جدوى للإستثمار
Jadwa Investment

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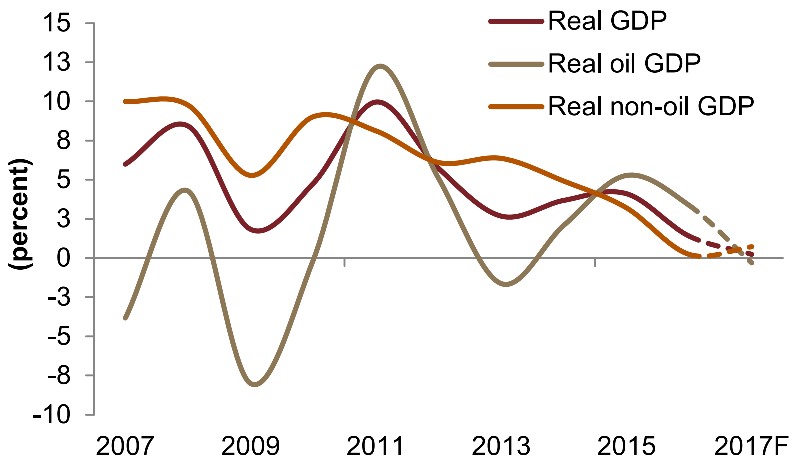
The Saudi Economy in 2017

We expect the Saudi economy to continue slowing in 2017, dragged down by negative growth in the oil sector. Non-oil sector growth should rebound but remain subdued. Annual growth in the oil sector will turn negative in 2017, with average oil output expected to decline slightly. This comes as the Kingdom complies with the OPEC production cuts during the first half of 2017. Growth in the non-oil private sector will accelerate from 25-year lows but remain relatively subdued, as the partial impact of fiscal balancing measures is offset by a full-fledged focus by the government on restructuring the private sector support mechanism. As oil prices rebound, the current account deficit will shrink considerably, while the fiscal deficit will fall to single digits. We believe the government will continue to comply with targets specified in the Fiscal Balance Program (FBP 2020), allowing for a smooth adjustment in the fiscal budget while cushioning the impact on growth in the non-oil private sector.

We expect economic growth to slow to 0.2 percent in 2017, down from 1.4 percent in 2016. Oil sector growth is expected to fall marginally by 0.3 percent in 2017 compared with growth of 3.4 percent in 2016. The negative growth in the oil sector will be due to a marginal fall in oil production as the Kingdom complies with production cuts during the first half of 2017. Growth in the non-oil private sector is expected to accelerate from 0.1 percent, the lowest since 1990, reaching 1 percent in 2017. We expect a growth of 7.5 percent in the non-oil mining sector which makes it the fastest growing sector in the Kingdom in 2017. The sector is expected to benefit from significant additions. Amongst these projects is the $96 billion phosphate joint venture between SABIC, Ma'aden, and Mosaic. Upon completion in 2017, the project will be one of the world's largest integrated phosphate complexes. Within the non-oil private economy, ownership of dwellings is likely to also be among the fastest growing sectors, benefiting primarily from major initiatives to promote residential real estate development.

Figure 1: Real economic growth
(year-on-year change)



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2017 should see a substantially lower deficit of SR198 billion.

We expect the gap between budgeted and actual expenditures to be eliminated.

The main risks to our forecast stem from regional political uncertainty and any delays to implementing reform plans.

Along with government spending, corporate lending and, to a lesser extent, domestic consumption will be the primary drivers of growth in the private sector.

A year-on-year increase in total budgeted spending has been announced for 2017, from SR840 billion in 2016 to SR890 billion in 2017. However, looking at the SR930 billion in actual spending from 2016, this represents a decline of SR40 billion. Nevertheless, 2017 should see a substantially lower deficit of SR198 billion (compared with SR326 billion in 2016's budget). This higher level of budgeted spending continues to highlight the government's willingness and ability to support the economy. At the same time, a lower deficit reflects the government's intent to become more efficient and prudent in protecting its fiscal buffers.

We view this total spending as supportive to the non-oil economy and it remains important since international and regional events have the potential to damage investment sentiment. We expect the gap between budgeted and actual expenditures to be eliminated, leading to a deficit of SR162 billion (6.2 percent of GDP). The closing of the overspending gap reflects an improvement in the efficiency of public spending through the Spending Rationalization Office. This represents an important part of the Kingdom's FBP. The financing of the deficit will continue to be a combination of debt issuance and a drawdown of government deposits. This financing strategy has also reduced the extent of foreign reserve depletion, though the deficits in the current account and non-reserve financial account will continue to be pressure points on foreign reserves.

The main risks to our forecast are from the external environment. A significant slowdown in global growth and geopolitical tensions constitute key risks. A sustained period of lower oil prices would lead to a higher-than-forecasted fiscal deficit. Regional political uncertainty will continue to cast a further shadow over the economy and any heightening of tensions will hit businesses and consumer confidence. Any delays of serious reform, particularly those that are the most growth-enhancing areas of the National Transformation Program (NTP 2020) constitute a downside risk to a thriving private sector. Other risks include further delays in government payments to the private sector, which may consequently impact sentiment, capital inflows, and business and household confidence, though this is not likely.

Figure 2: Global GDP growth
(year-on-year change)

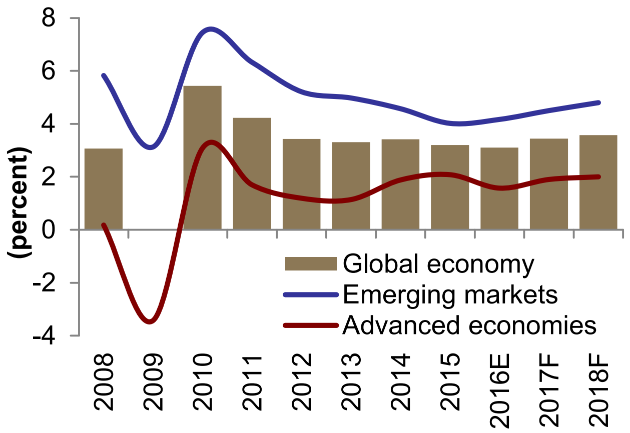
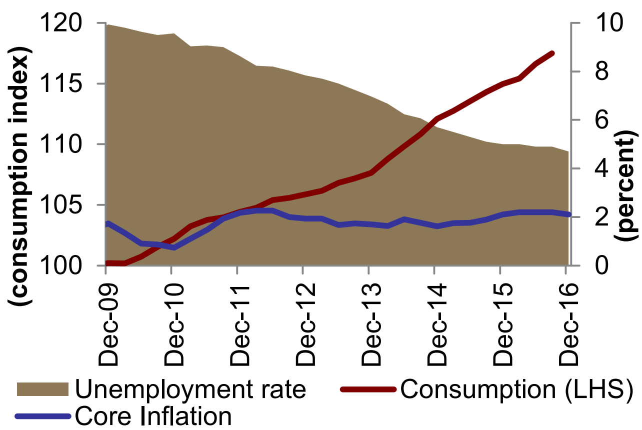


Figure 3: US inflation, unemployment and private consumption



Global Economic Outlook

Global economic growth has been steady, but unremarkable in the last few years…

...with 2017 growth rates not expected to show a huge improvement.

Global economic growth has been steady, but unremarkable in the last few years, with 2017 growth rates not expected to show a huge improvement. According to International Monetary Fund (IMF) data, global GDP averaged 3.3 percent year-on-year, between 2012 and 2015, and is expected at 3.1 percent in 2016, improving mildly to 3.4 percent in 2017 (Figure 2). According to the same IMF forecasts, the US, as has been the case in recent years, will be the major proponent of growth amongst the advanced economies. Canada and the Euro zone are expected to show more consistent, if somewhat slower growth. Meanwhile, the UK joins Japan as the weaker element amongst the major advanced economies. Emerging market (EM) growth in 2017 is expected to improve from 4.1 percent in 2016, to 4.5 percent in 2017, but will still be sizably slower than the 2010-15 average of 5.4 percent. Whilst the Chinese economy is expected to slow, this will be a more gradual decline. On a more positive note, India is expected to pick up the mantle of fastest growing major economy for the next few years.

As the IMF highlighted in the recently published World Economic Outlook (WEO), the above forecasts are subject to significant uncertainty. The most obvious risk is tied to the policy stance of the new US presidency, and with it, a potential knock-on effect on both the domestic and international economy. In addition, uncertainty tied to negotiations over the UK's decision to leave the European Union (EU), not only points to potentially slower economic growth, but also runs the risk of increasing political discord, which could produce a full blown economic crisis in Europe, with global implications.

US economy:

The US economy is expected to grow at a rate of 2.3 percent in 2017.

According to current IMF forecasts, the US economy is expected to grow at a rate of 2.3 percent in 2017, higher than the expected growth rate of 1.6 percent in 2016. Top line economic indicators throughout 2016 certainly support these higher growth forecasts. Unemployment stabilized at around 5 percent last year, compared to an average of 7.8 percent between 2009-15, suggesting the US economy is very close to full employment. Private consumption has been accelerating since 2014, whilst inflation remained stable (Figure 3).

How the US economy performs going forward compared to IMF forecasts is not so clear. An unexpected win in the recent US

Table 1: Global GDP growth
(percent; IMF and consensus projections)

	2015	2016E		2017F		2018F	
	IMF	IMF	Consensus	IMF	Consensus	IMF	Consensus
Global	3.2	3.1	2.6	3.4	2.9	3.6	3.0
US	2.6	1.6	1.6	1.9	2.3	2.0	2.4
UK	2.2	2.2	2.0	2.2	1.2	2.2	1.3
Canada	0.9	1.3	1.3	1.9	1.9	2.0	1.9
Euro zone	1.5	1.7	1.7	1.6	1.5	1.6	1.5
Japan	1.2	0.9	0.9	0.8	1.0	0.5	0.8
China	6.9	6.7	6.7	6.5	6.4	6.0	6.1
Russia	-3.7	-0.6	-0.6	1.1	1.2	1.2	1.6
Brazil	-3.8	-3.5	-3.5	0.2	0.6	1.5	2.2
India	7.6	6.6	7.0	7.2	7.4	7.7	7.6

Note: Consensus forecasts are those of FocusEconomics.

election for the Republican candidate, has resulted in increased uncertainty on a number of issues with early indications suggesting that domestic economic policies will add to inflationary pressure. Specifically, the new President's plans to reduce both corporate and personal tax rates, raise defense spending, and boost infrastructure investment are expected to push up inflation, which will probably result in further rises in interest rates from the US Federal Reserve (Fed). In fact, the sharp rise in US Treasury yields following the elections reflected heightened expectations of an expansionary fiscal stance in the US. This development, along with an uptick in inflation, and an already strengthening labor market, resulted in the Fed raising the Federal Funds Rate (FFR) in mid-December 2016 by 25 basis points (bps), its second such hike since 2008. One of the main risks for the US economy going forward, therefore, is a faster and more steeper pace of interest rate hikes occurring during 2017. Excessive monetary tightening would increase borrowing costs for corporates in the US, especially those engaged in borrowing heavily from the high-yield debt market, potentially nullifying any gains from proposed corporate tax reform. One sector in particular could prove more vulnerable is the US high-yield energy sector where outstanding debt has grown from $80 billion in 2009 to around $260 billion in Q3 2016, the majority of which is held within the shale oil industry.

One of the main risks for the US economy going forward is a faster pace of interest rate hikes occurring during 2017.

Eurozone economy:

Although the IMF forecasts slightly lower year-on-year growth for the Euro zone in 2017, there have been some bright spots for the bloc in 2016. Unemployment rates have dropped to the lowest levels in six years, whilst yearly growth in industrial production and loans to non-financials reached the highest in four years (Figure 4). The main impetus for this better-than-expected performance has been lower year-on-year oil prices, as well as higher exports, as a result of weaker euro. In fact, record levels of money supply continued to be pumped into the financial system in 2016, whilst deposit rates remained negative, all of which added to the euro's decline during last year.

There have been some bright spots for the bloc in 2016.

Despite these encouraging signs, there are a number of challenges ahead for the economic bloc. So far, there seems to be no economic effect, on either side, as a result of UK's decision to leave the European Union (EU), back in June 2016. However, following the UK Prime Minister's recent announcement that Britain's formal exit from

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Figure 4: Euro zone's economic indicators improved in 2016

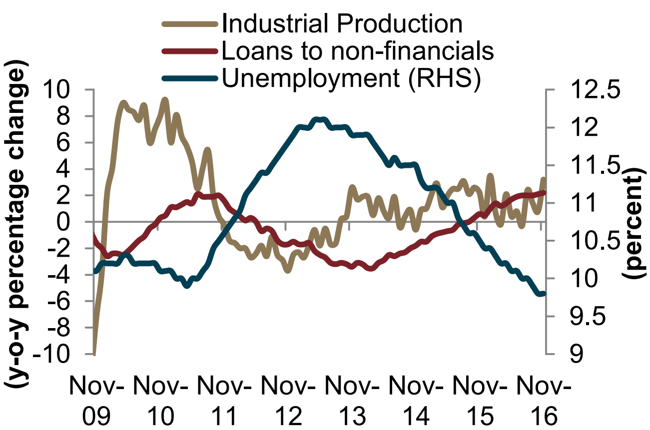
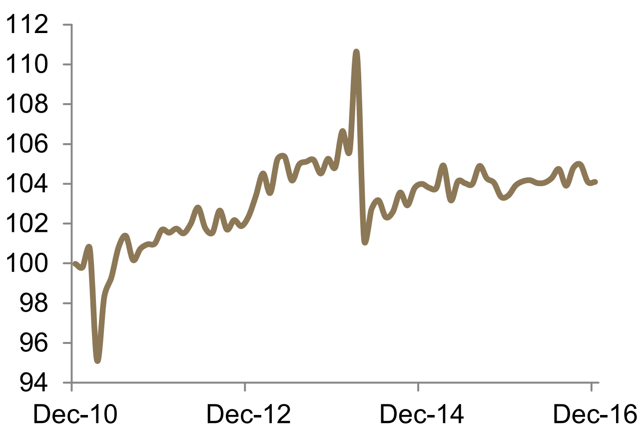


Figure 5: Key challenge for Japanese government is to increase private consumption



Note: rebased to 100 in December 2010

the EU will begin in Q1 2017, risks of a hard 'Brexit' are apparent. A worst case scenario could result in a weakening political cohesion between the remaining members of the Euro zone, which would have repercussions on the economy. A disorderly and drawn out 'Brexit' could see increased volatility in financial markets and widespread sell-off in both European and UK assets, potentially leading to slower European and therefore global economic growth. The 'Brexit' vote has exemplified the nationalist mind-set sweeping across Europe, which could lead to immense political volatility in 2017, with significant economic implications. Populist movements are increasingly gaining support across the region, with many of these movements being highly skeptical of the EU. Germany, France and the Netherlands all have federal/presidential elections during 2017. The risk of a more inward focused Eurosceptic government gaining power is therefore very real and, if so, could result in less economic cooperation or even a 'Brexit' style referendum in any of these countries.

The Euro zone is expected to continue fighting deflationary pressures.

Meanwhile, the Euro zone is expected to continue fighting deflationary pressures, with the European Central Bank (ECB) extending its bond-buying program throughout 2017, although the size of the monthly purchases will shrink to €60 billion from €80 billion beginning in April 2017. With steeper rises in US interest rates also expected in the year ahead, the euro is likely to remain weak, which should assist further export growth.

Japanese economy:

The Japanese economy will continue to show slower growth in 2017.

According to IMF forecasts, the Japanese economy will continue to show slower growth in 2017, at 0.8 percent versus 0.9 percent in 2016. Although not a flattering rate of growth, Japan's key economic indicators point to a general improvement. The labor market has become tighter, with the unemployment rate currently at 3.1 percent, the lowest in 20 years. Furthermore, Japanese corporate profitability remains healthy as a weaker yen supports export growth. Looking ahead, Japan will have two major challenges in 2017. Firstly, in order to stimulate the economy and battle against deflationary pressure, the government will have to try and increase domestic consumption, which has been tepid in recent years (Figure 5). Secondly, Japan will also have to negotiate a new multinational free trade deal following the new US administration's veto of its participation in the Trans-Pacific Partnership (TPP) agreement.

The yen is likely to continue weakening, whilst commodity prices, including oil, are expected to rise in 2017.

In the last few years, the main beneficiaries of the Japanese government's economic policies (often referred to as Abenomics) have been corporates. As a result of Bank of Japan's (BoJ's) quantitative easing program, and US dollar strength, a weaker yen has facilitated export-driven profits. In addition, the level of tax paid by corporates has also been reduced. Conversely, households have been impacted by higher unemployment insurance premiums and a rise in sales tax. In 2017, the government plans to increase household disposable income in an attempt to push up consumption. Measures to be implemented include raising the wages of teachers and nurses, increasing the number of educational scholarships and lowering unemployment insurance premiums. Despite this, such changes may not be enough to achieve higher private consumption. This is mainly because as the BOJ continues with quantitative easing and US interest rates rise further, the yen is likely to continue weakening, whilst commodity prices, including oil, are expected to rise in 2017. Both these factors combined could prevent a rise in private consumption by raising the prices of everyday household items.

One of the first acts of the new US administration was to end its county's participation in the TPP, effectively eliminating the agreement all together. Japan was expected to benefit from the TPP free trade deal, with the government forecasting up to 2 percent increase in real GDP over a 10-20 year period. As a result, the Japanese government will now have to seek a new multinational free trade deal by itself. One alternative could be the China-backed Regional Comprehensive Economic Partnership (RCEP), but talks over this are still ongoing and may not be fully agreed upon for a few years.

Emerging markets:

Latest IMF forecasts point to an improvement in EM growth in 2017.

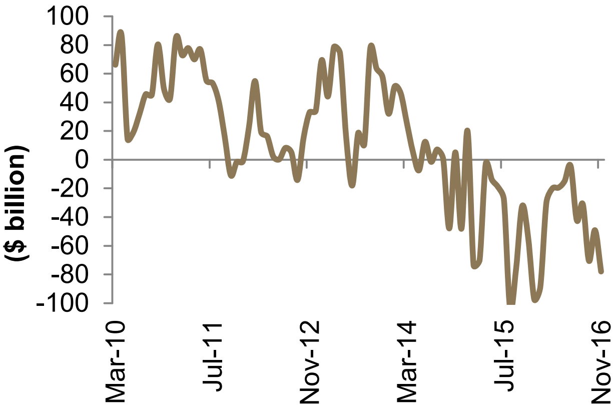
Latest IMF forecasts point to an improvement in EM growth in 2017 for the second consecutive year. Growth is expected to rise to 4.5 percent, compared with 4 and 4.1 percent in 2015 and 2016. The jump in 2017 year-on-year growth is due to an improvement from Russia and the Latin American region, both of which are expected to return to positive growth rates in 2017. Although this is an evident improvement for EMs, a number of risks remain which could pull down overall growth. Mounting debt levels remain a concern, and with expected acceleration in US interest rates in the year ahead, EMs could see a rise in debt servicing/borrowing costs or increased capital outflows. Also, although China's economic situation stabilized in 2016, there are still major risks ahead as the government attempts to prevent a bubble forming in the property sector.

EM debt has grown rapidly in the last few years…

...with total external debt of 41 EM countries rising from $4.5 trillion in 2008 to $7 trillion at the end of 2016.

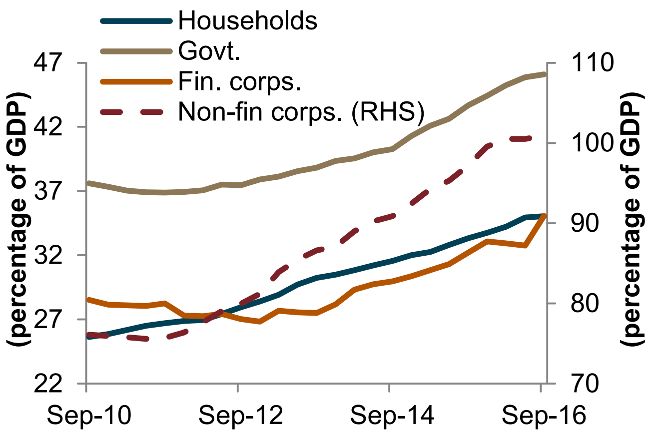
EM debt has grown rapidly in the last few years, with total external debt of 41 EM countries rising from $4.5 trillion in 2008 to $7 trillion at the end of 2016. During this period, EMs have also witnessed healthy growth rates, but whilst global economic growth rates have moderated recently, total external debt has not. In the context of further hikes in US interest rates during 2017, the concern is that many EMs may also be forced to raise interest rates in order to prevent large capital outflows. In November 2016, just prior to the US Fed's fund rate hike, net capital outflows from EMs reached their third largest monthly total since the global financial crisis, with around $448 billion leaving ten EM countries in the year-to-November 2016 (Figure 6). If EMs do raise interest rates, this will inevitably push up borrowing costs across all sectors, which could be of particular concern to the non-financial corporate sector, where debt levels have risen rapidly in the last few years (Figure 7).

Figure 6: EM net capital outflows accelerated prior to US Fed tightening in December in 2016



Note: Refers to Brazil, Chile, China, India, Indonesia, Mexico, Poland, Russia, S.Africa and Turkey

Figure 7: EM debt is rising across all sectors



Note: GDP weighted averages of twenty EM countries

The prospect of a sharp slowdown after more than a decade of rapid growth in China has receded…

...and the economy appears to be on a more stable footing.

The most immediate and wide-reaching risk to global economic growth is embedded in the policies of the new US administration.

<u>Chinese concerns remain:</u>

The prospect of a sharp slowdown after more than a decade of rapid growth in China has receded and the economy appears to be on a more stable footing. GDP is expected to reach 6.5 percent in 2017, down marginally from 6.7 in 2016, according to the IMF. China's foreign reserves currently amount to a massive $3.5 trillion allowing the government to maintain fiscal stimulus and infrastructure expenditure to stimulate the economy in the short-term. That said, risks still remain, with specific concerns related to the emergence of a bubble in the real estate sector. Recent data shows that property prices in many of the big cities in China have accelerated in the last year. For example, both Beijing and Shanghai's residential property prices rose by around 20 percent year-on-year in Q3 2016, versus an average of 1.8 percent in the capital cities of five emerging Asian countries. The steep rise in property prices has been bought about by a number of factors, including; the lack of urban land made available for development, Chinese capital controls which make it difficult for citizens to invest abroad, thereby encouraging property acquisitions as investments, and the existence of low retail deposit rates by banks. As result of all these factors, sales of residential properties have followed an upward trend since 2010, and so too have household debt levels (Figure 8). Although the government has recently made buying a property much harder, by raising the percentage of cash down-payments and cracking down on shadow bank lending, there is still a risk of a stock market type correction occurring in the property market. Such a correction in the sector would be far more detrimental to the economy than the stock market equivalent, since construction, and associated sectors, are estimated to contribute around 15 percent per annum to China's GDP.

<u>Major economic risks:</u>

The most immediate and wide-reaching risk to global economic growth is embedded in the policies of the new US administration. An unexpected win for the Republican candidate in the recent US elections has resulted in increased uncertainty on a number of issues. Specifically, in relation to the global economy, there are potential implications for global trade. The new US President's campaign in the run-up to the election was marked by a strong desire to remake the US' economic relationship with current trading partners, which was followed through by withdrawing from the TPP.

Figure 8: Chinese residential property sales and household debt-to-GDP

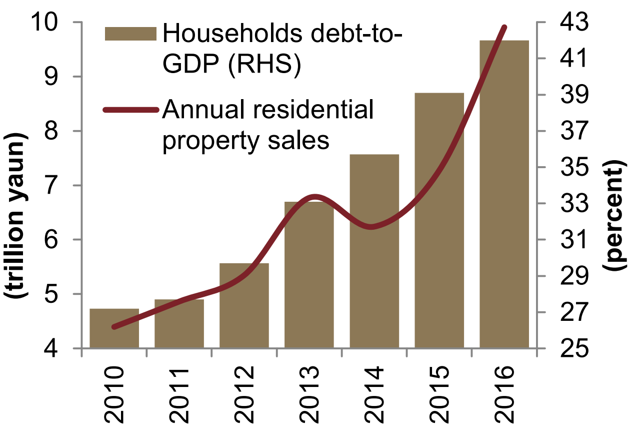
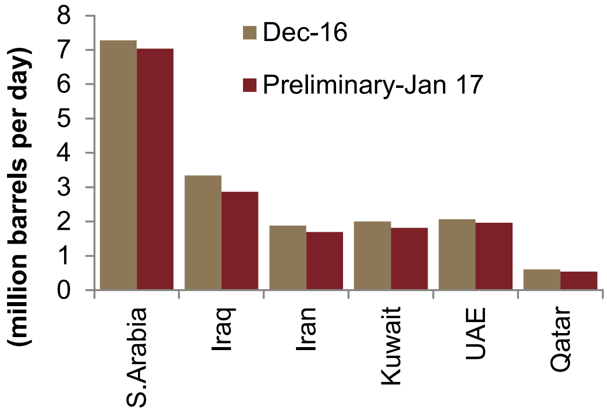


Figure 9: Preliminary data shows middle eastern OPEC producers complying with cuts



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...assuming that cuts at agreed levels continue until mid-2017.

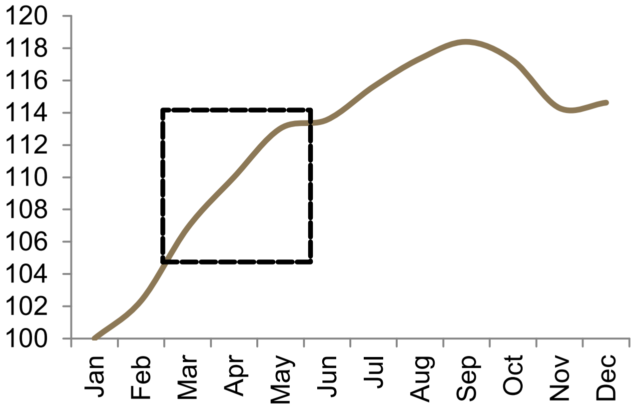
The US is also looking to renegotiate its engagement in the existing North American Free Trade Agreement, as well as potentially raising import tariffs and bringing trade cases against China. Whilst acting on these promises may be difficult, overall, the risk is that a more inward looking US could lead to a more protectionist policies across the global economy, resulting in a decline in global trade, all of which would negatively affect global economic growth.

The negative impact on global trade is likely to be aggravated by rising external financing costs, especially so for EMs, which have seen their debt levels rise considerably since 2008. Higher debt levels present dual challenges since a rise in US interest rates not only increases borrowing costs, but could also result in increased capital outflows from EMs. Money borrowed in dollars will therefore be more expensive to repay when using domestic currency, but the outflow of capital will also result in a drop in local investment, and will negatively impact growth.

The Oil Market in 2017

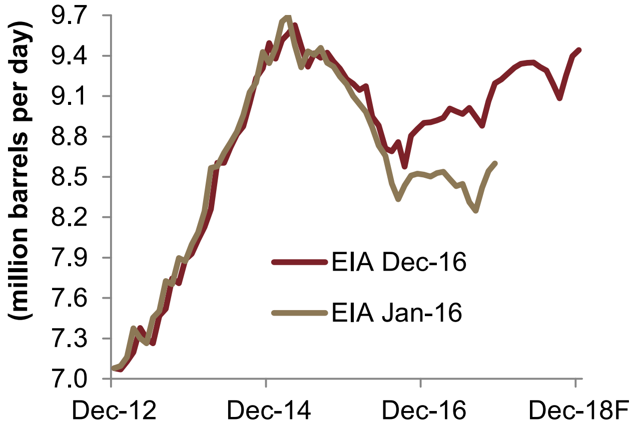
The first few weeks of the oil market in 2017 are a marked contrast to a year ago. In January 2016, intense competition amongst OPEC members, massive global oversupply, and the anticipated return of Iranian crude oil exports, following the lifting of sanctions, saw Brent oil prices drop to multi-year lows. In January 2017, oil prices are much more stable, at around $55 per barrel (pb), with little deviation from this level in the last two months. This stability in prices is mainly due to the coordinated action by OPEC and some non-OPEC members to cut 1.8 mbpd, or 2 percent of global oil supply, during the first half of 2017. Early indicators suggest that key OPEC producers are complying with cuts. Preliminary crude oil export data for Saudi, Iran, Iraq, Qatar, UAE and Kuwait, which account for 75 percent of total OPEC output, are down by a 9 percent month-on-month (Figure 9). Assuming that cuts at agreed levels continue until mid-2017, we would expect to see oil markets balancing more aggressively by Q2 2017, when the deal expires. In fact, oil markets could fall into deficit by 200 thousand barrels per day (tbpd) in Q2 2017, compared with a surplus of 1.5 million barrels per day (mbpd) without cuts. This forecast is, however, based on discounting two major risks which could delay balancing. The first of these risks relates to OPEC. Whilst the above preliminary January data shows genuine commitment from key OPEC producers, non-compliance

Figure 10: Average monthly movement in Brent oil price between 1995-2016



Note: January = 100

Figure 11: Recent upward revision in US oil output forecast equal to 50 percent of OPEC cuts



The danger is that as prices rise, the economic incentive to cheat will become more appealing.

remains a big risk, with the risk growing the longer the cuts go on. A crucial test in OPEC compliance is likely to come around March/April time, when global oil prices tend to rise following a period of refinery maintenance (Figure 10). The danger is that as prices rise, the economic incentive to cheat, especially for financially troubled producers such as Iraq and Venezuela, will become more appealing. Any production above agreed OPEC ceilings is likely to bring about reciprocal action from both OPEC and non-OPEC producers, resulting in higher output all round.

Another equally significant risk is present through a swift rebound in US oil production.

Another equally significant risk is present through a swift rebound in US oil production. The rise in oil prices following the OPEC agreement saw rises in key oil indicators from the US as well. Aside from a rebound in the oil rig count, US producers have also taken out a record number of contracts on short positions against the US crude oil benchmark WTI, thereby protecting themselves against a drop in prices. Consequently, US oil production has seen sizable revisions in recent months. According to the latest US Energy Information Agency's (EIA) Short-Term Energy Outlook report, US oil production is forecasted to be 630 tbpd higher than its January 2016 forecast, which amounts to roughly half of the proposed OPEC cut of 1.2 mbpd (Figure 11). More significantly, even if OPEC fails to fully implement its own cuts, and oil prices consequently decline, US producers will still be able to expand output since they have locked in current prices levels for at least six months through hedges. In this context, we do not see a sustained rise in oil prices beyond current levels, and we have therefore stuck to our Brent oil forecast of $55 pb in 2017.

Saudi Economic Growth

In 2016, the Saudi economy expanded by 1.4 percent…

...slowing notably from 4.1 percent in 2015.

In 2016, the Saudi economy expanded by 1.4 percent, slowing notably from 4.1 percent in 2015. This represents the slowest growth rate since 2002, when overall GDP expanded by 0.1 percent. A smaller increase in oil production, by 2.4 percent, meant a slower oil sector growth at 3.4 percent. Meanwhile, annual growth in the non-oil private sector was nearly flat at 0.1 percent. Based on our outlook for the current year, we forecast overall economic growth to slow further to 0.2 percent in 2017, owing to negative growth in the oil sector, while non-oil sector growth should accelerate but remain weak (Figure 12).

Figure 12: Contribution to real GDP growth

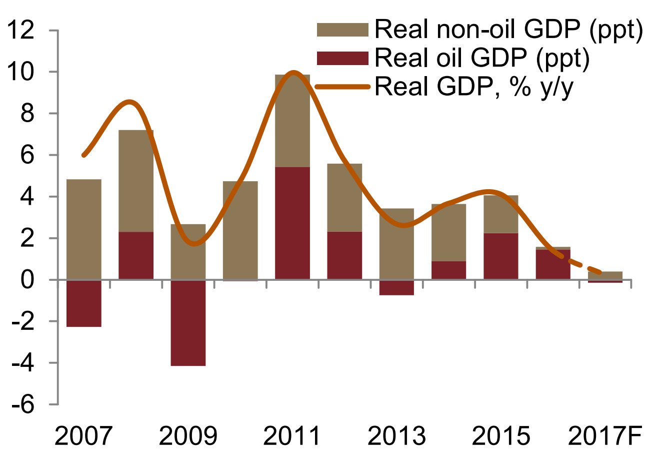
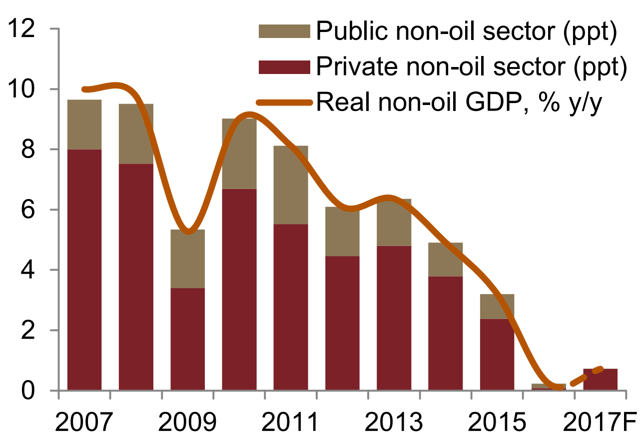


Figure 13: Contribution to non-oil GDP growth



We forecast overall economic growth to slow further to 0.2 percent in 2017.

The non-oil sector will recover following the negative sentiment associated with delayed payments by the government during 2016. Our view is that the economy will still be driven by a supportive fiscal policy, with the recently announced FBP providing a financial roadmap untill 2020. This should provide the private sector with clarity when deciding to invest in the domestic economy (Figure 13). The SR200 billion incentive package announced along the FBP will be an important factor in stimulating growth for businesses. Meanwhile, the Unified Citizen's Program will shield the most vulnerable households from any negative impact stemming from energy price reform, thereby preserving their purchasing power during 2017 (See Box 1).

Table 2. Real GDP shares and growth rates

	2016 % Share of		% year-on-year			
	Total GDP	Non-oil GDP	2014	2015	2016	2017F
Overall GDP	**100.0**		**3.7**	**4.1**	**1.4**	**0.2**
of which:						
Oil sector	44.3		2.1	5.3	3.4	-0.3
Non-oil sector	55.7	100.0	4.9	3.2	0.2	0.7
of which:						
Non-oil government		30.0	3.7	2.7	0.1	0.0
Non-oil private		70.0	5.5	3.4	0.1	1.0
Non-oil GDP by kind of activity						
Agriculture		4.2	2.5	0.6	0.6	0.6
Non-oil mining		0.7	10.1	4.1	-2.9	7.5
Non-oil manufacturing		14.9	6.3	4.4	-1.2	2.4
Electricity, gas and water		2.3	4.8	5.3	0.8	3.7
Construction		8.5	6.7	4.1	-3.1	0.8
Wholesale & retail trade		16.1	6.0	2.8	-1.2	0.4
Transport & comm.		10.4	6.2	5.8	2.6	2.4
Ownership of dwellings		9.0	3.5	3.4	3.6	7.5
Finance, insurance, & bus.		6.3	3.1	1.1	2.7	2.9
Community & social services		3.5	5.7	1.9	1.6	1.8
Producers of government services		24.9	3.3	2.3	0.1	0.0

Our estimate of budgeted investment spending for 2017 is 58 percent higher than 2016's actual figure.

That said, our estimate of budgeted investment spending for 2017 is 58 percent higher than 2016's actual figure, and we believe the government will stick to its budgeted figures during 2017. Further, the recent establishment of the Spending Rationalization Unit will

Figure 14: Oil production and oil GDP
(year-on-year change)

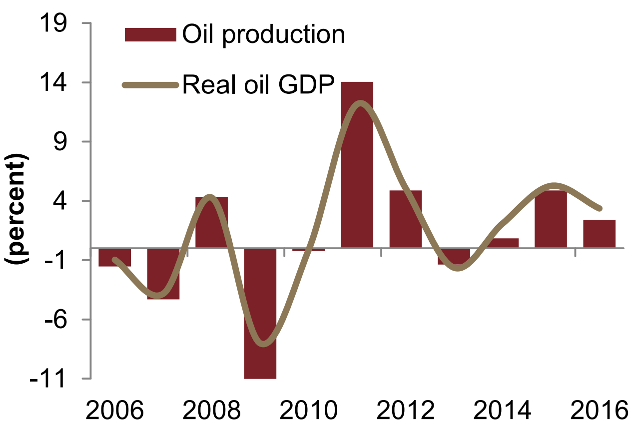
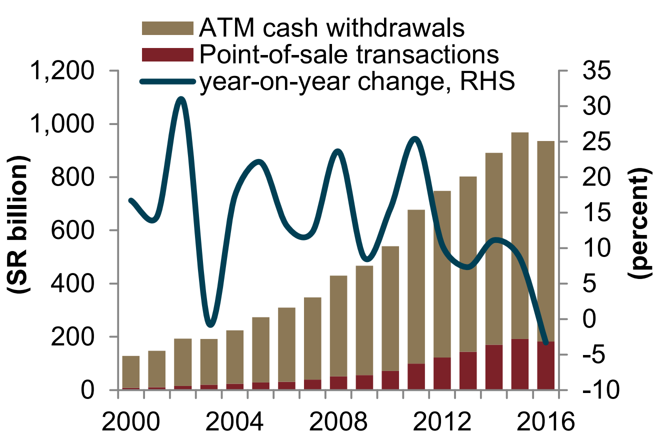


Figure 15: Indicators of consumer spending



Any potential delay in implementing reform plans constitutes the biggest risk to our forecast.

Oil GDP is forecast to decline marginally…

...as lower oil production will lead to negative growth in the sector.

contribute in optimizing both capital and operating expenses, thus ensuring efficient implementation of public sector projects. Capital spending by the government will remain psychologically important for private sector performance, at least until notable progress in structural economic reform ensures a self-sustaining private economy.

Concerns over global economic and regional political risks, as well as a prolonged period of lower oil prices continue to be the main risks to our forecast. We remain concerned about the continued volatility and tightening of global financing conditions, which could be triggered by an upward shift in market expectations of official interest rates. This may directly affect the Kingdom as it continues to tap into the international debt market. Nevertheless, the implications for the Kingdom should not be exaggerated, as markets need to differentiate the Kingdom's stable outlook from other vulnerable economies on the back of the Kingdom's solid credit profile and ample reserves. This is perhaps reflected in the forward exchange rate market, which, after short-term uncertainty, has now moved back to lower levels. That being said, we see any potential delay in implementing the reform plans outlined in the NTP 2020 and Vision 2030 to constitute the biggest risks to our forecasts. Whilst fiscal consolidation should have a long-term positive impact on the structure of the economy, any retraction to structural reform could result in negative growth in the non-oil economy over the next two years.

While we expect a slowdown in overall GDP growth, it will be mainly due to negative oil sector growth, while growth in the non-oil sector should rebound but remain subdued. Our expectations for growth in the main sectors are as follows:

The **oil sector**, the largest sector of the economy, accounting for 44.3 percent in real terms at the end of 2016 (Table 2), is forecast to decline marginally, as lower oil production (see oil market in 2017 section), will lead to negative growth (Figure 14). Saudi Arabia's full year average crude oil production (based on direct communication data) was 10.5 mbpd in 2016. This was directly a result of higher year-on-year crude oil and refined product exports. Going forward, there are obvious implications for Saudi crude oil production following the OPEC deal, with recent comments from the Saudi energy minister suggesting that current production levels are even

Figure 16: Petrochemical and plastic exports

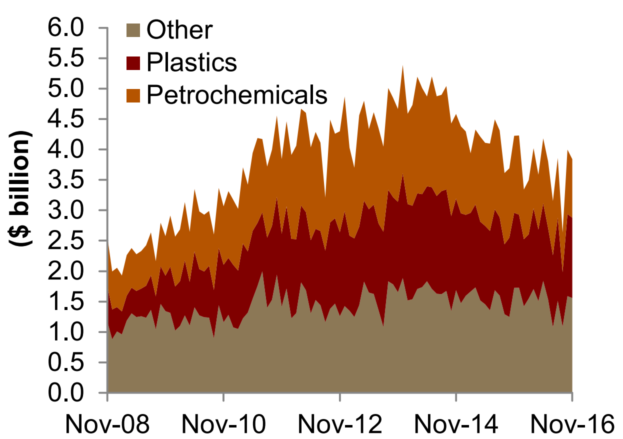
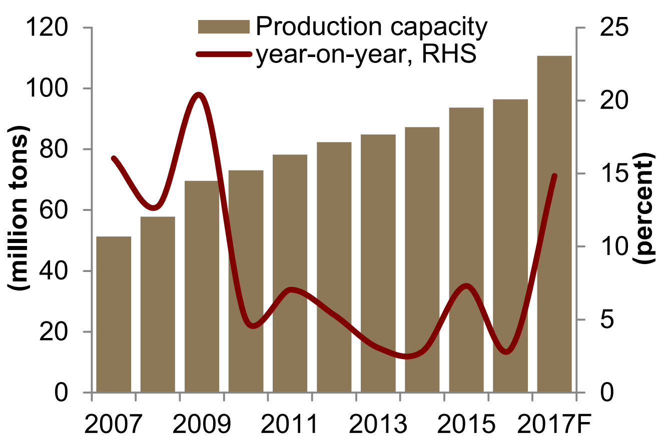


Figure 17: Saudi petrochemical capacity



Source: GPCA and Jadwa Investment

lower than the Kingdom's proposed reduction. Assuming OPEC sticks to proposed production cuts, we would expect to see Saudi production cuts being made possible due to lower domestic consumption rather than significantly lower crude oil exports. As historical JODI data highlights, Saudi domestic consumption is usually at its lowest during the first few months of the year, as cooler temperatures result in less energy consumption. In addition to the seasonally observed pattern, domestic consumption will also be pushed down even further as a result of slower economic growth and higher year-on-year gas production takes effect. However, in the case of non-compliance from other OPEC members, we would expect to see Saudi production rebounding pretty quickly to around 2016 levels (Box 1).

Box 1. Saudi Crude Oil Production

Under the OPEC agreement, Saudi Arabia will cut its production by 323 tbpd to 10.1 mbpd in H1 2017…

...however, this does not guarantee that other OPEC countries will follow through on their agreed cuts.

Under the OPEC agreement, Saudi Arabia will cut its production by 323 tbpd to 10.1 mbpd in H1 2017 (according to secondary sources data). Despite this, we have kept our Saudi crude oil production forecast unchanged year-on-year at 10.4 mbpd for 2017. It has been apparent, both before and after the OPEC meeting, that Saudi Arabia is committed to cutting production. This point was recently underlined by comments from the Saudi energy minister which stated that the Kingdom was producing below its currently agreed amount. However, this does not guarantee that other OPEC countries will follow through on their agreed cuts. In fact, historical data shows that OPEC has consistently exceeded its own production ceilings since 2001. Additionally, Russia, who also committed to cut 558 tbpd, does not have a history of following through on agreements, as highlighted by a similar deal 15 years ago, in which it failed to deliver on promises to cut in tandem with OPEC. As we pointed out above (see oil market in 2017 section) a crucial test in OPEC compliance is likely to come around March/April time, when the economic incentive to cheat for financially troubled producers will become more appealing. If non-compliance from other OPEC member did occur, we would expect to see Saudi production rebounding pretty quickly to 2016 levels of 10.5 mbpd. Besides this, the current OPEC agreement is for six months and, although it can be extended, there is no guarantee it will be, meaning higher Saudi production is still possible in H2 2017.

Lastly, on a technical note, OPEC's deal is based on output data from secondary sources (independent global oil agencies) whereas we use direct communications data (official production statistics) in our coverage of Saudi oil production. Historically, there are notable, differences between the two, with direct communication data being consistently higher. Due to all the above factors, our full year Saudi forecast remains at 10.4 mbpd for 2017.

Wholesale and retail sector growth contracted by 1.2 percent in 2016…

...compared to 2.8 percent growth in 2015

Wholesale and retail sector (16.1 percent of non-oil GDP) growth contracted by 1.2 percent in 2016, compared to 2.8 percent growth in 2015. We see the subdued performance in consumer spending rebounding in the year ahead, but not significantly (Figure 15). Despite the negative impact stemming from domestic energy price hikes and public sector allowance reductions, we believe the commencement of the household allowance program by mid-2017 will allow low-to-middle income households more room in spending on retail goods. It is well established that higher income groups are most likely to be affected by the energy price hikes, due to their proportionally higher use of energy consuming products. High income groups have a lower marginal propensity to consume retail goods, and are less likely to adjust their spending patterns significantly as a result of higher energy prices. We also expect to see a rise in demand for consumer products towards the end of 2017, as consumers bring forward the purchase of goods in anticipation of VAT in 2018, thereby pushing up demand for retail products in 2017.

The full effect of the government's policies for wage bill adjustment will be felt in 2017.

That being said, the full effect of the government's policies for wage bill adjustment will be felt in 2017. We expect the government to save around SR55 billion in wages and allowances, thereby impacting consumer spending. This adjustment should have a significant impact on the wholesale and retail sector during 2017.

***Non-oil manufacturing** growth is forecast to accelerate to 2.4 percent in 2017…*

...following a contraction of 1.2 percent in 2016.

Non-oil manufacturing (14.9 percent of non-oil GDP) growth is forecast to accelerate to 2.4 percent in 2017, following a contraction of 1.2 percent in 2016. The introduction of economic reforms under the NTP and Saudi Vision has facilitated developmental opportunities in the manufacturing sector. The government has encouraged strategic partnerships and Saudi-foreign joint ventures to raise foreign investor participation. Low oil prices in 2016 led companies to focus on developing a more sophisticated petrochemical derivatives market in the Kingdom, by aiming to introduce new regional products and utilizing more innovative technologies.

Moreover, we expect an improving trend in 2017 petrochemical exports and production capacity (Figures 16 and 17) as a result of the following project additions:

Several major manufacturing projects will enter the operational phase in 2017.

Several major manufacturing projects, which contribute to our forecasted sector growth, will enter the operational phase in 2017. The $20 billion Jubail-based Sadara Chemical Company complex, which is expected to come online during the first quarter of 2017, will be able to produce over 3 million tons per year (t/y) of ethylene and propylene. The complex is expected to generate more than 4 thousand jobs for Saudis once it is fully functioning. In addition, Sadara's adjacent chemical conversion and industrial park, PlasChem, will create over 15 thousand direct and indirect jobs for Saudis. PetroRabigh's Phase II project, coming on-stream in early 2017, will add 1.2 million t/y of ethylene to current production levels and introduce 12 new petrochemical products to the Kingdom, and the region as a whole. The $500 million Rabigh complex expansion will also employ thousands of Saudis in direct and indirect capacities.

Figure 18: Number of pilgrims performing Hajj

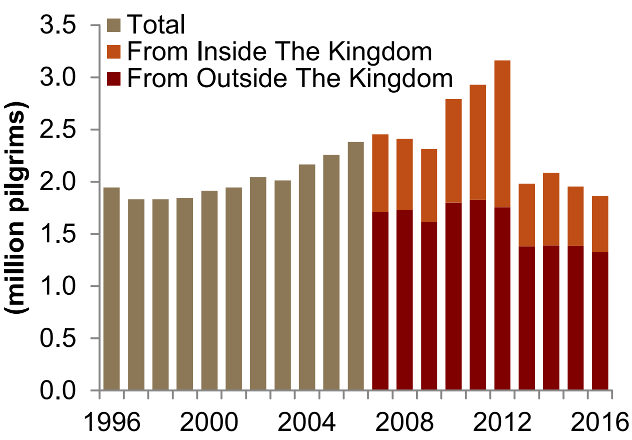
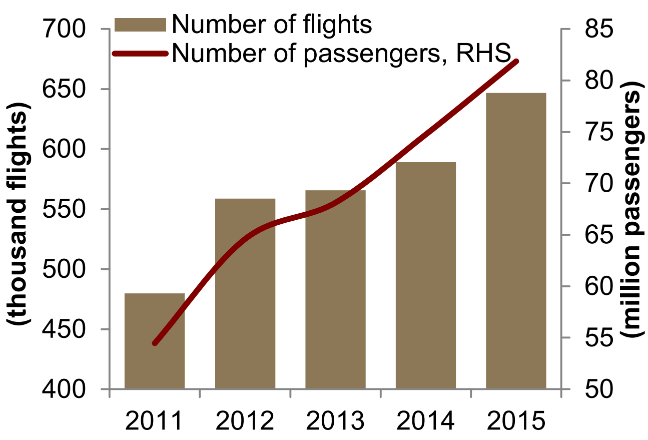


Figure 19: Total flights and passenger traffic



Source: GACA and Jadwa Investment

This will lead to other sectors, such as finance, insurance, and business services, to benefit from positive spillovers effects. Furthermore, the diminishing impact of 2016's energy price increases will lead to higher growth as the sector adjusts. Also, the government has communicated through the FBP, that no energy price increases will be implemented on industrial sectors during 2017. This should allow industries enough room to simultaneously expand and adapt to future energy price hikes. The government intends to gradually reform non-household energy prices from 2018 to 2020. This will be cushioned, to an extent, by the government's commitment to increase global market competitiveness by supporting private sector development and technological innovation, as well as developing sectoral-focused reforms (trade, investment, labor market) to enhance export potential.

We expect transport and communication to experience a slight slowdown from 2.6 percent to 2.4 percent.

We expect **transport and communication (14 percent of non-oil GDP)** to experience a slight slowdown in the year ahead, from 2.6 percent to 2.4 percent. The Kingdom's ranking in the World Economic Forum's Logistics Performance Index (LPI) has gone down in 2016; it was ranked 49th in 2014 but now holds the 52nd position. The LPI takes into account the competitiveness of a country's trade logistic performance and areas of improvement in comparison to 159 other countries, and ranks it accordingly. This drop underlines the need for investment and infrastructure development in the Kingdom's transport and telecommunications sector. In an effort to address this issue, the government has allocated the sector SR52.2 billion in its 2017 budget; mainly relying on public-private partnerships to improve local infrastructure, efficiency, and global communication.

Furthermore, the decrease in the total number of pilgrims and hajj visitors during 2016, a 17-year low (Figure 18), has contributed to lower sector growth. However, we believe this drop is due to the expansion projects that were taking place in Makkah at the time. With that being said, the cuts in the quota of domestic and foreign pilgrims have recently been lifted following the Council of Ministers' approval to increase the number of pilgrims and visitors performing hajj.

Airport expansions taking place in 2017 should improve future sector growth.

Airport expansions taking place in 2017 should improve future sector growth as well, as the Kingdom works to accommodate higher passenger traffic, especially during the peak religious seasons such

Figure 20: Real estate price index
(year-on-year change)

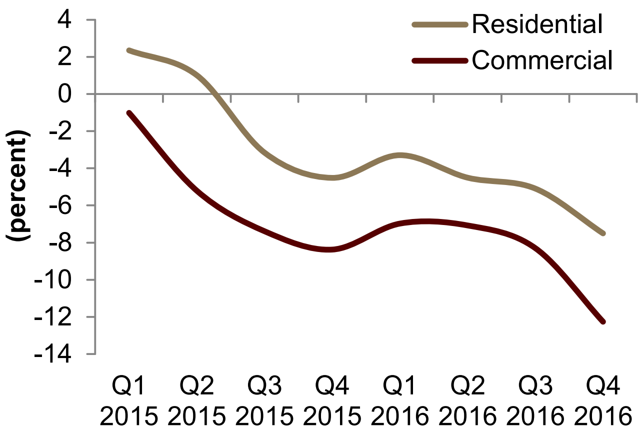
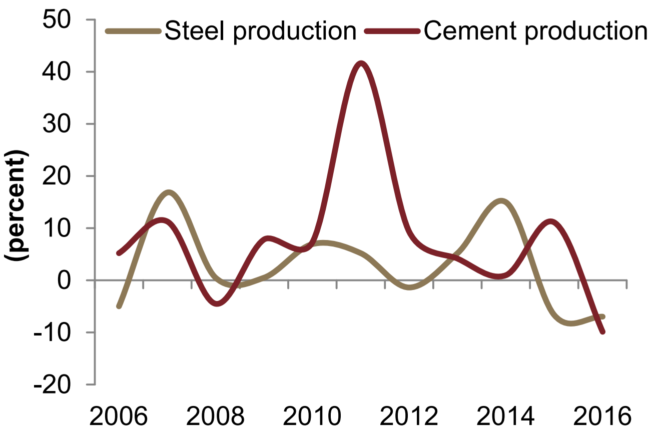


Figure 21: Cement and steel production
(year-on-year change)



of Ramadan and Hajj. The SR400 million King Khalid Airport expansion in Terminal 3 and 4 will be completed in Q1 2017, and they will each be able to handle 5 million passengers above current levels. In 2015, King Khalid Airport handled over 22.5 million passengers. Additionally, the $7.3 billion development project in Jeddah's King Abdulaziz International Airport will be able to handle over 15 million additional travelers. According to GACA, the airport handled over 30.1 million passengers during 2015. Both expansions should contribute to significant capacity additions over current levels (Figure 19).

Ownership of dwellings is likely to contribute significantly towards private sector growth in 2017 and beyond...

Ownership of dwellings (9 percent of non-oil GDP), is likely to contribute significantly towards private sector growth in 2017 and beyond. The announcement of the 'My House' program by the Ministry of Housing will be a major boost to this sector, as financial support will be given to 85 thousand eligible citizens as well as the handing of 75 thousand land plots in various residential areas. According to the Ministry of Housing, the program will result in the construction of 120 thousand units over three years, helping inject SR562 billion into the Saudi economy. Also, SAMA recently increased the maximum loan-to-value cap from 70 percent to 85 percent for citizens buying their first home. This will support growth in demand for housing units, thereby stimulating more residential real estate development.

...driven by major initiatives led by both public and private entities.

The Council of Ministers recently announced the establishment of the General Authority for Real Estate. It will be responsible for regulating, developing, and monitoring the real estate sector for the purpose of increasing efficiency and encouraging investment. It will also take charge of achieving the NTP objective of accelerating GDP growth in ownership of dwellings from an average of 4 percent between 2014-16, to an average of 7 percent by the year 2020. In addition, the General Authority for Statistics (GaStat) recently released the real estate price index (Figure 20), showing a downward trend in activity since 2015. We expect the trend in residential real estate to reverse during 2017 as major initiatives led by both public and private entities commence.

The construction sector's forecasted 2017 growth outlook of 0.8 is an improvement from -3.1 in 2016.

The **construction (8.5 percent of non-oil GDP)** sector's forecasted 2017 growth outlook of 0.8 is an improvement from -3.1 in 2016. Cement and steel production, a gauge of construction sector activity, have been down in recent months (Figure 21), but we expect this trend to reverse in 2017. We anticipate a pick up as

Figure 22: Bank claims on private sector

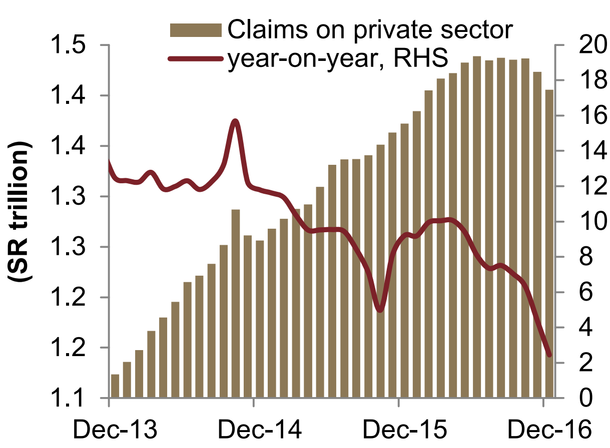
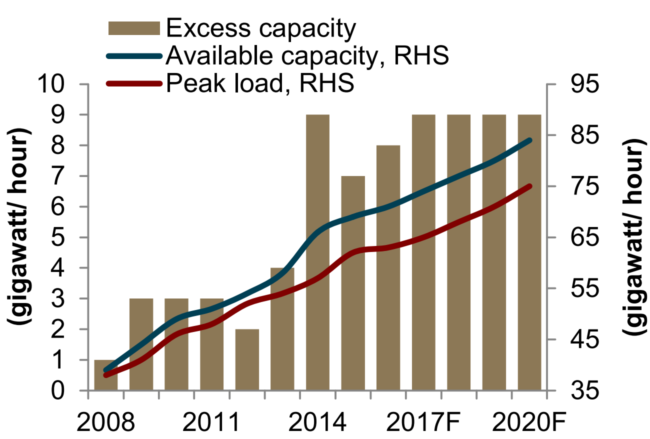


Figure 23: Peak loads and excess capacity



Source: ECCRA and Jadwa Investment

recommencement of government payments to contractors, which began in late 2016 continues, and as a result of the imposition of white land fees in 2017. The revenue arising from white land fees will facilitate the Ministry of Housing's (MoH) plans to provide affordable housing to those in the Eskan program and improve the Kingdom's housing infrastructure. In March 2016. the MoH signed agreements with contractors to build over 56 thousand units in the Eastern Province, Riyadh, Makkah, Ha'il and Tabuk. Further, the Ministry studied population growth patterns and estimated last year that over 3 million homes will be needed by 2025. In addition, the introduction of Real Estate Investment Traded Funds (REITs) to the Saudi market in October will contribute to sector growth, as they encourage real estate investment and diversification. The majority of the benefits associated with REITs should begin to take form in 2017, as a more established infrastructure continues to develop (For more details see our December 2016 publication titled Real Estate Investment Traded Funds)

We expect finance, insurance, and business services to be among the fastest growing sectors in the economy during 2017.

We expect **finance, insurance, and business services (6.3 percent of non-oil GDP)** to retain its position of being among the fastest growing sectors in the economy during 2017. Despite the slowdown in bank claims on the private sector (Figure 22), the 2017 budget announcement highlighted promising initiatives to accelerate the overall pace of non-oil economic development, to which this sector plays a key role. The most anticipated initiative is the government's 5-year SR200 billion private sector incentive program, SR42 billion of which will be spent during 2017; due to this sector's close correlation with private sector activity, positive spillovers will transpire as the year runs course and the government continues to support private sector development and technological innovation. Furthermore, sector growth will be stimulated as the government continues to develop and open its capital market. The recently approved Parallel Market, with a planned launch this month, marks a move to further advance capital market development, which is aligned with the goals underpinning the Saudi Vision 2030; that underline the significance of developing a more mature capital market, thereby creating more investment diversification opportunities.

Electricity, gas, and water growth is forecast to accelerate to 3.7 percent in 2017…

...up from 0.8 percent in 2016.

Electricity, gas, and water (2.3 percent of non-oil GDP) growth is forecast to accelerate to 3.7 percent in 2017, up from 0.8 percent in 2016. This growth is reflected in the number of power and water projects coming on stream to satisfy national demand during 2017, which are valued at around $22.2 billion; an increase from the previous year's $20 billion investment in projects - the largest of which is the Saudi Electricity Company's $5 billion Rabigh project. The Makkah-based plant will work to meet the Kingdom's long-term increase in demand for power, with a particular focus on the Western region. As a whole, the project will be complete during the first quarter of 2017, with a total power capacity of 3.1 thousand megawatts (mw). Another project to come online in 2017 is the $3.3 billion, 2.7 thousand mw thermal power plant in Shuqaiq, Jizan. The plant will use fuel oil fitted with sulfur-removing technology, and will contribute in meeting the growing demand for power.

Based on data from the Electricity and Cogeneration Regulatory Authority (ECRA), the total level of electric energy sold during the 10 years from 2006 increased by 74.5 percent to arrive at 294 thousand gigawatt hours (GWh) in 2015 (Figure 23). Peak loads rose by 10.1 percent to 62 thousand GWh between 2014 and 2015; we expect this trend to slow in 2017 as the Kingdom plans to establish a National Water and Electricity Efficiency Program. It is important to maintain a reasonable amount of excess capacity over peak load, in order to help attract industrial development and foreign capital, and ultimately establish a sizable industry. Further, government officials previously suggested that the Kingdom needs SR500 billion worth of power projects over the next decade to cope with rising demand. However, over the long-term, the gradual increases to energy and water prices could contribute to slowing demand and improving energy efficiency, thereby reducing the need for a fast-paced expansion in electricity and water projects.

The non-oil mining and quarrying sector is forecast to post significant growth in 2017…

The non-oil mining and quarrying (0.7 percent of non-oil GDP) sector is forecast to post significant growth in 2017. This comes as a result of the extensive large-scale investment projects to come into the operational phase during the year. Amongst these projects is the $96 billion phosphate joint venture between SABIC, Ma'aden, and the Mosaic Company. The project, which will be completed in late 2017, includes 10 production facilities; with 7 in Waad AlShammal and 3 in Ras AlKair, making it one of the world's largest integrated phosphate complexes. It will have a total production capacity of 16 million tons per year of phosphates, to be used for industrial purposes and in food industries. This should have a positive impact on the non-oil manufacturing and wholesale and retail sectors. The president of Ma'aden Aluminum also recently stated that the company has plans to export 300-400 thousand tons of alumina in 2017.

...driven by the commencement of the $96 billion Ras Alkhair phosphate joint venture...

...which would become one of the world's largest integrated phosphate complexes.

Economic reform plans announced under the Saudi Vision 2030 this year aim to increase the mining sector's GDP contribution to SR240 billion from the current SR64 billion. Additionally, the sector is targeted under FBP 2020 to undergo structural reform in order to stimulate private sector investment. FBP has also highlighted infrastructure investment, improvements in licensing procedures, and development of funding methods as ways to support growth in the mining sector. The sector has already seen a notable increase in net employment of 37 thousand jobs during 2016, with similar growth expected in 2017.

Fiscal Policy

The 2017 budget outlines a return to an expansionary stance with budgeted spending up by SR50 billion, year-on-year to SR890

Figure 24: Fiscal deficit to shrink

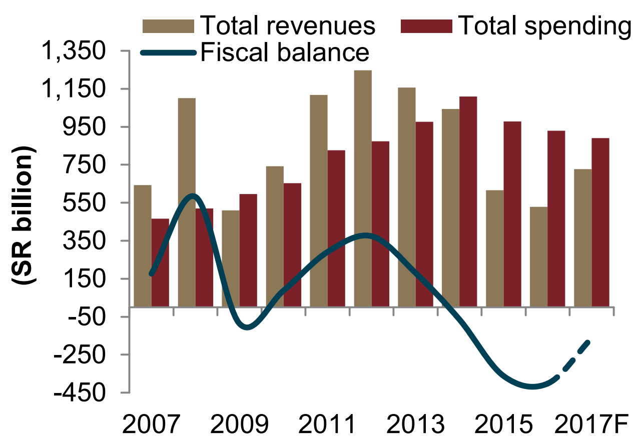
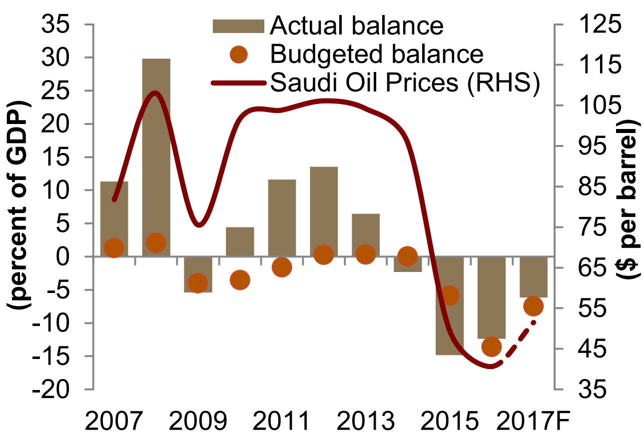


Figure 25: Fiscal balance and Saudi oil prices



2017's budget is set in a unique way that serves the overarching goals of the Kingdom's Vision 2030.

The government established the Spending and Rationalization Office in 2016…

...with an estimated SR79 billion being saved from reviews to a number of planned and ongoing projects.

As a result, 2016 spending reached SR825 billion, coming out lower-than-budgeted for the first time since 1998.

billion. This underscores the government's resilience in not curtailing spending despite the persistence of subdued oil prices, with Brent averaging $43pb in 2016, down from $52pb in 2015. That said, this year's budget is set in a unique way that serves the overarching goals of the Kingdom's Vision 2030, with a strong focus on supporting economic diversification, shielding economically vulnerable households from necessary energy price reforms, and spending on key physical and social infrastructure. We believe the 2017 budget numbers are less conservative than previous years, based on the underlying assumption of the budget oil price. However, prudent spending by the government in 2016 is an indicator that a strong commitment will be made to keep within the budgeted total of SR890 billion (Figure 24).

As highlighted in our 2016 budget report last year, we expected the government to demonstrate an increasing tendency to monitor both current and capital spending in order to increase operational efficiency. In line with this, the government established the Spending and Rationalization Office in 2016, with an estimated SR79 billion being saved from reviews to a number of planned and ongoing projects. We also witnessed the reduction to public workers' allowances in October 2016, which we estimate could save up to SR55 billion per year, and help realize the NTP target of reducing the share of spending on the wage bill from 45 percent to 40 percent by 2020. As a result, total spending –excluding the SR105 billion in delayed payments- reached SR825 billion in 2016, coming out lower-than-budgeted for the first time since 1998. Even when taking into account the SR105 billion payment for pre-2016 dues to the private sector, the overspending ratio was 10.7 percent in 2016, significantly lower than the 2005-15 average overspending of 24.4 percent.

The budget statement highlighted several NTP initiatives for tighter control over capital spending, including narrowing the variation in project expenditure from 35 percent to 10 percent by 2020. Revenue diversification initiatives, including the introduction of excise tax in 2017, and value-added tax in 2018 were also announced and will likely further enhance the structure of the budget, placing the Kingdom on a more sustainable fiscal path.

That being said, the Kingdom has budgeted for a third consecutive fiscal deficit, amounting to SR198 billion in 2017, compared with SR145 billion in 2015 and SR326 billion in 2016. With optimism

Figure 26: Gross public debt

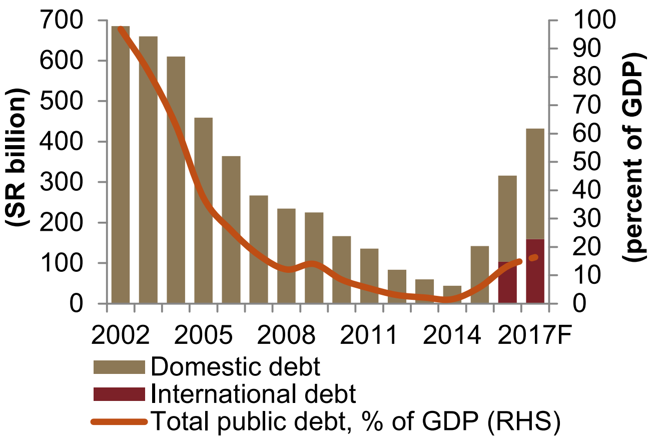
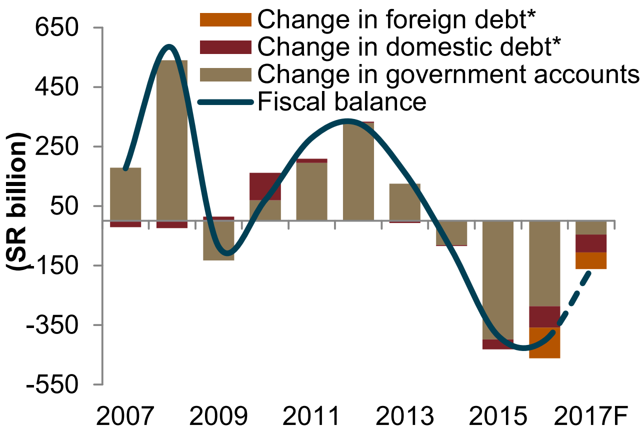


Figure 27: Financing the fiscal deficit



Note: * negative sign denotes accumulation of debt regarding the outlook for global oil market, and a strong drive to increase non-oil revenue, the budget foresees a rebound in revenues by 34.7 percent. As for spending, a positive growth of 6 percent is budgeted compared to last year.

We believe the government is budgeting for a compliance with OPEC cuts...

...our baseline forecast, however, is still at 10.4mbpd due to a number of risks.

We calculate the Saudi export price at $52 per barrel (pb) (around $55pb for Brent) and crude oil production of 10.1 million barrels per day (mbpd) in 2017 are consistent with the revenue projections contained in the budget (Figure 25). We believe the government is budgeting for a compliance with OPEC cuts, agreed back in October, thereby reducing year-on-year production by 323 thousand barrels per day (tbpd). Our baseline forecast, however, is still at 10.4mbpd due to a number of risks associated with non-compliance from other OPEC members, but not Saudi Arabia, and therefore resulting in the OPEC deal not materializing. We, therefore, expect 2017 government revenues to be higher than the budgeted level. We also believe that more efficient spending measures will mean that spending will match the budgeted figure of SR890 billion. We therefore forecast a lower deficit of SR162 billion (6.1 percent of GDP) based on an oil price of $54.5 pb for Brent in 2017.

According to the budget statement, a further SR120 billion worth of new debt instruments will be issued in 2017…

...implying a 2017 year-end debt level of SR433 billion (16.4 percent of GDP).

Following the Kingdom’s first international sovereign bond issuance of $17.5 billion in October 2016, the budget statement explicitly states that the government will raise a further SR120 billion through the issuance of new debt instruments in 2017, implying a 2017 year-end debt level of SR433 billion (16.4 percent of GDP) (Figure 26). Further, government officials were quoted as saying that SR70 billion will be issued domestically, with the remaining SR50 billion ($13 billion) being made up of new international sovereign issuances in 2017. It is important to highlight that although the government has room to raise SR160 billion in debt annually to reach the targeted level of 30 percent of GDP by 2020, it has chosen to raise a smaller amount in 2017, at SR120 billion. Also, the expected recommencement of the domestic bond program, likely to be priced by the market, will lead to the establishment of a credible yield curve.

That said, we believe that financing the 2017 deficit will include the simultaneous drawing down of the stock of government deposits (29 percent of the 2017 deficit), in addition to raising domestic and international debt (71 percent of the 2017 deficit) (Figure 27).

Figure 28: Fiscal savings from FBP initiatives

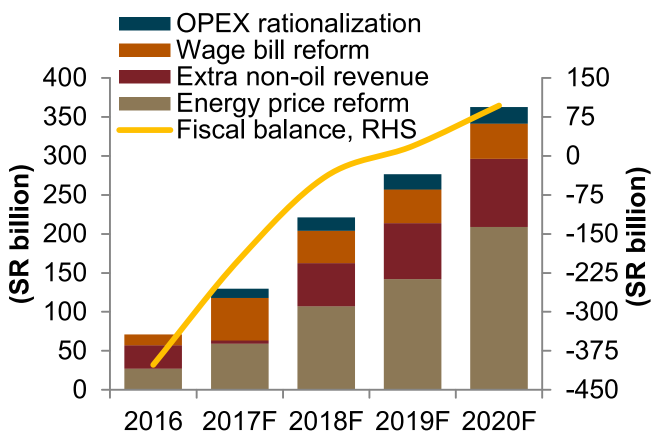
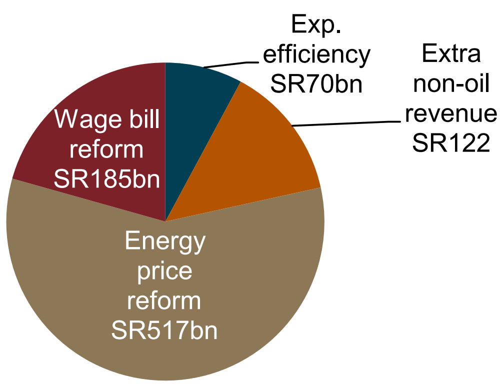


Figure 29: Cumulative distribution of Fiscal savings (2017 to 2020)



The FBP contains all reforms relevant to reaching a balanced budget by 2020.

We estimate that FBP initiatives will result in SR100 billion worth of gross savings in 2017 alone.

The FBP touches on critical socioeconomic aspects as well…

...such as the creation of a household allowance program.

Box 2. Fiscal Balance Program

The 2017 budget statement included details of the FBP, one of the programs highlighted in Vision 2030. The FBP contains all reforms relevant to reaching a balanced budget by 2020 and includes initiatives designated for enhancing spending efficiency, reforming energy prices, and promoting non-oil revenue.

We estimate that FBP initiatives will result in SR100 billion worth of gross savings in 2017 alone. Incorporating the reductions in public sector worker's allowances and wage freeze will contribute to 55 percent of 2017 gross savings. A further 29 percent of these savings will come from energy price reform - whilst new measures to enhance the efficiency of spending and raise non-oil revenue will contribute 12 percent and 4 percent, respectively (Figures 28 and 29). That being said, we believe that the government has already incorporated these savings into the 2017 budget (Table 3), and therefore believe in the commitment of the government to deliver on these reforms. These initiatives will help in keeping total government spending in an expansionary mode from 2018 to 2020, as an expansionary fiscal policy across three different scenarios is highlighted in the FBP document.

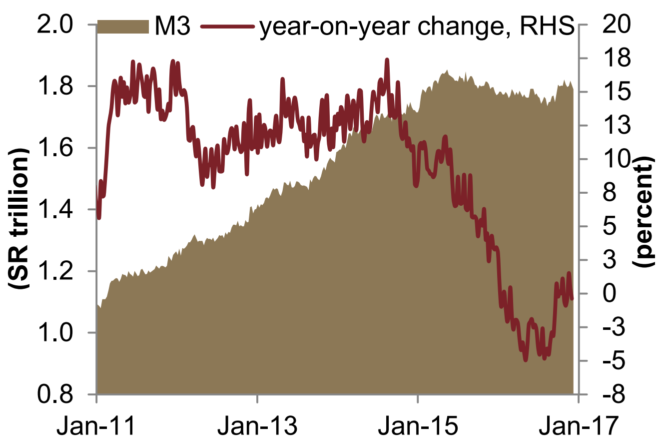
Table 3. Impact of FBP initiatives on 2017's budget

SR Billion	No reform	With reform	Difference
Non-oil revenue	207	211	4
Oil revenue	452	481	29
Total spending	957	890	-67
Of which: Wage bill	356	302	-55
Fiscal deficit	-298	-198	100

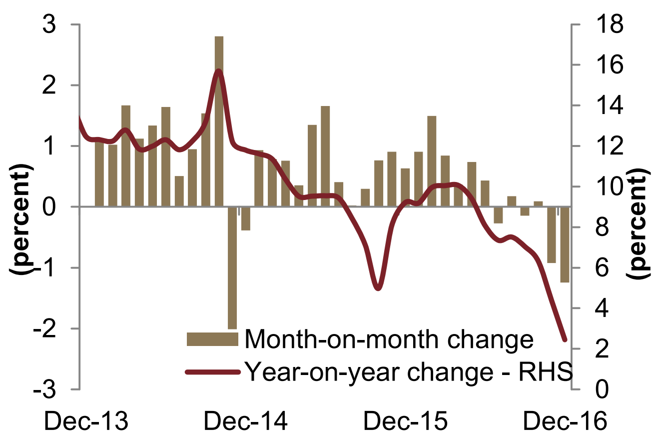
The FBP touches on critical socioeconomic aspects as well, such as the creation of a "Household Allowance Program", which is aimed to safeguard vulnerable low-to-mid income households from the negative consequences of energy price reform. This program will eventually develop into the "Unified Citizen's Account Program", a comprehensive platform acting as a social safety net for a more efficient determination of the true needs of eligible households.

FBP's other major focus is on supporting overall growth in the economy. This will be achieved through the recently established "Local Content and Private Sector Development Unit". This unit will

Figure 30: Broad money supply (M3)



31: Growth in credit to the private sector



FBP's other major focus is on supporting overall growth in the economy.

take charge of providing stimulus to the private sector, creating a framework for local content development, and ensuring that specific economic sectors are promoted.

FBP has reemphasized several economic targets which were highlighted in both Vision 2030 and NTP 2020. These include raising the share of non-oil private sector GDP from 38.8 percent of overall GDP to 65 percent by 2030. Another target is to raise non-oil exports' share of non-oil GDP from 13 percent in 2015 to 50 percent by 2030. A shorter-term target is to increase the local content share of expenditures from 36 percent to 50 percent by 2020.

Monetary and Financial Developments

Policy measures undertaken by SAMA in recent months have contributed to halting the rise in the cost of funding.

On December 14, 2016, the Saudi Arabian Monetary Authority (SAMA) increased its reverse repo policy rate by 25bps to 0.75 percent, its second such increase since 2008, mirroring the hikes in US interest rates. Meanwhile, SAMA's key policy repo rate was kept unchanged at 2.0 percent. SAMA's rate increase and the prospect of further Fed hikes in 2017 will not have a significant impact on the domestic liquidity situation. This is specifically due to SAMA recently passing several measures to enhance liquidity in the domestic financial system. In September, SAMA introduced new 90-day repos, and capped the weekly issuance of SAMA bills to SR3 billion, down from SR9 billion previously. SAMA has also recently approved changes to calculate the Saudi Interbank Offer Rate (SAIBOR) more appropriately. These changes, along with the international bond issuance, and the resumption of payments by government to contractors, as per an official announcement made in October, have contributed to halting the rise in the cost of funding. The SAIBOR has started to decline, and annual growth in deposits and broad money supply turned positive in October for the first time in 2016 (Figure 30).

Despite the recent improvement in monetary aggregates, credit growth has showed recent signs of a slowdown.

Despite the recent improvement in monetary aggregates, credit growth has showed recent signs of a slowdown, falling to a six-year low of 2.5 percent in December 2016 (Figure 31), reflecting the negative sentiment following the delays in government payments to contractors during 2016. We, however, expect an improving trend in

Figure 32: Estimate of bank excess liquidity

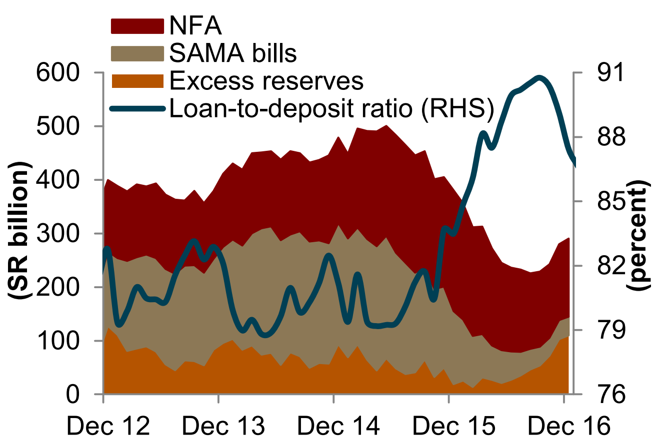
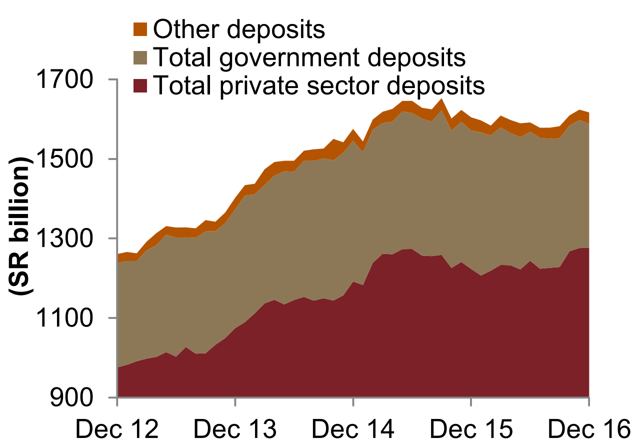


Figure 33: Total deposits by institution



Monetary aggregates rebounded following the commencement of the international sovereign bond program in October 2016.

2017 as the government delivers on multiple initiatives announced along the 2017 budget and Fiscal Balance Program.

The impact of the resumption in government spending is already being reflected through a recent rebound in growth of monetary aggregates. Growth in monetary aggregates have also been made possible through the substitution of monthly domestic sovereign bond issuances with a $17.5 billion international sovereign bond program in October 2016 (see fiscal policy section). As a result, monetary aggregates have showed a recovering trend in recent months, confirming our earlier view that the prospect of international borrowing will lead to an improvement in domestic liquidity conditions (Figure 32). A breakdown by institution showed that private sector deposits rose, on a net basis, by SR48 billion since the commencement of government payments (Figure 33). That said, we believe this growth in monetary aggregates will turn positive, but remain slow in 2017.

We expect SAMA's key policy repo rate to be raised by 0.50 percentage points in 2017, mirroring the anticipated Federal Funds rate hike. However, as mentioned in our December 2016 publication titled Monetary and Financial Update, we do not expect this policy move to have a material impact on liquidity levels, deposit growth, or significant movements in market rates. We also believe higher rates should benefit banks through higher profitability, since a large proportion of their liabilities are denominated in non-interest bearing demand deposits. That said, previous incidences show that interest rate pass-through effects have been minimal on demand for credit, and that government spending is the main catalyst behind such growth in demand for credit.

Maintaining a domestic issuance with reasonable amounts is nevertheless necessary to establish a benchmark yield curve.

While the 2015-16 series of government sovereign bond issues had a significant impact on reducing excess bank liquidity, maintaining a domestic issuance with reasonable amounts is nevertheless necessary to establish a benchmark yield curve. Also, moving to market-based pricing for domestic debt through the announcement of an auction schedule would further support the development of a highly needed local debt capital market. We therefore estimate that a monthly issuance in the range of SR5-10SR billion will ensure the eventual establishment of such curve. We believe that such a regular issuance will not have a damaging impact on liquidity, given the ample buffers enjoyed by domestic banks. Eventually, the

Figure 34: Inflation

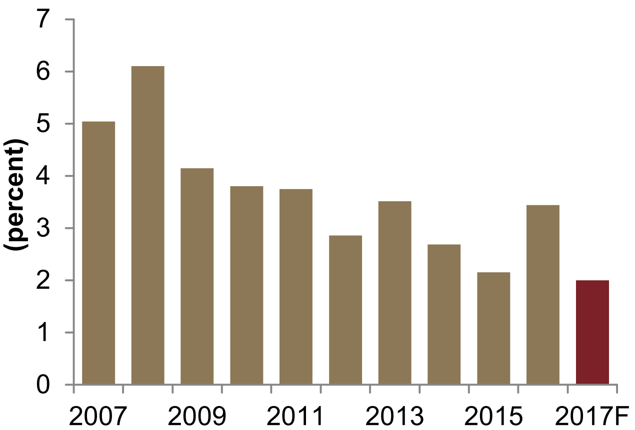
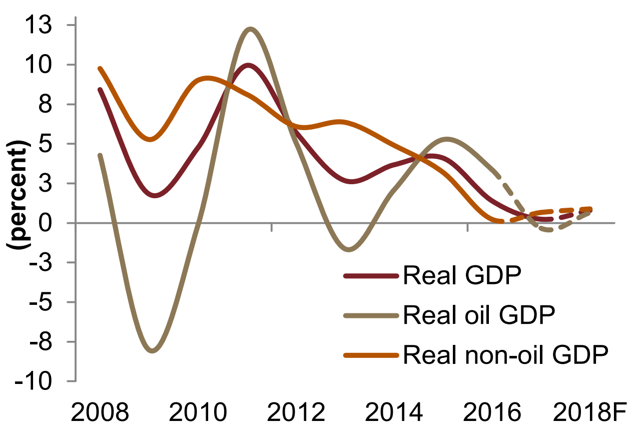


Figure 35: Real GDP growth forecast



establishment of such a curve will allow corporates to price their issuances and enable a liquid fixed income market within the Kingdom.

Year-on-year growth in credit to the private sector fell to 2.5 percent in December, a six-year low.

In 2016, bank credit to the private sector showed a slowing trend. Year-on-year growth in credit to the private sector fell to 2.5 percent in December, a six-year low. In month-on-month terms, average growth in credit was 0.2 percent in 2016, compared with 0.7 percent in 2015. This is somewhat in line with our expectations, as a subdued level of economic activity, coupled with negative sentiment due to the delays in government payments during 2016, resulted in a slower expansion in credit. In 2017, we forecast credit growth to rise slightly to 5.5 percent, benefiting mainly from promising initiatives highlighted in the FBP.

Lower spending by the government, particularly on wages, and higher energy prices, will translate into less credit being extended to consumers, which could potentially result in significantly lower consumption expenditure. However, the commencement of the household allowance program by mid-2017 could limit such impact. Meanwhile, growth in corporate credit will hinge on the general sentiment within the economy and the effectiveness of the SR200 billion private sector incentive package announced along with the Fiscal Balance 2020 program. Also, persistence of regional geopolitical risk and the external economic environment present downside risks on the general market sentiment.

Inflation is likely to slow despite cost-push factors

Inflation is expected to slow further in 2017, reaching 2 percent.

Inflation is expected to slow further in 2017, reaching 2 percent, mainly owing to a higher base particularly during the first half of the year. Inflation spiked early in 2016 as a result of initial energy price hikes, but will show an opposite trend in the first six months of 2017. The implementation of excise taxes on tobacco and other harmful products in Q1 2017 is not likely to have a material impact on the headline figure given these products carrying a small weight in the consumer basket. However, the new round of energy price hikes by mid-2017 will push inflation upwards again, putting the annual average close to 2 percent according to our estimates (Figure 34). We do not foresee any changes to the Riyal's peg to the US Dollar. The stronger outlook for the US Dollar and the prospect of a faster pace of interest rate hikes may also put further downward pressure on prices of imports.

The Outlook for 2018

In 2018, economic growth is likely to accelerate slightly.

The implementation of VAT will offset any growth-enhancing measures specified in the NTP and Vision 2030 plans…

...leading to a marginal acceleration in non-oil GDP growth.

In 2018, economic growth is likely to accelerate slightly (Figure 35), owing to an increase in oil sector GDP. Oil production will likely increase as global oil balances turn into a deficit. Meanwhile, non-oil GDP growth will likely be at similar levels to 2017. The implementation of VAT in 2018 will offset any growth-enhancing measures specified in the NTP and Vision 2030 plans, leading to a marginal acceleration in non-oil GDP growth. The implementation of VAT will likely have a considerable impact on private sector activity, particularly wholesale and retail, finance, and transport. Furthermore, growth in the non-oil manufacturing sector will likely continue, driven by major capacity additions.

The fiscal position will nearly balance, as a combination of improving oil revenues and additional sources of non-oil revenue will cover

The fiscal position will nearly balance.

A new round of reform to electricity prices is likely to be implemented on non-households.

most of the planned spending for the year. According to the baseline scenario represented in the FBP (See Box 2), the government is planning to spend SR928 billion in 2018, representing a SR38 billion increase over the 2017 budgeted level. This spending is likely to be increasingly targeted towards NTP initiatives and therefore be more growth-enhancing to the private sector. That said, a new round of reform to electricity prices is likely to be implemented on non-households. According to the FBP, electricity pricing for non-households will be linked 100 percent to a reference price that would eventually be disclosed.

The current account balance will turn positive for the first time since 2014,

The current account balance will turn positive for the first time since 2014, as both oil and non-oil exports rebound, while imports should grow at a slower pace. This could have a significant impact on slowing the net FX reserve withdrawals. Other factors such as foreign borrowing, FDI attraction, and portfolio investment inflows will play an increasingly important role in further slowing down the pace of FX reserve withdrawals.

Inflation will accelerate, pushed by the introduction of VAT.

Inflation will accelerate, pushed by the introduction of VAT. This acceleration will also be due to a rebound in international food prices and other products. An important mitigating factor will be the increased supply of residential housing units, which should slow rental inflation. Another mitigating factor could be the continued strengthening of the US Dollar. However, this will mainly depend on the relative economic performance of the Kingdom's other major trade partners.

Key Data

	2010	2011	2012	2013	2014	2015	2016E	2017F	2018F
Nominal GDP									
(SR billion)	1,976	2,511	2,760	2,800	2,836	2,444	2,399	2,639	2,819
($ billion)	527	670	736	747	756	652	640	704	752
(% change)	22.8	27.1	9.9	1.5	1.3	-13.8	-1.9	10.0	6.8
Real GDP (% change)									
Oil	-0.1	12.2	5.1	-1.6	2.1	5.3	3.4	-0.3	0.7
Non-oil private sector	9.7	8.0	6.5	6.9	5.5	3.4	0.1	1.0	1.2
Government	7.4	8.4	5.3	5.1	3.7	2.7	0.5	0.0	0.2
Total	4.8	10.0	5.7	2.7	3.7	4.1	1.4	0.2	0.8
Oil indicators (average)									
Brent ($/b)	79.8	112.2	112.4	109.6	99.4	52.1	43.2	54.5	60.8
Saudi ($/b)	77.5	103.9	106.1	104.2	95.7	49.4	40.6	51.5	56.8
Production (million b/d)	8.2	9.3	9.8	9.6	9.7	10.2	10.4	10.4	10.5
Budgetary indicators (SR billion)									
Government revenue	742	1,118	1,247	1,156	1,044	616	528	728	926
Government expenditure*	654	827	873	976	1,110	978	930	890	928
Budget balance	88	291	374	180	-66	-362	-402	-162	-2
(% GDP)	4.4	11.6	13.6	6.4	-2.3	-14.8	-16.8	-6.1	-0.1
Domestic debt	167	135	99	60	44	142	317	433	628
(% GDP)	8.5	5.4	3.6	2.1	1.6	5.8	13.2	16.4	22.3
Monetary indicators (average)									
Inflation (% change)	3.8	3.7	2.9	3.5	2.7	2.2	3.5	2.0	4.7
SAMA base lending rate (%, year end)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.5	3.0
External trade indicators ($ billion)									
Oil export revenues	215	318	337	322	285	157	131	168	188
Total export revenues	251	365	388	376	342	204	181	220	243
Imports	97	120	142	153	158	159	145	144	147
Trade balance	154	245	247	223	184	44	36	76	96
Current account balance	67	159	165	135	74	-57	-51	-12	14
(% GDP)	12.7	23.7	22.4	18.1	9.8	-8.7	-8.0	-1.7	1.8
Official reserve assets	445	544	657	726	732	616	523	463	423
Social and demographic indicators									
Population (million)	27.4	28.2	28.9	29.6	30.3	31.0	31.7	32.4	33.1
Saudi unemployment (15+, %)	10.5	12.4	12.1	11.7	11.7	11.5	12.0	11.6	11.1
GDP per capita ($)	19,211	23,766	25,471	25,223	24,962	21,014	20,150	21,720	22,737

Note*: 2016 Government expenditure includes SR105 billion in due payments for previous years

Sources: Jadwa Investment forecasts for 2016 to 2017. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. General Authority for Statistics and Jadwa Investment estimates for oil, social and demographic indicators.

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The data contained in this Research is sourced from Reuters, Bloomberg, The World Bank, Markit, Tadawul and national statistical sources unless otherwise stated.

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