as fiscal consolidation and subdued private sector activity take their toll on the non-oil economy

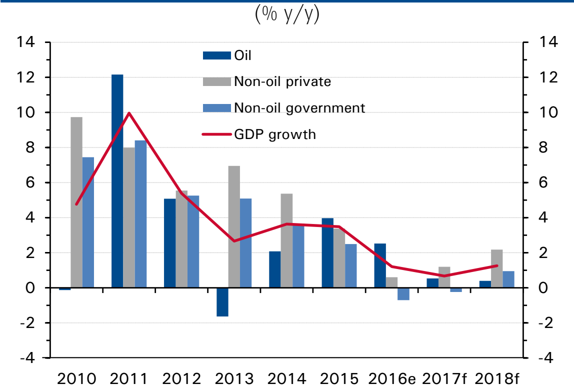
Real GDP is expected to slow significantly in 2016 to 1.2% from 3.5% in 2015 amid cutbacks in capital spending and weaker consumer spending. (Chart 1.)

Key economic indicators

		2015	2016e	2017f	2018f
Real GDP growth	% y/y	3.5	1.2	0.7	1.3
Oil	% y/y	4.0	2.5	0.5	0.4
Non-oil	% y/y	3.1	0.2	0.8	1.9
Inflation	% y/y	2.2	3.6	2.5	4.3
Fiscal balance	% of GDP	-15.0	-12.1	-7.5	-6.7
Public debt	% of GDP	5.9	13.0	18.3	23.6

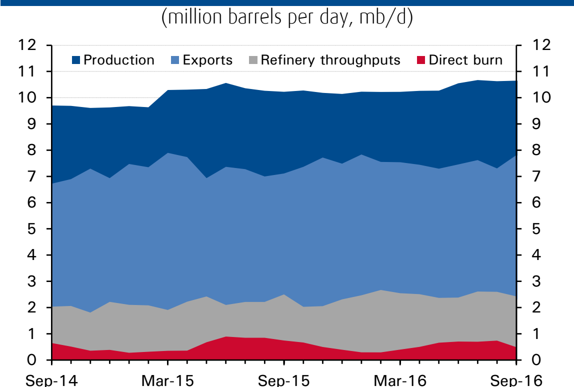
Sources: Official sources and NBK estimates

Chart 1: Real GDP growth
(% y/y)



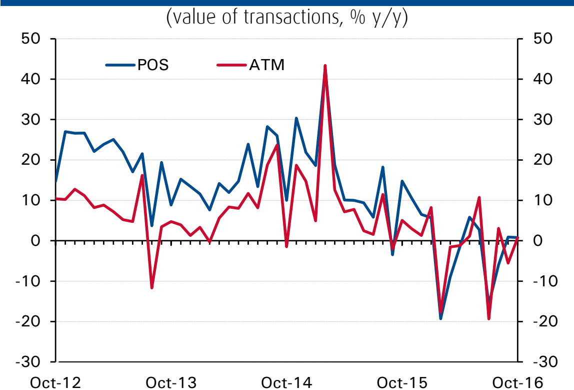
Source: General Authority for Statistics, NBK estimates

Chart 2: Oil production, exports and consumption
(million barrels per day, mb/d)



Source: JODI, OPEC

Chart 3: ATM and POS transactions growth
(value of transactions, % y/y)



Source: Saudi Arabian Monetary Agency (SAMA)

Non-oil growth is also projected to slow considerably in 2016, from 3.1% y/y in 2015 to 0.2% y/y, as the government pushed through with aggressive fiscal consolidation and as the private sector feels the impact of lower retail spending and the overall fall in consumer confidence. Indeed, the non-oil economy could be on the verge of a technical recession, should soon-to-be-published 3Q16 real GDP data show another quarter of negative growth. Key metrics of consumer and business activity, such as point of sale (POS) and ATM transactions, private sector credit growth and the Purchasing Managers' Index (PMI), all trended lower in 2016, although the latter was more volatile m/m and did not dip below 50, which would have suggested a contraction in business activity. (Charts 3-5.) Looking ahead to 2017 and 2018, activity is expected to pick up as the government resumes paying contractors and as deposits increase on higher oil prices and thanks to the international bond issuance. With deposit flows rising, lending should also pick up. We expect non-oil growth to reach 0.8% and 1.9% in 2017 and 2018, respectively.

Meanwhile, the oil sector continued to expand in 2016, with the kingdom ramping up both crude oil production—to a record 10.5 million barrels a day (mb/d) in 2016—and gas production following the commissioning of the Wasit gas plant. Since oil prices headed south in 2014, Saudi Arabia has pursued its strategy of maximizing market share and accelerated its plan to move up the hydrocarbon value-chain by expanding its refining capacity. The launches of the Satorp and Yasref refineries brought an additional 0.8 mb/d of refined products output capacity. Real oil GDP growth should clock in at 2.5% in 2016 before moderating to 0.5% in 2017 and to 0.4% in 2018 as output gains recede and as Saudi Arabia complies with its reduced production quota under the terms of the recent OPEC/non-OPEC production cut agreement. While Saudi crude output is expected to contract in accordance with the agreement, on a full year basis, we don't expect production to decline by as much as the 4.5% stipulated in the deal.

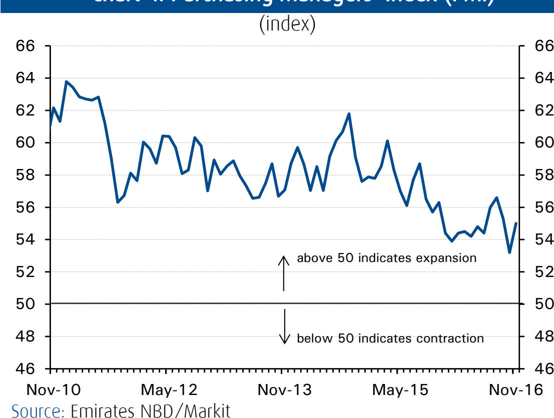
Inflation slowing as economic activity cools

Inflation was on a downward trend in 2016, slowing for the seventh consecutive month in October, to 2.6% y/y. (Chart 7.) Food and beverages were the chief negative influence on the cost of living index. The moderation in inflation comes despite a significant uptick at the start of 2016 in response to the government's fuel and utility price hikes. With their effects on headline inflation receding throughout the year, increases in the CPI thus tended to reflect other factors such as falling import prices, especially food and clothing (related to the stronger USD and SR in 2016) and moderating house price inflation as well as, more broadly, the contraction in money supply that was a feature for most of the year. The trend should continue into 2017, bringing inflation down to 2.5% before rebounding in 2018 to 4.3% as the economy picks up. Higher energy and utility costs and higher taxes (including VAT) will also pressure CPI in 2018.

A third consecutive fiscal deficit is expected in 2016 but fiscal reforms and higher oil prices should see the budget in balance by 2020

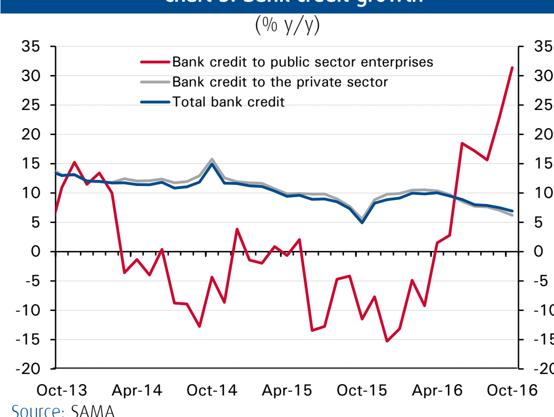
Saudi Arabia's fiscal deficit, having widened significantly in 2015 to -15% of GDP ($96.6 billion), is expected to narrow in 2016 to -12.1% of GDP and further over the forecast period as the government reins in its spending, including its expensive subsidy bill. (Chart 8.) Of course, expectations that oil prices will be 33% higher in 2018 (averaging $60 per barrel) than their average in 2016, is central to the improvement in the fiscal outlook.

Chart 4: Purchasing Managers' Index (PMI)



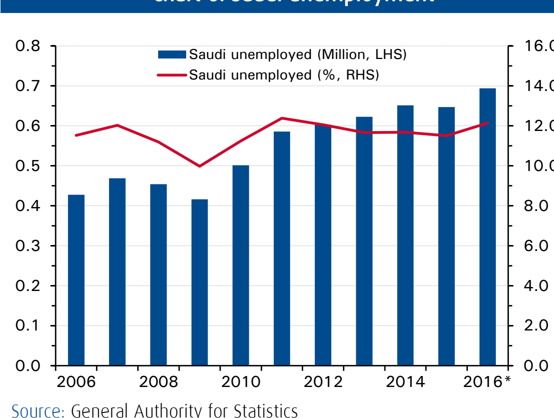
Source: Emirates NBD/Markit

Chart 5: Bank credit growth



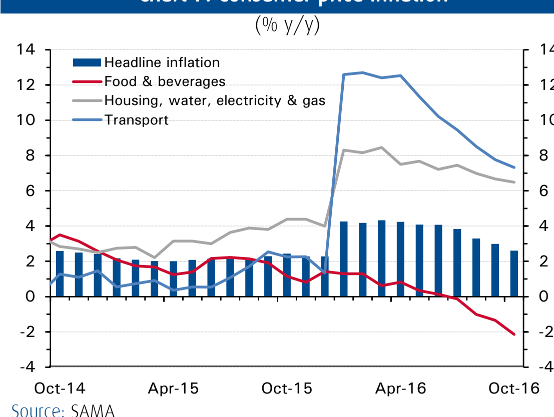
Source: SAMA

Chart 6: Saudi unemployment



Source: General Authority for Statistics

Chart 7: Consumer price inflation



Source: SAMA

Indeed, given the surprising degree of progress achieved so far, in what is undoubtedly a very bold and ambitious fiscal adjustment program, there is a very realistic chance that the authorities will deliver on their National Transformation Program (NTP) target of a balanced budget by 2020. Subsidies on fuel and utilities have already begun to be reduced (working towards the NTP target of a cut of SR200 billion, or 8.3% of GDP, over 5 years), wages and benefits for public sector workers have been frozen for a year (the NTP sets a target of reducing the wage bill by 5% to SR456 billion by 2020), and outlays on non-essential capital projects have been scaled back, by an estimated 12% in 2015 and 2016.

On the revenue side, though the NTP plan of more than trebling non-oil revenues to SR530 billion ($141 billion, or 17.3% of GDP) by 2020 still appears ambitious, the authorities have made some headway in tapping new non-oil revenues. These include: higher fees on public services, immigration and traffic violations; new taxes on cigarettes and soft drinks as well as on undeveloped urban land (so-called "white lands"); and the introduction of a value-added tax (VAT), which will come into effect in 2018 at a rate of 5%. A rough estimate of the gain to the Saudi treasury resulting from the VAT could be in the order of $10 billion, which would approximate to about 16% of projected non-oil revenues in 2018 and 1.4% of forecasted GDP in that year.

The privatization of state entities, including up to 5% of state oil giant Saudi Aramco, and the transformation of the Public Investment Fund (PIF) into the kingdom's official SWF with a global footprint and assets under management of at least $1.8 trillion by 2030, are key strategic objectives of the Saudi Vision 2030. (See table below.)

Key Vision 2030 objectives

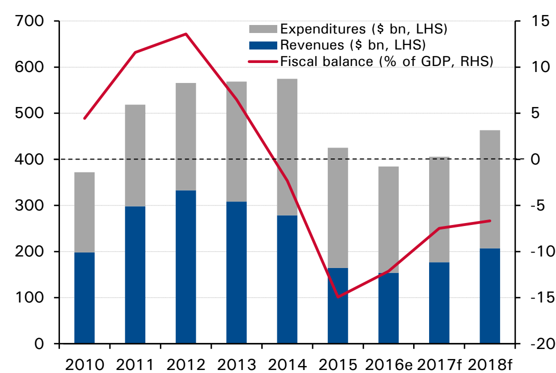
		2015	2030
Private sector	% of GDP	40	65
Small & medium-sized enterprises (SME) sector	% of GDP	20	35
Non-oil exports	% of non-oil GDP	16	50
Non-oil revenue	% of GDP	6.7	16.8
Domestic oil & gas production	%	40	75
Domestic procurement of defense equipment	%	2	>50
Public Investment Fund (PIF) assets	$ billion	160	1,866
Foreign direct investment (FDI)	% of GDP	3.8	5.7
Global Competitiveness Index	Rank	25	10
Unemployment rate	%	11.6	7.0
Female labor force participation rate	%	22	30
Number of pilgrim tourists per year	Million	8	30
Social Capital Index	Rank	26	10
Household savings rate	%	6	10

Source: Saudi Vision 2030

Public debt rises as the authorities proceed with their bond issuance program; the pressure on foreign reserves eases though

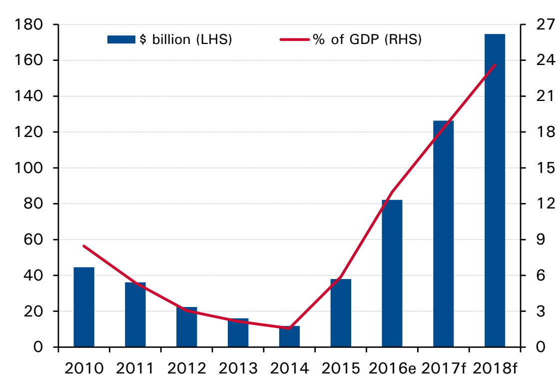
With Saudi Arabia expected to continue to post fiscal deficits over the next few years, public debt is projected to rise markedly from its historic low of 1.6% of GDP in 2014 to at least 23% of GDP in 2018. (Chart 9.) This is, however, still an extremely low level of debt by international standards. Up until mid-to-late 2016, when domestic and international bond issuance accelerated, the burden of deficit financing fell squarely on the kingdom's foreign reserves and the government's accounts at SAMA. Since June 2016, the rate of reserve drawdown has slowed significantly to $7.8 billion per month from an average of $10.9 billion per month in 1H16. Total net foreign assets stood at $572 billion in October, which is still an ample 30 months-plus in terms of goods and services import cover. (Chart 10.)

Chart 8: Fiscal balance



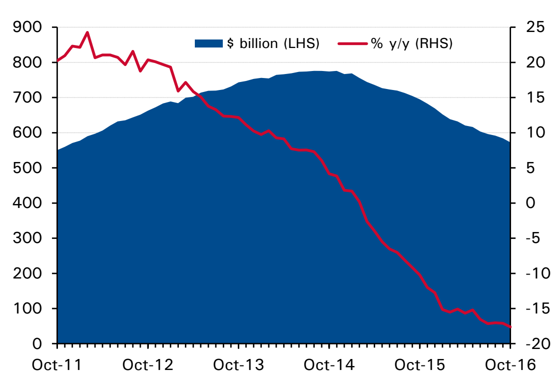
Source: SAMA, NBK estimates

Chart 9: Public debt (gross)



Source: SAMA, NBK estimates

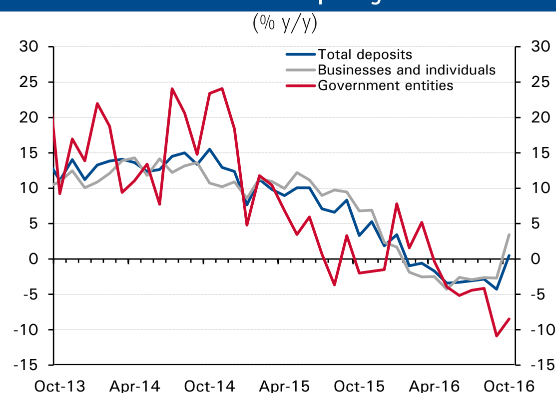
Chart 10: Net foreign assets



Source: SAMA

Chart 11: Bank deposit growth

(% y/y)



Source: SAMA

2015 witnessed approximately SR98 billion ($26 billion) worth of government bonds sold to local financial institutions, which helped to cover a quarter of the deficit. In 2016, the authorities augmented their domestic bond issuance program with an additional, record-breaking $17.5 billion international sovereign bond sale and a $10 billion syndicated loan from foreign banks. We expect bond issuance to proceed apace during the next two years, with probably at least another $80 billion added to central government debt.

Liquidity conditions improving with a resumption of deposit growth; private sector credit growth remains lackluster, however

Deposit, credit and liquidity indicators continue to point to a banking system that has been pressured by the fall in oil prices, albeit, one that is showing some signs of a recovery following Saudi Arabia's record international bond sale in October 2016. Bank deposit growth turned positive in October for the first time in 2016, rising by 0.5% y/y on a slight improvement in private sector deposits (3.4% y/y) after the government resumed payments to private contractors. (Chart 11.) This should continue over the next few months as the government honors $26.7 billion in back payments. However, deposits from government entities still remain well down, by -8.5% y/y, and are unlikely to expand significantly without higher oil prices. The pick-up in deposits was also reflected in the money supply, with growth in the broadest measure, M3, turning positive in October for the first time since January 2016. (Chart 12.)

On the credit side, lending to the private sector has been lackluster; October showed a rise of only 6.2% y/y, which is one of the slowest rates since 2011. (See Chart 5.) In contrast, public sector credit growth accelerated significantly in 2016, rising to 31.4% y/y in October. This is the fastest pace of growth in more than three years, a trend that is likely to continue as the government borrows more from banks.

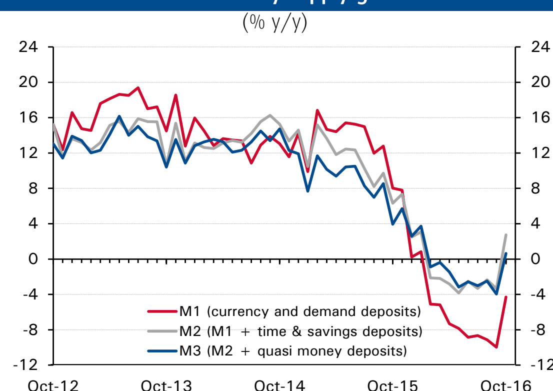
Despite overall deposit growth lagging credit growth, indicators of liquidity in the Saudi banking system have started to improve: banks' loan-to-deposit ratio (LDR) eased a little last October to 89.1%; the 3-month interbank rate has fallen by around 33 bps from its high of 2.38% in October to around 2.05% as of mid-December; and excess bank deposits at SAMA have increased 24% y/y to almost $53 billion, according to the most recent data. (Charts 13 & 14.)

A number of measures, including the resumption of long-delayed government payments to private contractors, have contributed to this easing in liquidity. SAMA, for example, has alleviated some of the liquidity constraints through its broadening of the window for repo arrangements, reducing the size of its T-bill issuances and by injecting SR20 billion ($5.3 billion) into the deposits of public sector companies. Also, the kingdom's record-breaking $17.5 billion international sovereign bond issuance in October, of course, has the potential to significantly improve liquidity as well as the government's fiscal situation. The bond sale should indirectly help the private sector as well by lessening the pressure on domestic banks to finance the government, thereby freeing up credit lines for private enterprises. These are vital for a healthy and dynamic non-oil economy. Indeed, government bonds, as a share of total bank claims, went from a low of 3.3% in 2013 to a post-financial crisis high of 10.6% in October as bank holdings of government bonds skyrocketed in 2016 to $46.9 billion. (Chart 15.)

Market perceptions of Saudi sovereign risk moderating

The material improvement in banking sector metrics is reflected in the

Chart 12: Money supply growth

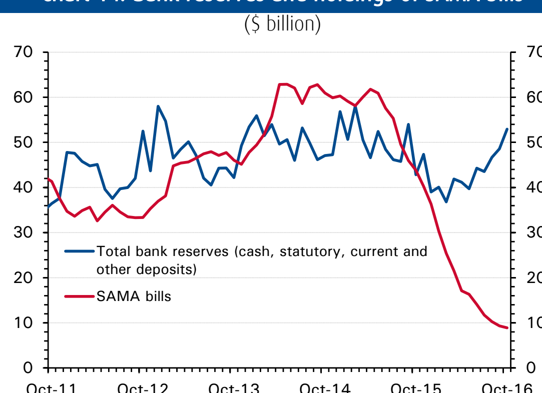


Source: SAMA

Chart 13: Interbank rates

Source: Thomson Reuters Datastream

Chart 14: Bank reserves and holdings of SAMA bills



Source: SAMA

Chart 15: Bank holdings of government bonds

Source: SAMA

improvement in market perceptions of risk. In the currency markets, the difference between the spot and forward Saudi-US Dollar exchange rate (SR/USD) narrowed to around 300 forward points by mid-December, having hit its widest margin of 975 points in two decades earlier in the year on speculation that the authorities would be forced to devalue the riyal, in effect abandoning the 30-year peg to the US dollar. (Chart 16.)

The kingdom is, however, unlikely to shift away from an exchange rate regime that has served it well in the past, anchoring both the economy and inflation. The dollar peg provides stability to trade and income flows, especially given the fact that oil, which is priced in dollars, continues to dominate the Saudi economy. Over the last decade, with the exception of 2015, oil has accounted for close to 90% of the kingdom's export and fiscal revenues.

5-year credit default swap spreads (CDS), though still elevated, have also fallen in the last few months as the outlook has improved. (Chart 17.) Expectations of higher oil prices in 2017 and beyond in the wake of the recent OPEC deal is also a key factor in the improvement in sentiment.

Borrowing costs rise after the US Fed raises interest rates

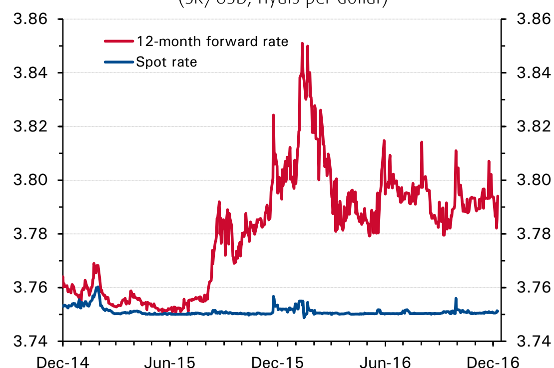
SAMA, following the US Fed's lead, raised its key interest rate, the reverse repo, by 25 bps to 0.75% in December. The repo rate remains unchanged at 2.0%. (Chart 18.) This, the second rate rise in this cycle, points to further rising borrowing costs, as the US Fed moves ahead with monetary policy tightening in 2017.

Optimism returns to the Saudi bourse following the successful sovereign bond sale and the OPEC output cut agreement

The main Saudi stock index, the Tadawul All-Share Index (TASI), reversed course in October after being down -21% ytd at one point in the year. As of mid-December, the index was in positive territory, up 3.3% ytd at 7,137, as it continued to ride on the marked improvement in optimism that came about in 4Q16 thanks to the international bond sale and the OPEC production cut agreement, which was positive for oil prices. (Chart 19.)

Chart 16: Saudi riyal 12-month forward rate

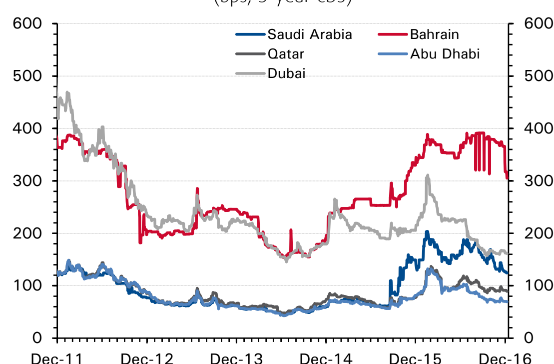
(SR/USD, riyals per dollar)



Source: Thomson Reuters Datastream

Chart 17: Credit default swaps (CDS)

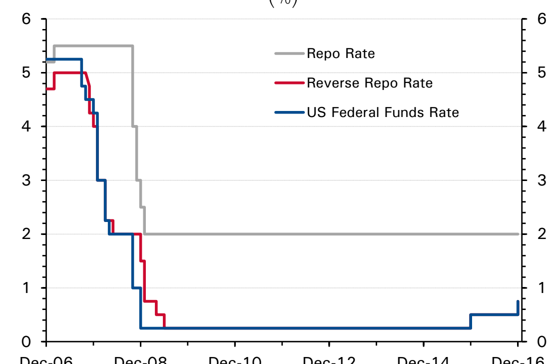
(bps, 5-year CDS)



Source: Thomson Reuters Datastream

Chart 18: Key interest rates

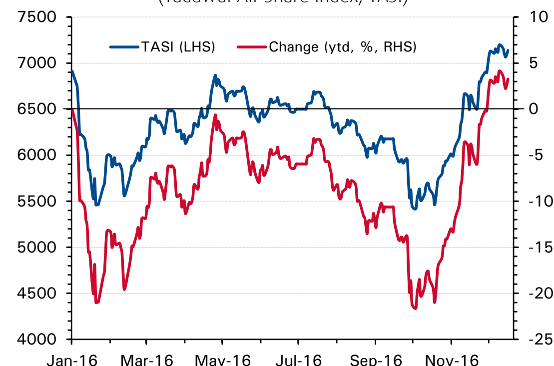
(%)



Source: Thomson Reuters Datastream

Chart 19: Stock exchange index

(Tadawul All-Share Index, TASI)



Source: Thomson Reuters Datastream

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Representative Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

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