22 December 2016

www.alahli.com

Saudi Arabia's 2017 Budget Report

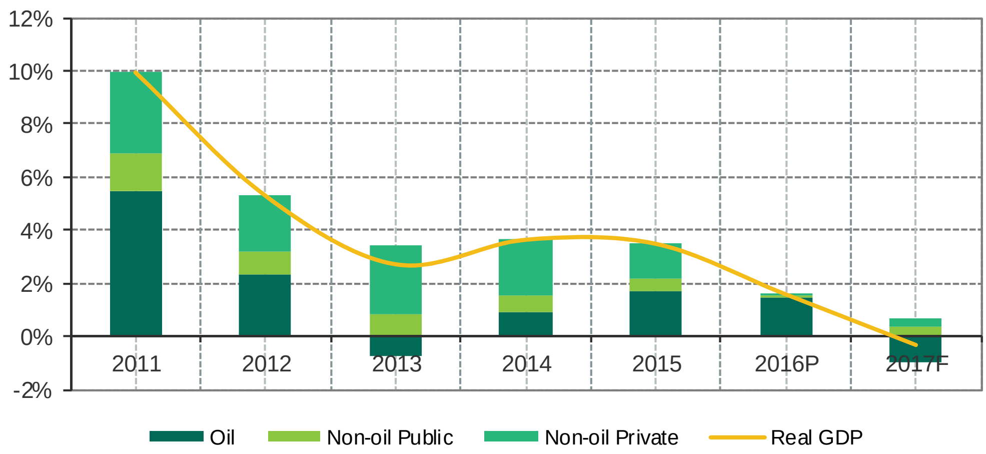
Timely, Targeted and Expansionary Fiscal Policy

Contents

Highlights and NCB Views

On Thursday, 22 December 2016, the Council of Ministers endorsed the government's budget for 2017 and announced the final outcome of fiscal operations and macroeconomic performance for 2016. The highlights are:

- In 2016, actual government expenditures are expected to record their first back-to-back decline since 1999, falling by 15.6% to settle at SAR825 billion. Actual spending will also be 1.8% below budget, which is an inflection from the historical tendency to post double-digit budget overruns.
- The Saudi economy will register a moderate growth of 1.4% in 2016 on the back of higher oil production that averaged 10.4 MMBD.
- The government maintained a two pronged strategy of covering the funding gap via drawing down reserves and debt issuances. Net foreign assets currently stands at USD536.6 billion while the government's debt increased to SAR316.5 billion.
- The government had adopted a targeted fiscal expansionary policy in 2017 after two years of fiscal consolidation that saw government spending falling by a significant 27% from an unsustainable SAR1 trillion in 2014. The increased expenditure will be directed towards projects and initiatives that enhance the absorptive capacity of the economy.
- 2017 annual budget release estimates revenues at SAR692 billion, a gain of 34.7%, while expenditures are expected to reach SAR890 billion, increasing by 6.0%. Accordingly, the budget will register another deficit, albeit lower than the last two years, supported by both oil and non-oil revenues.
- According to our estimates, oil prices will average USD55/bbl for the Arabian light spot price and production will average 10.05 MMBD, thus, we project revenues and expenditures to reach SAR702.5 billion and SAR882.8 billion, respectively, registering a deficit of SAR180.2 in 2016.
- Gauging the macroeconomic risks through the debt level, adequacy of reserves and financial stability reveals that Saudi is well poised to encounter possible future shocks.



Said A. Al Shaikh
Chief Economist | s.alshaikh@alahli.com

Authors

Tamer El Zayat
Senior Economist/Editor | t.zayat@alahli.com

Majed A. Al-Ghalib
Senior Economist | m.alghalib@alahli.com

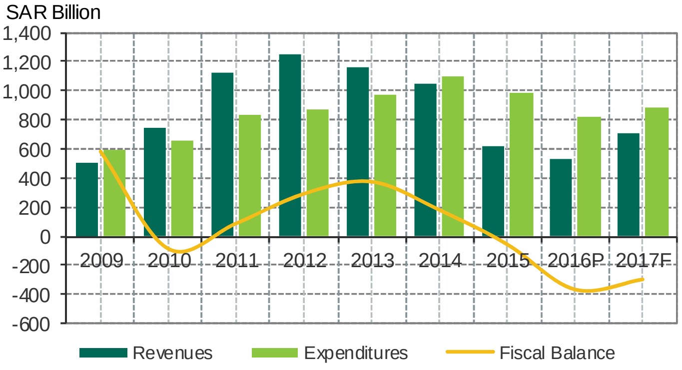
Macroeconomic Indicators	2012	2013	2014	2015	2016P	2017F	Latest
Real Sector							
Average Arab Light Spot (USD/bbl)	110.2	106.4	97.2	50.2	40.0	55.0	39.9
Average Saudi Crude Oil Production (mbd)	9.8	9.6	9.7	10.2	10.4	10.1	10.4
GDP at Current Market Prices (SAR billion)	2,752.3	2,791.3	2,826.9	2,422.5	2,573.2	2,707.8	-
GDP at Current Market Prices (USD billion)	734.9	745.3	754.8	646.9	687.1	723.0	-
Real GDP Growth Rate, %	5.4%	2.7%	3.6%	4.5%	1.4%	-1.0%	-
CPI Inflation (Y/Y % Change, Average)	2.9%	3.5%	2.7%	2.2%	3.4%	2.0%	2.6%
External Sector							
Trade Balance (USD billion)	246.6	222.6	184.0	47.3	29.1	73.6	-
Current Account Balance (USD billion)	164.8	135.4	73.8	-53.5	-69.5	-22.2	-
Current Account/GDP	22.4%	18.2%	9.8%	-8.3%	-10.1%	-3.1%	-
Net Foreign Assets with SAMA (USD billion)	648.5	717.7	725.2	609.7	542.5	505.2	537
Fiscal Sector							
Actual Revenues (SAR billion)	1,247.4	1,156.4	1,044.4	612.3	528.0	702.5	-
Actual Expenditure (SAR billion)	873.3	976.0	1,100.0	978.0	825.0	882.8	-
Overall Budget Balance (SAR billion)	374.1	180.3	-55.6	-365.7	-297.0	-180.2	-
Budget Balance/GDP	14%	6%	-2%	-15.1%	-11.5%	-6.7%	-
Break-Even Oil Price (USD/bbl)	73.9	82.6	99.1	82.9	62.6	69.8	-
Financial Sector							
SAR/USD Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.9%	10.9%	11.9%	2.6%	-1.4%	2.3%	0.6%
Growth in Credit to the Private Sector	16.4%	12.1%	11.9%	9.8%	6.5%	4.1%	6.2%
Average 3M SAR Deposit Rate	0.9%	1.0%	0.9%	0.9%	2.3%	3.0%	2.1%

Source: Reuters, SAMA, GAS and NCB

I. Macroeconomic and Fiscal Performance in 2016

The budget deficit eased on the back of fiscal discipline and efficiency measures. Fiscal consolidation contained total expenditures for the second year in a row to settle at 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. In 2016, revenues fell by 13.8% to reach SAR528 billion, yet higher than the budgeted revenues of SAR514 billion by 2.8%. Accordingly, the budget balance recorded a deficit of SAR297 billion, representing 11.5% of GDP.

Figure (1): Fiscal Balance

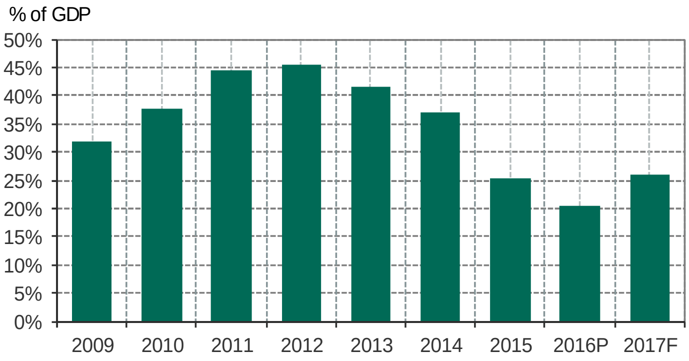


Sources: MOF, SAMA and NCB

Non-oil revenues posted a record while oil revenues contracted on the back of lower oil prices. OPEC's battle for market share against high-cost producers, with the Kingdom producing at record levels, as well as moderating global oil demand, pressured Arabian Light crude price that averaged USD40/bbl in 2016YTD. Consequently, domestic oil revenues decreased to settle at SAR329 billion, 26.3% below 2015's level. However, the surprising inflection in OPEC's strategy that abandoned "pumping at will" in favor of rebalancing the oil markets through a 1.2 MMBD production cut will be supportive for prices in the coming quarters. Meanwhile, non-oil revenues 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 register SAR62.2 billion. Looking ahead, the myriad changes to municipal and visa fees as well as the 2.5% vacant land fees will be fully realized next year, which will propel the non-oil item.

The Kingdom is adamant to streamline spending to ensure fiscal sustainability. Government expenditures are expected to record their first back-to-back decline since 1999 this year. The broad-based fiscal adjustment resulted in a drop of 15.6% in actual expenditures, which was also 1.8% below budget, an inflection from the historical tendency to post double-digit budget overruns. The government had started to ease the CAPEX drive, given its elastic nature, evident from an expected SAR100 billion drop in investments during this year, which brought total capital expenditure to an estimated SAR183 billion, with USD44.5 billion worth of projects put on hold. We expect current expenditures to have contracted to SAR642 billion, a decline of 6.2% Y/Y, as the government started to streamline operating expenses and contain allowances. The full benefit from the Royal decree to freeze public salaries and constrain allowances will be reaped in 2017.

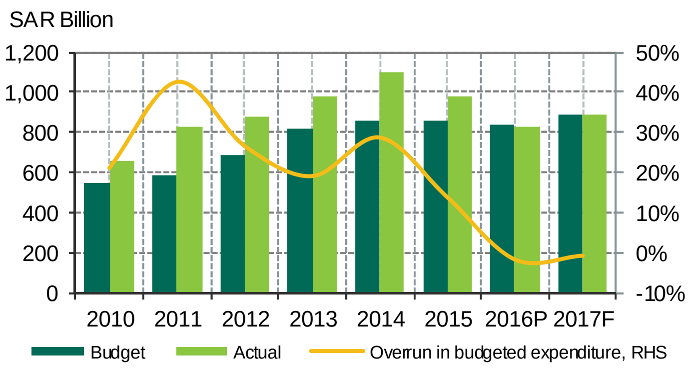
Figure (2): Fiscal Revenues in % of GDP



Sources: MOF, SAMA and NCB

The external balance is expected to remain pressured given the inherent volatility of the oil markets. 2017 budget did not release the balance of payments data, yet we expect a deficit of USD69.5 billion, equating to 10.1% of GDP. A stronger dollar, moderating domestic demand and contained commodity prices for most of the year will reduce the import bill by 12.5% on an annual basis to settle at USD134.8 billion. However, low oil prices will curtail exports to USD163.9 billion, an 18.9% decline, despite oil production peaking in July at 10.7 MMBD. Accordingly, the trade balance will fall drastically to USD29.1 billion, 38.5% Y/Y decline. We expect exports to rebound in 2017 and beyond as oil prices edge higher, positively impacting the trade balance and restraining the current account deficits. The government maintained a two pronged strategy of covering the funding gap via drawing down reserves and debt issuances. As such, net foreign assets fell by USD73 billion to USD536.6 billion by end of October, yet as we expected last year the draw down was slower compared to USD84

Figure (3): Budgetary Overruns

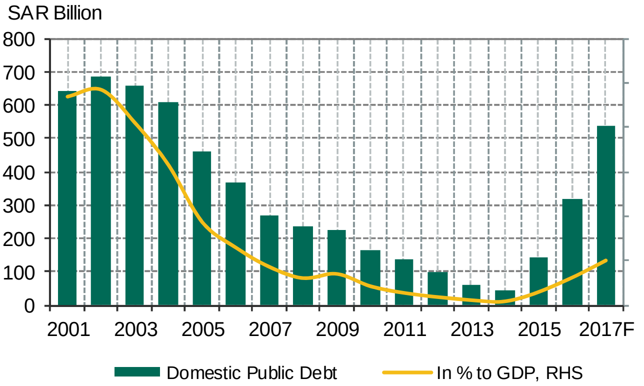


Sources: MOF, SAMA and NCB

billion withdrawn during the similar period of 2015. Importantly, official net foreign assets remain at a healthy position, equivalent to approximately 48 months of imports.

International and domestic debt issuances propelled total outstanding public debt to SAR316.5 billion, amounting to 12.3% of GDP, yet it remains significantly low compared to regional and international counterparts. The debt instruments included local issuances worth SAR97 billion, a USD10 billion international syndicated loan arranged in May as well as a USD17.5 billion international debt issued in October. The newly created Debt Management Office at the Ministry of Finance had clearly diversified the debt portfolio by tapping into international capital markets, a shift from the long standing policy of only raising debt domestically. Critically, a crowding-out effect resulting in tighter liquidity amid the rising issuances of domestic bonds was a major concern, with the three months interbank offer rate rising to 2.39%, a multi-year high by the end of October. However, SAMA had been proactive to mitigate this issue via different measures that included the injection of SAR32 billion into the banking sector, especially for small and medium-sized banks. In addition, the central bank in October limited the weekly subscription in T-bills from SAR9 billion to SAR3 billion and extended repo maturities to 90 days, complementing the maturities of 1, 7, and 28 days. These monetary policy decisions coupled with the Kingdom's international bond sale, an emerging markets record, were beneficial to the banking system in reducing leakage especially that local banks subscribe in the monthly issuances of government bonds, thus, driving the interbank rate lower to 2.1% in December.

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

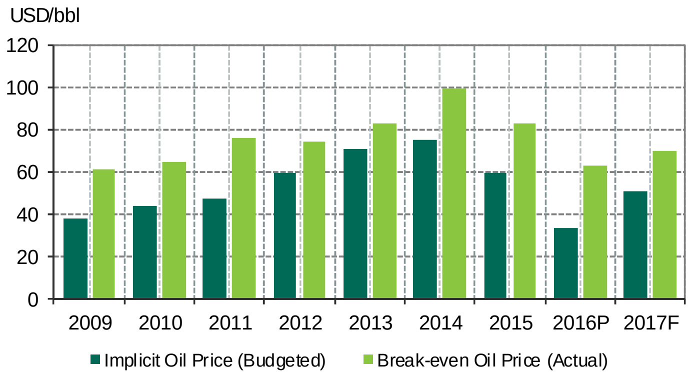


Sources: MOF and SAMA

II. Fiscal Budget Outlook in 2017: Timely, Targeted and Expansionary Fiscal Policy

The government had adopted a targeted fiscal expansionary policy in 2017 after two years of fiscal consolidation that saw government spending falling by a significant 27% from an unsustainable SAR1 trillion in 2014. The increased expenditure will be directed towards projects and initiatives that enhance the absorptive capacity of the economy. Additionally, the government will continue to revamp and overhaul archaic policies and regulations to encourage domestic and foreign investment. 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. The education and healthcare sectors remain pivotal to the strategy of the Kingdom as their allocations represent over 36.0% of total allocations. According to the government, the budget will register another deficit in 2017, albeit lower than the last two years, supported by both oil and non-oil revenues. However, downside risks emanating from geopolitical uncertainties, global macroeconomic conditions, and domestic liquidity concerns will constitute the main challenges for these estimates going forward.

Figure (5): Implicit Budget Oil Price



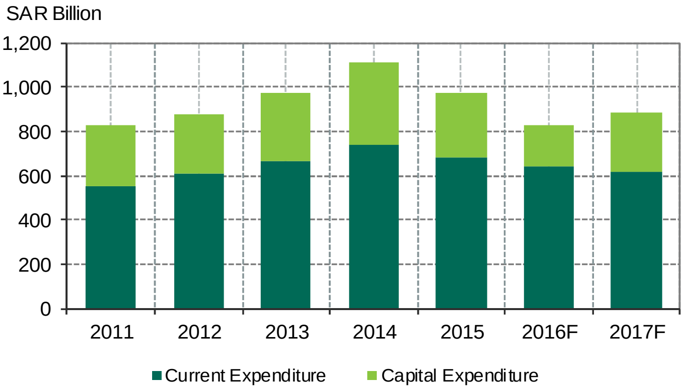
Sources: NCB

The government's disciplined and realistic approach in estimating revenues and avoiding spending deviations since last year implies that underestimating both revenues and expenditures in prior budgets is a discarded practice. The budget does not provide oil price expectations and production level assumptions. However, based on announced figures, government's assumed oil price for next year is USD50/bbl. In our opinion, oil prices will average USD55/bbl for the Arabian light spot price and production will average 10.05 MMBD, thus, we project revenues and expenditures to reach SAR702.5 billion and SAR882.8 billion, respectively. Accordingly, the budget deficit is projected to reach SAR180.2 billion, 6.7% of estimated GDP in 2017.

Actual expenditures in 2017 will be close to the government budget, with more emphasis on capital expenditures. Current expenditures will represent 70.0%, or SAR617.9 billion, of the budgeted SAR890 billion.

The freeze on public sector employees' allowances will reduce the wage bill by an estimated SAR20-30 billion. As for capital expenditures, an estimated SAR262 billion will be directly allocated rather than through last year's discretionary budget support provision that was dependent on oil price movements and the viability of projects. In our opinion, actual capital expenditures will not exceed the budgeted figure, as the government aims towards a private sector led growth.

Figure (6): Actual Expenditures



Sources: MOF, SAMA and NCB

Saudi Vision 2030 has myriad initiatives to support SMEs, seeking to increase their contribution from 20% of GDP to 35%. Hence, continued support of specialized credit institutions will remain a cornerstone of such strategy. Government entities such as the Public Investment Fund, Real Estate Fund, and the renamed Social Development Bank will continue to support industrial, social, and human development projects by providing financing to small and medium scaled enterprises. Recently, the Saudi Industrial Development Fund (SIDF) was boosted by SAR6 billion to provide further opportunities into new industries such as military and pharmaceuticals. The SIDF had approved 73 new loans with an investment value of SAR2.6 billion through the first half of 2016. Additional measures of finance towards SMEs came from the Loan Guarantee Program "Kafala", facilitating credit worth around SAR1.3 billion by the end of 3Q2016 to 1'229 establishments. Since inception in 2006, Kafala has granted a total of SAR17 billion to almost 8'500 establishments.

A semblance of normalcy is expected in oil markets after the first production cut by OPEC since 2008, hence we expect oil prices to average USD55/bbl in 2017. The cut, amounting to 1.2 MMBD, effective January 2017, is expected to push crude prices into a higher range between USD50-60/bbl in 2017. Additionally, 11 non-OPEC countries agreed to cut by 558 thousand barrels per day, which will also underpin prices. Yet, lower compliance among OPEC members, increased supplies from Libya and Nigeria, albeit unlikely, as well as shale producers bringing back a large amount of mothballed production capacity might limit the upside movement.

The outlook for global oil demand are weakening amid signs of a slowdown in Chinese demand that is evident from the lower headline GDP growth rates of recent quarters, with the IMF expecting decelerating growth during 2017 and 2018 respectively at 6.2% and 6%, the slowest pace of expansion since 1990. Furthermore, emerging markets are projected to expand at 4.2% next year, still well below their ten-year average of 7%. The IEA, EIA and OPEC are forecasting oil demand to rise between 1.2 and 1.6 MMBD in 2017, slower than this year. The record US and global crude oil inventories will also remain a drag on oil markets. The latest US crude oil inventory around 480 MMbbls might have edged lower from a record 543.6 MMbbls posted in April 2016, nevertheless, it is near the upper limit of the average range for this time of year. Additionally, the OECD's commercial total oil inventories around 3.06 billion barrels remains 350 MMbbls above the five-year average. Given these dynamics, we do believe that rebalancing the market will be challenging, yet it might materialize by the end of 2Q2017.

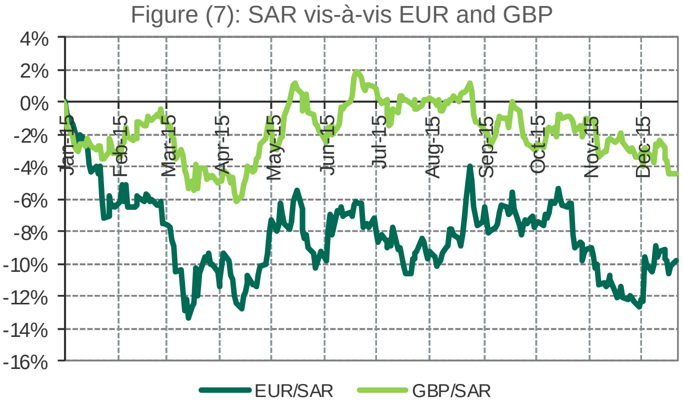
The fiscal deficit will contract on the back of rising revenues. The expected rebound in oil prices will raise oil revenues to SAR483.6 billion, a gain of 47.0% despite the reduction in oil production following OPEC's agreement. As for non-oil revenues, we believe 2017 will register SAR218.9 billion 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.

(SAR billion)	2016 Actual	2017 Budget	2017 Forecast
Total Revenue	**528**	**692**	**703**
Oil	329	480	484
Non-Oil	199	212	219
Total Expenditure	**825**	**890**	**883**
Current	642	628	618
Capital	183	262	265
Deficit/Surplus	**(297)**	**(198)**	**(180)**

Sources: MOF and NCB

A stronger USD, contained commodity prices, weakening domestic consumption and base effects will bring inflation down to around 2-2.5%. Recently, domestic inflation had started to edge below the 4%, registering 2-3% Y/Y. The decline in the food component had partly offset the significant impact from reduced subsidies, which underpinned higher prices for energy and transport services. The domestic food sub-index, which represents 21.7% of the consumer price index, registered four consecutive monthly declines by the end of October. The upside momentum of the greenback, with the trade-weighted dollar crossing the 103 mark, a 14-year high, will reduce imported inflation. Additionally, rental prices are expected to moderate given demand and supply factors such as the lower incomes for 1.25 million government employees, regulations pertaining to the leasing process, and the land fees that will break monopolies. We do believe that the the negative income effect from the Royal decree pertaining to the public sector's salaries and allowances will be the critical factor in offsetting the cost push nature of streamlining subsidies, as evident from the downward trends witnessed across proxies such as the points of sale transactions and opened letters of credit.

Figure (7): SAR vis-à-vis EUR and GBP



Sources: Reuters and NCB

III. Towards a Balanced Budget

Fiscal consolidation is an integral part of the National Transformation Plan 2020 and Vision 2030, with the government planning to propel non-oil revenues to around SAR530 billion by 2020, which according to policy makers will balance the budget at that time. Accordingly, we expect additional measures to reduce water and electricity subsidies in the months ahead, given the target of cutting SAR200 billion by 2020. These revisions will complement the Royal decree announced in September to freeze salaries and constrain allowances that is expected to save a significant SAR50 billion starting next year. In our opinion, tackling the unsustainability of wages and salaries that represented a hefty 46% of the total actual expenditures in 2015 is an unprecedented measure that has removed a major impediment to achieving 2020 fiscal targets.

The government is adamant to scrap the "subsidies for all" model towards a more targeted arrangement. A new program is in the pipeline to grant financial aid mostly to lower income groups, factoring in the size of the family and consumption based on rational levels, with the objectives of shielding these groups from elevated prices as well as encouraging them to conserve and save. Families will have to submit their requests starting February before applying the new prices in July 2017. Furthermore, in its first phase, the 2.5% fee on 653 million square meters of undeveloped land is expected to raise around SAR10 billion, which will support the housing program without straining the government's budget. On a medium-term note, Saudi Aramco's floatation and the introduction of a GCC-wide Value-added Tax (VAT) by 2018 will give a further boost to non oil revenues, with estimates for VAT revenues ranging between SAR25-50 billion. It seems the government had realized that the high frequency of policy changes has created an "announcement fatigue", and as such was more gradual and transparent in its approach this year, which was needed to avoid undermining investor and consumer sentiments.

IV. Concluding Remarks

Global economic concerns will remain in place during 2017, especially that a populist backlash had led to unexpected outcomes pertaining to the Brexit, the American presidential elections, and most recently the Italian constitutional referendum. Downside risks stemming from Chinese economic moderation and monetary policy reversal by the Federal Reserve can act as headwinds for global growth. A United States policy reversal will most likely reignite another cycle of capital outflows from emerging markets especially those that suffer from structural deficiencies in their current and fiscal accounts. Speculative outflows might cause a rout in currencies and commodities in the couple of months following rate decisions by the Fed. The interest rate environment will adjust upwards, resulting in a tighter and costlier external borrowing.

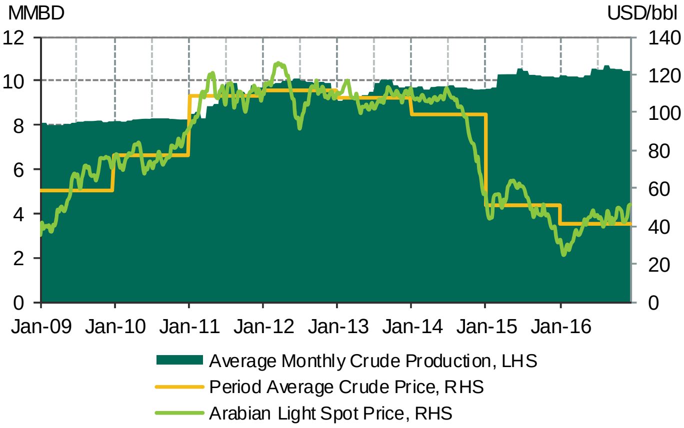
The Saudi economy is projected to contract by 1.0% in real terms in 2017. The oil sector will be the drag especially that the Kingdom bore the brunt of OPEC's agreed upon cut, slashing 486 thousand barrels a day that will bring down domestic production to around 10 MMBD, yet in nominal terms, GDP will increase by 5.2% to SAR2.7 trillion due to higher oil prices. Additionally, the non-oil sector will be moderating, growing by 1.2%. The moderation in non-oil will be driven by decelerating domestic consumption and the global headwinds.

Gauging the macroeconomic risks through the debt level, adequacy of reserves and financial stability reveals that Saudi is well poised to encounter possible future shocks. Despite the increase in the Kingdom's debt to GDP, it remains low in comparison to international counterparts like Japan and the US that respectively registered 253% and 108%, while also faring better than regional economies, with the UAE and Kuwait posting 19% and 18% respectively. Saudi reserves remains adequate according to different individual benchmarks, whether relative to imports, public and private short-term debt, current account balance and broad money, which implies that the economy can cover its financing needs, withstand capital outflows and sustain its imports. On the banking side, the currently contained NPL ratio illustrates the prudent management and supervisory practices that have been applied by banks and SAMA. By the third quarter of 2016, banks registered an industry-wide NPL ratio of 1.1%, in comparison to the 1.9% recorded during 2004-2008. Nevertheless, the moderate macroeconomic backdrop is part of any economic transition, especially that rebalancing an economy is a long-term process that will bear fruit until the needed shift ends, a' la China.

Annex I: Macroeconomic Update

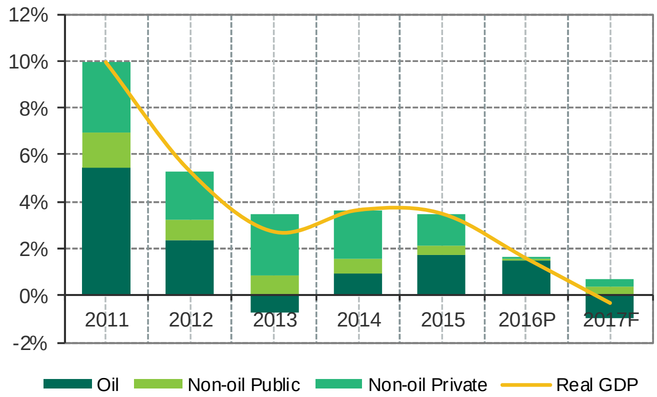
1. Crude oil prices retreated from an average of USD50/bbl in 2015 to USD40/bbl in 2016 while Saudi crude oil production rose from 10.2 million b/d in 2015 to 10.4 million b/d in 2016.

Figure (1): Crude Oil Prices and Production



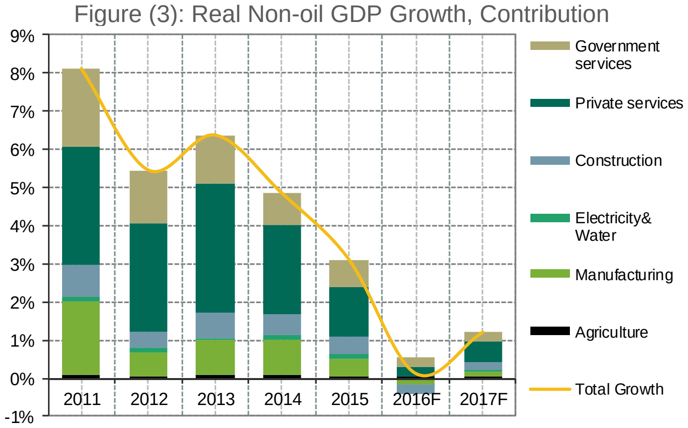
2. Accordingly, real GDP decelerated to record an annual growth of 1.4% in 2016, following 2015's 3.5% rise.

Figure (2): Real GDP Growth Contribution



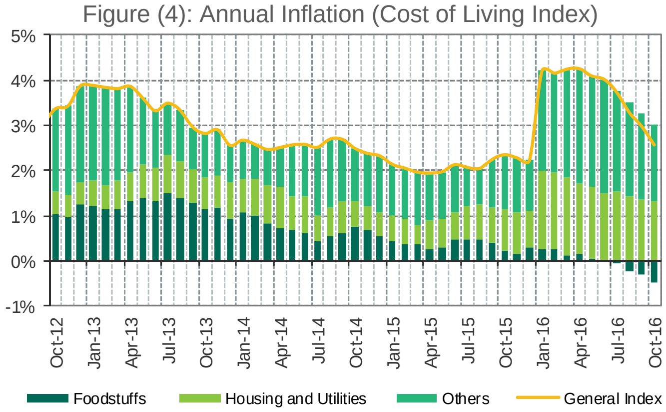
3. Non-oil private GDP stagnated as consumer and business sentiment weakened on the back of the macroeconomic backdrop.

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



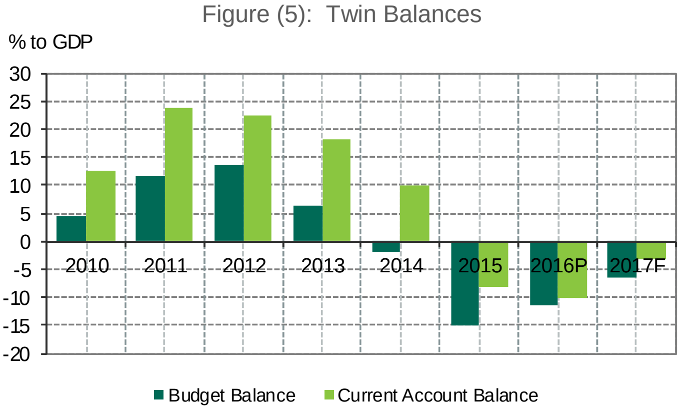
4. The decline in the food component had partly offset the significant impact from reduced subsidies as the inflation rate recorded an average rise of 3.4% in 2016.

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



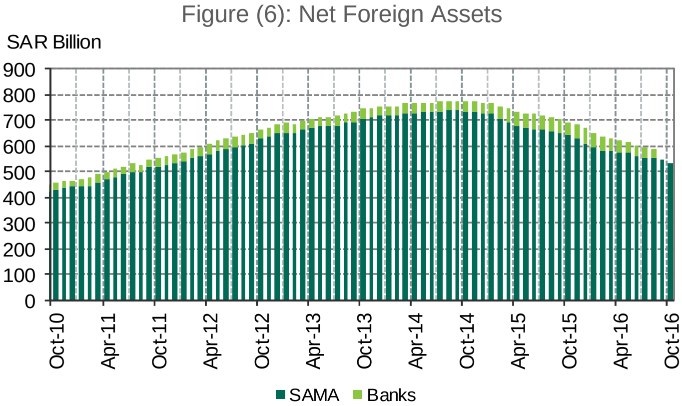
5. The external balance record an expected deficit at 11.9% while the fiscal balance is estimated to have remained negative at 15.3% of GDP in 2016.

Figure (5): Twin Balances



6. As such, net foreign assets settled at USD536.6 billion in October to finance the deficit, after a drawdown of USD73.1 billion.

Figure (6): Net Foreign Assets



Sources: MOF, SAMA, Reuters, GAS and NCB

Annex 2: 2017 Budget and Announced Budgetary Allocations by Sector/Institution

The 2015 budget estimates total revenues at SAR692 billion and total expenditures at SAR890 billion, a deficit of SAR 198billion. Out of the SAR890 billion budgeted expenditures, total capital expenditures represent approximately 29.4%, inclusive of both green-field projects and on going projects from previous years. Like in previous years, the Ministry of Finance did not provide a breakdown between capital and current expenditures for the designated sectors and/or institutions. Below, we summarize the key budgetary allocations as presented in the official press release.

Sector/Institution	Allocation
Education	Expenditures are projected at SAR200.3 billion (22.5% of total), 2.7% lower than the amount budgeted for last year. As the largest recipient of budget allocations, development of the King Abdullah Public Education Development Project will continue with an estimated cost of SAR9 billion, and continued work on 1'376 educational facilities and schools. The announcement renewed its commitment to its overseas targeted scholarship program as SAR16.5 billion is allocated for over 207'000 students.
Health and Social Development	Expenditures are projected at SAR120.4 billion (13.5% of total), over 18.7% over the amount budgeted in 2016. New projects include equipping of hospitals and healthcare centers, completion of 38 new hospitals with a capacity of 9'100 beds, and two medical cities with a capacity of 2'350 beds. The budget also includes appropriations for sport cities in cooperation the General Administration of Sport.
Economic Resources and General Programs	Expenditures are projected at SAR155 billion (17.4% of total). The budget includes appropriations to enhance water resources, as well as to improve water and sewage networks by reducing waste. The length of drinking water network reached 105'042 KM in 2016 which will be further expanded.
Municipality Services	Expenditures are projected at SAR55 billion (6.1% of total). New projects include intercity roads, intersections and bridges, road lights, as well as sanitary and other environment related projects.
Infrastructure and Transportation	Expenditures are projected at SAR52 billion (5.8% of total), which is 38.8% higher than the amount budgeted for in 2016. New projects include 500 km of roads, along with feasibility studies and design for the existing roads network. The allocation will also be directed towards new projects and expansions that will be disbursed across ports, railways, postal services and various industrial cities.

The Economics Department Research Team

Head of Research

Said A. Al Shaikh
Chief Economist
s.alshaikh@alahli.com

Macroeconomic Analysis

Tamer El Zayat
Senior Economist/Editor
t.zayat@alahli.com

Majed A. Al-Ghalib
Senior Economist
m.alghalib@alahli.com

Yasser A. Al-Dawood
Economist
y.aldawood@alahli.com

Sector Analysis

Ahmed Maghrabi
Associate Economist
a.maghrabi@alahli.com

Sharihan Al-Manzalawi
Associate Economist
s.almanzalawi@alahli.com

Sultan Mandili
Economist
s.mandili@alahli.com

Hanan M. Al-Asiri
Economist
h.alasiri@alahli.com

To be added to the NCB Economics Department Distribution List:

Please contact: Mr. Noel Rotap
Tel.: +966-2-646-3232 / Fax: +966-2-644-9783 / Email: n.rotap@alahli.com