جدوى للإستثمار
Jadwa Investment

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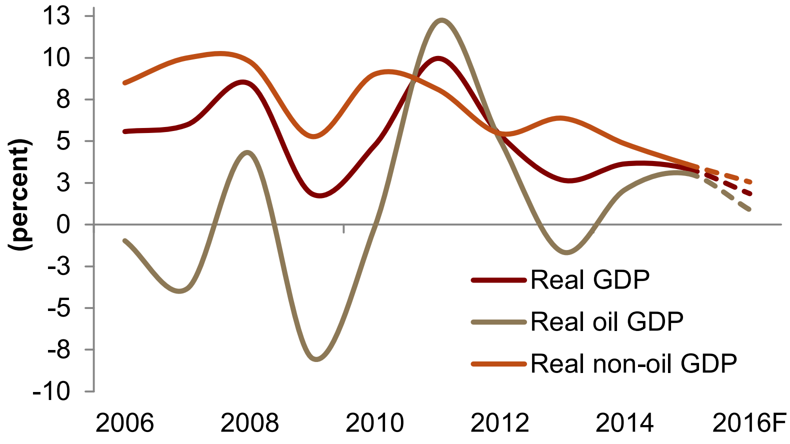
The Saudi economy in 2016

We expect that the Saudi economy will continue to slow in 2016, dragged down by slower growth in both the oil and non-oil sectors. Annual growth in the oil sector will remain positive in 2016 with average oil output expected to increase slightly, as the Kingdom continues to protect its share in the oil market. The non-oil private sector will continue to grow albeit at a slowing pace, as reduced government spending will most likely have a negative impact on business activity. However, growth in all sectors in the non-oil private economy will remain positive. As oil prices fall further, the current account balance will record a second consecutive external deficit, while the fiscal deficit will remain in double digits. However, we believe the government will continue to gradually diversify its revenue base and consolidate its spending.

We expect economic growth to slow to 1.9 percent in 2016, down from 3.4 percent in 2015. Oil sector growth is expected to slow to 0.9 percent in 2016 compared to 3.1 percent in 2015. The slower growth in the oil sector will mainly be due to a marginal rise in oil production following a more pronounced increase of 4.3 percent in 2015. This is likely to come as the Kingdom continues to satisfy its growing domestic energy consumption as well as maintain its market share in the global oil market. Growth in the non-oil private sector is expected to continue to slowdown but remain positive at 2.6 percent. We predict a growth of 4 percent in the utilities sector which makes it the fastest growing sector in the Kingdom in 2016. This is because the sector is expected to benefit from significant additions to power and water generation, transmission, and distribution projects. The non-oil private sector should continue to be the engine for growth in the economy, with government spending remaining central for the growth in private sector activity. Corporate lending and domestic consumption will also be primary drivers for growth. Within the non-oil private economy, wholesale & retail and transport are likely to also be among the fastest growing sectors.

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



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For the first time since 2002, a cut in total spending has been budgeted for 2016.

We expect a narrower gap between budgeted and actual expenditures, leading to a deficit of SR402 billion.

We think financing of the deficit will continue to be through a combination of debt issuance and a drawdown of foreign reserves.

The main risks to our forecast stem from the external environment.

An absence of serious reform also constitute a downside risk to long-term fiscal and income diversification.

According to International Monetary Fund (IMF) data, global GDP growth is forecasted at 3.3 percent in 2016.

For the first time since 2002, a cut in total spending has been budgeted for 2016. Despite the lower budgeted spending of SR840 billion (compared to SR860 billion for 2015), the Kingdom is still budgeted for a fiscal deficit. This is the second consecutive budgeted deficit, amounting to SR326 billion, compared to SR145 billion for 2015. This continues to highlight the willingness and ability to support the economy despite lower budgeted revenues at SR514 billion. We view this total spending as accommodative and it will remain important as international and regional events have the potential to damage investment sentiment. We expect a narrower gap between budgeted and actual expenditures, leading to a deficit of SR402 billion (17.8 percent of GDP). This narrowing gap will reflect the improvement in the efficiency of public spending as the government seeks to be more prudent in managing the fiscal budget. We think financing of the deficit will continue to be through a combination of debt issuance and a drawdown of foreign reserves. This financing strategy has already reduced the pressure on foreign reserves as the main fiscal deficit financing tool, though the deficit in the current account balance will maintain another pressure point on foreign reserves. The government will also be able to utilize the excess liquidity with banks as it continues to carry on with more domestic bond issuance.

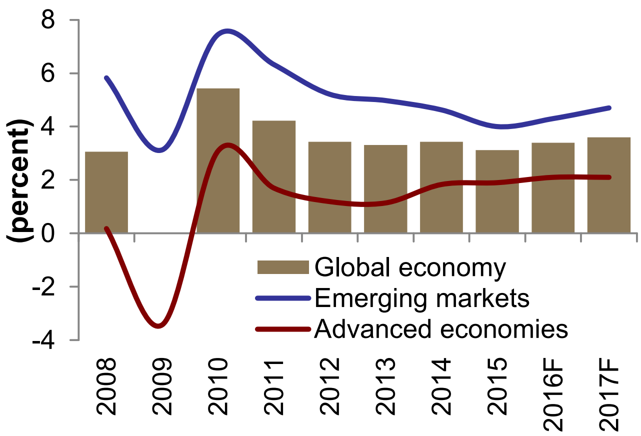
The main risks to our forecast stem from the external environment. A significant slowdown in global growth and geopolitical tensions constitute key risks. A sustained period of lower oil prices would lead to a higher-than-forecasted fiscal deficit. This, however, is likely to have a small impact on the Saudi private sector. This is because the momentum of growth in the Kingdom is dependent mainly upon the government maintaining an elevated level of spending that is comfortably afforded. Regional political uncertainty will continue to cast a further shadow over the economy and any heightening of tensions will hit businesses and consumer confidence. An absence of serious reform, including any further delays to the highly anticipated National Transformation Plan (NTP), constitute a downside risk to long-term fiscal and income diversification.

Global economic outlook

Global economy:

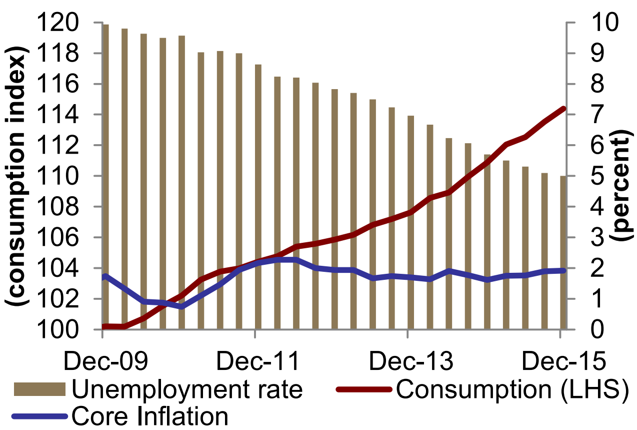
Global economic growth in 2016 is expected to be in line with growth rates of the last few years. According to International Monetary Fund

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



Source: IMF and Jadwa Investment

Figure 3: US inflation, unemployment and private consumption*



Source: US Bureau of Economic Analysis, Thomson Reuters and Jadwa Investment

*Note: Private consumption index = 0 in 2009

The US will be the major proponent of growth amongst the advanced economies.

Emerging market growth rates averaged 6 percent year-on-year between 2010-2015, but this will drop to 4.3 percent in 2016.

The US economy will grow at a stable rate of 2.6 percent in 2016, according to the IMF.

The danger going forward includes the Fed tightening cycle, which is likely to result in the dollar gaining more value and, in turn, affecting exports…

...steeper interest rates rises would increase borrowing costs for corporates, especially those with large levels of high-yield debt.

(IMF) data, global GDP averaged 3.3 percent; year-on-year, between 2012-2015 and 2016 forecasts point to only marginally higher growth rate of 3.4 percent (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 UK will continue to show similarly solid growth rates and the Euro zone is expected to show more consistent, if somewhat slower, growth too. Japan remains the weaker element amongst the major advanced economies but is nevertheless forecast to improve mildly in 2016. Compared to recent historical performance, emerging market growth in 2016 is expected to disappoint. Emerging market growth rates averaged 5.4 percent year-on-year between 2010-2015, but this will drop to 4.3 percent in 2016. As China's slowdown becomes more apparent, this is expected to have a knock-on effect on other emerging market's exports, especially so on commodity-orientated economies, which will be more severely impacted.

US economy:

The US economy will grow at stable rate of 2.6 percent in 2016 according to the IMF, unchanged from 2015. Most indicators seem to support this view; payroll data rose consistently throughout 2015 whilst unemployment is currently at 5 percent, the lowest level post-financial crisis, and private consumption has been rising at a healthy pace (Figure 3). Whilst inflation has remained stable, the US Federal Reserve's (Fed) decision to raise interest rates in December 2015 has been down to anticipated rises in inflationary pressure as slack in the labor market is slowly diminishing. We see recently released economic data, which showed the US economy grew by a meagre 0.7 percent in the final quarter of 2015, and the deflationary effect of a devaluation in the Chinese currency, forcing the Fed to embark on a gradual interest rate tightening cycle during 2016. Nevertheless, risks linked to further, albeit gradual, tightening still remain. Firstly, any further increases in the interest will result in the dollar gaining more value. The trade-weighted dollar has been increasing in value over the last year and further gains could push it to 13 year highs all of which could adversely impact export competitiveness (Figure 4). Secondly, rises in the rate of interest would increase borrowing costs for corporates, especially those engaged in borrowing heavily from the high-yield debt market. Particularly vulnerable is the US high-yield energy sector where outstanding debt has grown from $80 billion in 2009 to around $260 billion in 2015, the majority of which is held within the shale oil industry. With oil prices expected to remain lower for longer (see oil market in 2016 section) there is a real risk that such debt could be unsustainable leading to widespread

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

	2014	2015E		2016F		2017F	
		IMF	Consensus	IMF	Consensus	IMF	Consensus
U.S	2.4	2.6	2.5	2.6	2.5	2.6	2.4
U.K	3.0	2.5	2.4	2.2	2.3	2.2	2.2
Canada	2.4	1.0	1.2	1.7	1.9	2.1	2.2
Euro zone	0.9	1.5	1.5	1.7	1.7	1.7	1.7
Japan	-0.1	0.6	0.6	1.0	1.0	0.3	0.7
China	7.3	6.8	6.9	6.3	6.5	6.0	6.2
Russia	0.6	-3.8	-3.8	-0.1	-0.1	1.0	1.0
Brazil	0.1	-3.0	-3.2	-3.5	-1.8	0.0	0.2
India	7.3	7.3	7.4	7.5	7.6	7.5	7.6

Note: * Consensus forecasts are those of FocusEconomics.

defaults, already on a rise since 2015, with negative consequences for the US economy.

Until the issue liquidity flowing to the non-financial sector is addressed, the Euro zone is likely to follow a moderate pace of growth.

The IMF forecasts Euro zone growth at 1.7 percent in 2016.

Euro zone economy:

The Euro zone continues to witness record levels of money supply being pumped into the financial system through the European Central Bank's (ECB) quantitative easing (QE) program. Although there has been some results from QE, through a weaker euro which has helped promote exports, there is still the challenge of ensuring that liquidity flows to the non-financial sector to promote investment. Since non-financial investment dropped dramatically after the financial crisis, back in 2008, it has failed to recover to pre-crisis levels even as the ECB has kept policy rates at record lows and has moved deposit rates to negative (Figure 5). In seems that the intermediaries in all of this, the banks, have not passed liquidity onto the non-financial sector, primarily because they remain risk averse due to the still holding $1 trillion in bad loans, a legacy of the financial crisis. Until the issue of liquidity flowing to the non-financial sector is addressed, the Euro zone is likely to follow a moderate pace of growth, due to investment growth remaining subdued, with GDP growth forecasted by the IMF at 1.7 percent in 2016.

Japan's challenge going forward is encourage to investment so to help push up domestic consumption...

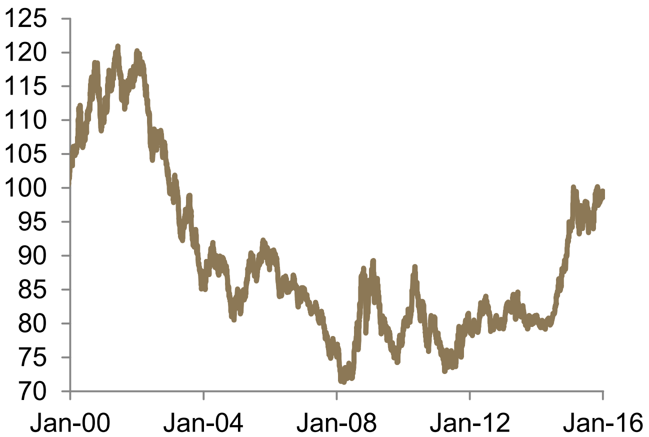
..this will be pursued by the adoption of negative interest rates for deposits held at the BoJ…

...and cutting the corporate tax rate as well as continuing with further monetary easing via the QE program.

Japanese economy:

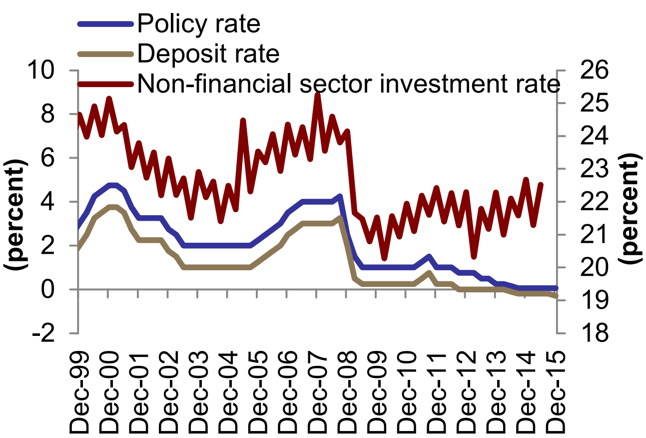
The Japanese economy is expected to strengthen, but only slightly, in 2016. Key economic indicators point to a general improvement. The labor market has become tighter, with the unemployment rate currently at 3.1 percent, the lowest in 20 years. Furthermore, Japanese corporate profitability has increased as a weaker yen, partially as a result of Bank of Japan's (BoJ's) QE program, has helped increase exports. However, the challenge going forward is to encourage corporates and banks, who are sitting on their profits, to increase investment so to help push up domestic consumption which will sustain economic growth and drive inflation towards the BoJ's target. Inflation, which averaged 0.5 percent in 2015, is still much lower than the BoJ target of 2 percent. Encouraging investment and lending by institutions will be pursued through the adoption of negative interest rates for deposits held at the BoJ, which were announced at the end of January 2016. The Japanese government will also push for a record fiscal budget in 2016 which is expected to see higher growth and tax revenue in order to revive the economy and rein in huge public debt. In the recently announced budget the Japanese government set total spending at $800 billion, broadly flat

Figure 4: Trade-weighted dollar



Source: Thomson Reuters and Jadwa Investment

Figure 5: Eurozone central bank policy & deposit rate and non-financial sector investment rate



Source: Eurostat and Jadwa Investment

year-on-year, but stated that tax revenue would be the highest in 25 years on the back of rising corporate profits. Higher tax revenue is expected to help reduce new borrowing and contribute towards achieving a targeted primary budget surplus by 2020.

The IMF forecasts emerging Markets' GDP growth to 4.3 percent in 2016...

...but they face several hurdles in 2016.

Emerging markets:

The IMF forecasts a mild pick-up in emerging market GDP growth to 4.3 percent in 2016, up from an expected 4 percent in 2015. Although this is an evident improvement, emerging markets face several hurdles in 2016 and, with it, a downside risk to overall growth. The challenges facing emerging markets are two-fold. Firstly, there is the issue of declining levels of foreign investment and the prospect of higher debt service costs, both of which are related to the US Fed's interest rate tightening. Secondly, there is the slow-down in the largest, and historically fastest growing emerging market, China, and the knock-on effect on other emerging markets.

Rising debt levels:

Emerging market debt has grown rapidly in the last few years…

...the concern going forward is that debt levels are not expected to come down even as the global economy exhibits slower growth…

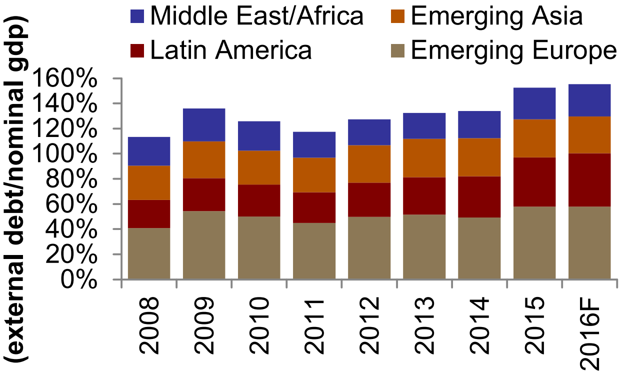
...the major emerging economies facing challenges in 2016 are Russia, Turkey and Brazil.

A rise in US interest rates not only increases borrowing costs but results in capital flowing from emerging economies to the US.

Emerging market debt has grown rapidly in the last few years, with total external debt of thirty emerging market countries rising from $4.1 trillion in 2008 to an expected $6.6 trillion at the end of 2015. Of course during this period emerging markets have also witnessed healthy growth rates but the concern going forward is that debt levels are not expected to slow down even as the global economy exhibits slower growth. The regions which are witnessing the largest growth in total external debt to GDP are 'emerging Europe' and 'Latin America' (Figure 6). Within these regions the major emerging economies facing challenges in 2016 are Russia, Turkey and Brazil. Russia is still subject to international sanctions and faces oil price volatility and increased geopolitical tension, with the IMF predicting GDP to fall by -1 percent in 2016. Brazil, Latin America's largest economy, is expected to contract by -3.5 percent as spending cuts to reduce the budget deficit result in two consecutive years of negative GDP growth for the first time since 1948. Also, GDP growth in Turkey in 2016 is likely to be lower than the IMF's 3 percent forecast since it does not capture the recent economic impact of the political fall-out with Russia. Russia was Turkey's second largest trade partner, with trade totaling $33 billion in 2014.

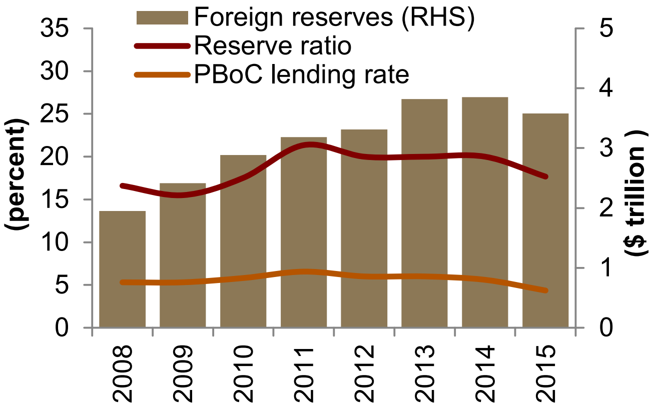
Higher debt levels also present a challenge for emerging markets since a rise in US interest rates not only increases borrowing costs,

Figure 6: Emerging market external debt
(as a percentage of nominal GDP)



Source: IIF and Jadwa Investment

Figure 7: China's foreign reserves, reserve ratio and central bank lending rate



Source: PBoC, Thomson Reuters and Jadwa Investment but, as has been the case during 2015, results in capital flowing from emerging economies to the US. 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.

It is apparent that the Chinese economic transition is likely to result in a slower pace of growth now, than in previous years…

Slower Chinese growth:

Although the Chinese economy did grow by 6.9 percent in 2015, concerns over reaching future targeted growth of "around 7 percent" in 2016 remain. Throughout 2015, despite the government acting to boost growth by devaluing the currency and pumping liquidity into the financial system, there was still a real risk that Chinese growth will be slower than in previous years. This was reinforced by more disappointing data at the beginning of 2016 with the Caixin/Markit China Manufacturing PMI showing factory activity shrinking for 11 consecutive months. However, we view the prospect of a sharp slowdown after more than a decade of rapid growth (referred to as a 'hard-landing') unlikely. This is because Chinese policy makers have ample room to maneuver in order to keep boosting the economy. China's foreign reserves currently amount to a massive $3.5 trillion allowing the government to easily turn to fiscal stimulus or infrastructure expenditure to stimulate the economy in the short-term. Pumping liquidity in the financial system through two channels remains an option. During 2015 the People's Bank of China (PBoC) used cuts in both the central bank lending rate and reserve ratio to make more loans available at cheaper rates. With current central bank lending rates at 4.35 percent and reserve ratio at comfortable levels, both these options are still available going forward and can be used to ensure growth reaches the IMF's projected forecast of 6.3 percent in 2016. (Figure 7).

...but a 'hard-landing' is less likely as a result of large foreign reserves and ample room for pumping more liquidity into the system.

The oil market in 2016

The current period of low prices is set to remain throughout 2016 pulled down primarily by persistently high oil supply.

The current period of low prices is set to remain throughout 2016 pulled down primarily by persistently high oil supply. All out competition between members of OPEC will be the main reason for continued oversupplied markets. Even as non-OPEC supply begins to slow during 2016 the additional supply coming on-line from Iran will mean global oil markets will be looking at demand to lift prices. As mentioned above (see global economy 2016) with economic activity not picking up significantly in the year ahead, this will translate to moderate yearly growth in oil demand.

Even as non-OPEC supply begins to slow during 2016 the additional supply coming on-line from Iran will mean global oil markets remain over-supplied.

OPEC data shows that non-OPEC supply will decrease by 0.5 million barrels per day (mbpd), year-on-year, in 2016. Amongst the largest non-OPEC players both the US and Russia will see year-on-year declines in production. For Russia the combination of international sanctions preventing Russian oil companies' access to international finance and government proposals for higher crude taxes to boost state revenue, will mean crude production will slow slightly in 2016. According to latest Energy Information Agency (EIA) data, total US oil production will not be negative in 2015 but it will slow to 8 percent year-on-year. However, the combination of low oil prices, oil hedges expiring and tighter lending conditions will result in total US production declining by 7 percent or 0.5 mbpd in 2016, to a total of 8.8 mbpd, compared to an average growth of 16 percent between 2012-14. Declines in Russia and US shale oil will be partially compensated by OPEC supplies rising by around 0.5 mbpd year-on-year to average of 32.9 mbpd in 2016. Most of the OPEC rises are expected to come from a sanction-free Iran.

Amongst the largest non-OPEC players both the US and Russia will see year-on-year declines in production.

Declines in Russia and US shale oil will be partially compensated by Iranian crude coming on-line.

Further substantial increases in Iraqi production will be more difficult due to the less money available to continue upstream investment.

A number of other OPEC member countries are also facing financial pain which could negatively impact their ability to sustain production at current levels…

We expect 2016 Saudi production to be unchanged, year-on-year, at 10.2 mbpd in 2016.

So far Saudi policy of market share has worked with lower prices undercutting both OPEC and non-OPEC competitors in key markets.

Saudi Arabia's current strategy of maintaining market share will result in lower levels of oil revenues in the short-term, it will ultimately benefit the Kingdom in a few years' time.

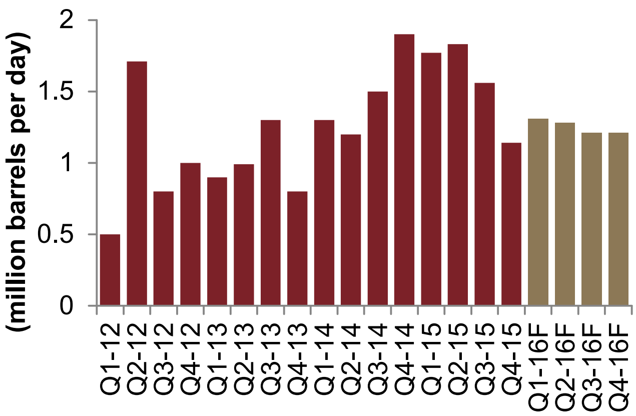
OPEC will see some modest rises in production from Iraq. Iraq saw an estimated 11 percent increase in production year-on-year in 2015 as result of investment in the upstream sector which has been carried out since 2009. Further substantial increases in Iraqi production will be more difficult due to the less money available to continue upstream investment as the country copes with deteriorating fiscal situation as a result of lower oil prices, higher military spending, and costs associated with civil conflict.

A number of other OPEC member countries are also facing financial pain which could negatively impact their ability to sustain production at current levels. Nigeria's economy has been adversely affected by lower oil revenues and a weaker naira currency which has affected economic growth forecasts. In addition, the new President, who took office in May 2015, pledged to reform the oil sector including renegotiating 20 year old production sharing agreements with major oil companies. These developments have resulted in delays in parliamentary approval for new oil projects and investment in existing ones. Lower oil prices have also impacted the finances of Venezuela with the majority of government revenues being diverted to social spending thereby leaving very little cash for capital expenditure for the national oil company Petroleos de Venezuela (PDV).

Saudi Arabian crude production averaged 10.2 mbpd in 2015 and we do not see any cuts in production to support upward movement in prices going forward. We therefore expect 2016 Saudi production to be unchanged, year-on-year, at 10.2 mbpd in 2016.

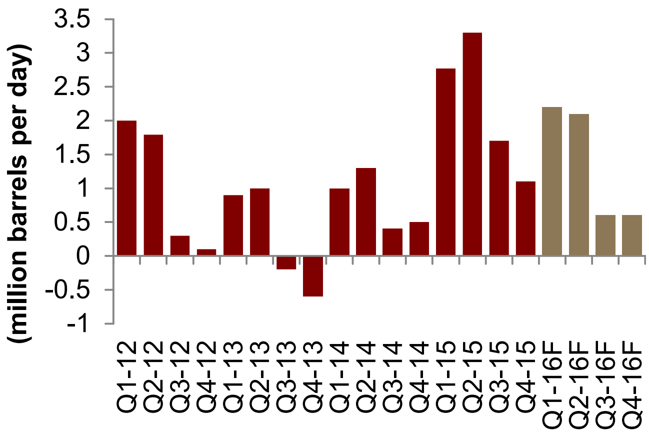
So far Saudi policy of market share has worked with lower prices undercutting both OPEC and non-OPEC competitors in key markets. In the US, China and Europe, Saudi Arabia has faced intense competition from the likes of Russia, Iraq and Nigeria, to name a few, who all face acute financial situations domestically. Furthermore, this competition will only intensify as Iran comes back on-line, which has explicitly stated that it will aim to regain lost market share prior to sanctions. Again, Iran represents another producer that is desperate to increase oil sales in order to boost government revenue. Although Saudi Arabia's current strategy of maintaining market share will result in lower levels of oil revenues in the short-term, it will ultimately benefit the Kingdom in a few years' time. As production in high-cost non-OPEC producers starts to slow down gradually, in response to lower prices, Saudi Arabia will reap a larger share of a larger share of the market by 2020.

Figure 8: Global oil demand
(year-on-year change)



Source: OPEC and Jadwa Investment

Figure 9: Global oil balances



Source: OPEC and Jadwa Investment

According to OPEC data global demand will rise by 1.25 mbpd in 2016, year-on-year, in line with the average of the last four years, supported almost entirely by non-OECD countries. Weak oil demand growth in the EU and Japan will keep rises amongst OECD countries to a bare minimum. Amongst the non-OECD, India (up 3.5 percent, year-on-year), China (up 3 percent, year-on-year) and the Middle East (up 2.5 percent, year-on-year) will be the main drivers of growth in 2016.

China's demand for crude will be maintained by lower pump prices, rising vehicles sales and ongoing efforts to boost commercial crude stocks.

The largest non-OECD consumer of oil, China, will not see a rapid decline in oil consumption regardless of slower economic growth. China's demand for crude will be maintained by lower pump prices, rising vehicles sales, changes in the structure of China’s industrial base and ongoing efforts to boost commercial crude stocks. China is expected to add around 120 million barrels of crude to storage tanks in 2016, the equivalent of 0.3 mbpd.

Even as global oil markets tighten toward the second half of 2016, commercial crude stocks will have peaked to beyond the 15 year average…

Moderate oil demand and a glut in oil supply will result in a continued build in OECD commercial crude stocks during most of 2016. Even with currently high levels of geopolitical tension there is no risk premium attached to oil prices since commercial stocks are more than capable of handling any adverse supply shocks in the short term. Even as global oil markets tighten toward the second half of 2016, commercial crude stocks will have peaked to beyond the 15 year average, squeezing crude storage capacity. In the US, which has seen a major rise in crude output in recent years, crude storage capacity utilization rates have risen rapidly. Whilst current utilization rates, at around 60 percent, are not alarming, there is a danger that continued glut in oil markets could lead to near full capacity, putting further pressure on prices.

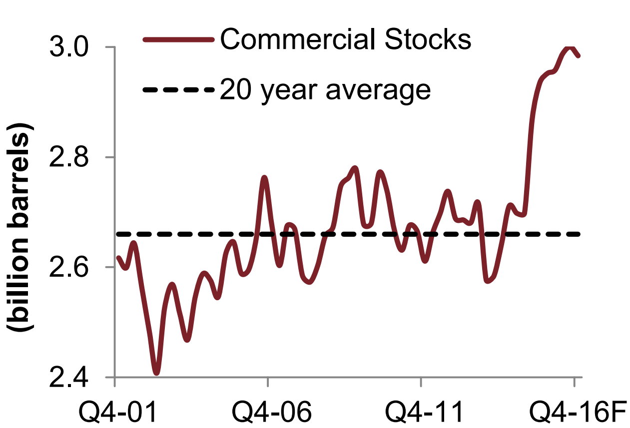
...whilst the US dollar is expected to continue strengthening throughout 2016...

In the background, despite a gradual interest rate tightening cycle from the Fed, the US dollar is expected to continue strengthening throughout 2016 as central banks in Europe, Japan, and possibly China, pursue monetary easing policies.

...as a result our revised Brent forecast is $33 pb, down from $47 pb previously, for 2016.

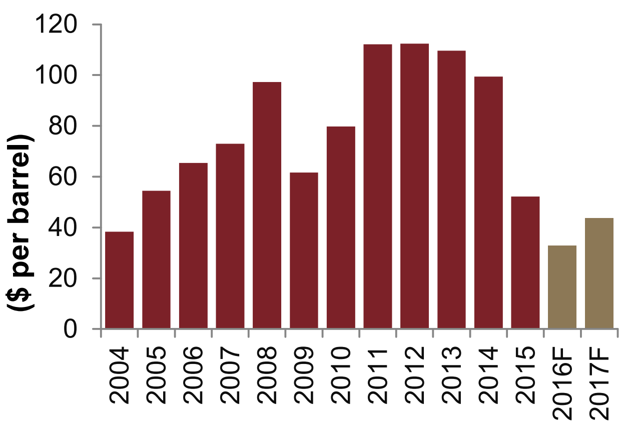
All the above factors put together means we see no support for oil prices, which leads us to cut our full year 2016 Brent forecast to $33 pb, from $47 pb previously, and 2017 forecast to $44 pb from $58 pb previously.

Figure 10: OECD commercial crude stocks



Source: OPEC and Jadwa Investment

Figure 11: Oil prices



Source: OPEC and Jadwa Investment

Saudi economic growth

In 2015, the Saudi economy expanded by 3.4 percent, slowing slightly from 3.6 percent in 2014.

We forecast the economy to slow further to 1.9 percent in 2016…

... owing to lower growth in both the oil and non-oil sectors.

In 2015, the Saudi economy expanded by 3.4 percent, slowing slightly from 3.6 percent in 2014. An increase in oil production, by 5 percent, year-on-year, and a new refinery coming on-line during the year meant that overall oil sector growth remained positive at 3.1 percent. Meanwhile, the non-oil private sector posted its slowest annual growth since 2003, growing at 3.6 percent. Based on our outlook for the current year, we forecast overall economic growth to slow further to 1.9 percent in 2016, owing to lower growth in both the oil and non-oil sectors (Figure 12).

We forecast that total government spending will be equivalent to 48.4 percent of 2016 non-oil GDP…

... lower than the 64.7 percent average over the last five years.

The non-oil sector will continue to benefit from government spending, corporate lending, and domestic consumption. Our view is that the economy will be driven by an accommodative fiscal policy. We think that recent data on real GDP by expenditure further supports our view of a healthy contribution from government consumption expenditure (see Box 1). We forecast that total government spending will be equivalent to 48.4 percent of 2016 non-oil GDP, lower than the 64.7 percent average over the last five years, but consistent with similar episodes of falling oil prices. Between 1998-2000, total spending averaged 48 percent of non-oil GDP, when the Asian financial crisis caused oil prices to fall sharply. We estimate that budgeted investment spending was cut by 19 percent to SR222 billion for 2016. While this is the second consecutive year that the government has reduced its budgeted investment spending, this was anticipated given the revenue shortfall, and the rapid growth in this type of spending over the last ten years, which has averaged 25 percent between 2004-2014.

We estimate that budgeted investment spending was cut by 19 percent to SR222 billion for 2016.

That said, our estimate of budgeted investment spending for 2016 is 21 percent higher than its level five years ago. Further, the recent establishment of the National Project Management Agency, an entity tasked with working with all concerned parties in the public sector, will contribute in optimizing capital spending, thus ensuring efficient implementation of public sector projects. Capital spending by the government has an important psychological implication on private sector performance, given the centrality of economic development planning.

This willingness and ability to support the economy will remain important as international and regional events dampen sentiment and create an increasingly difficult economic climate. The main

Figure 12: Contribution to real GDP growth

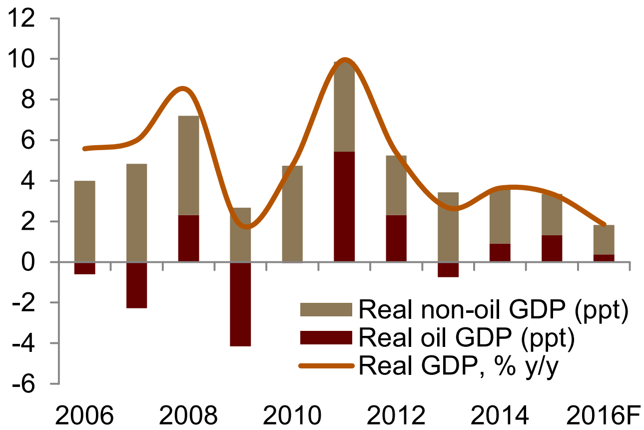
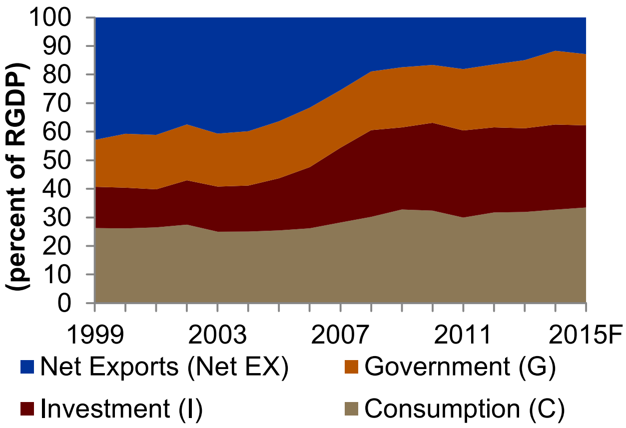


Figure 13: Real GDP by expenditure



economic risk is from China's slowdown, and a more complex regional political situation will make foreign investors wary and may negatively affect the sales of companies that export to the region. It also increases the risk of stock market and oil price volatility. Another risk factor includes any knock-on effects stemming from domestic energy price increases, which could dampen growth in the non-oil private sector in 2016. A number of companies -mostly in the non-oil manufacturing sector- reported that they expected higher costs.

Box 1. The real expenditure approach

the composition of the real economy, based on the real expenditure approach, has shifted significantly in the last 15 years.

Net exports (Net EX) saw its share of total GDP fall from 46 percent in 1999 to just 12 percent in 2014...

...being counterbalanced by a rise in all the other three expenditure components that make up GDP; ...

...consumption (C),…

...government (G),…

...and Investment (I).

According to data from the Ministry of Economy and Planning (MEP), the composition of the real economy, based on the real expenditure approach, has shifted significantly in the last 15 years. Net exports (Net EX) saw its share of total GDP fall from 46 percent in 1999 to just 12 percent in 2014, before rising slightly to 13 percent in 2015. The general decline in the share of Net EX was counterbalanced by a rise in all the other three expenditure components that make up GDP; consumption (C), government (G), and investment (I). The share of (C) showed a relatively gradual rise over the years eventually overtaking net EX in 2007 and becoming the largest component of GDP, while the rise in shares was also significant in (G) and (I) (Figure 13). Elevated spending on wages and salaries, as well as strong growth in credit helped to stimulate consumption expenditure (C). (I) took the largest share briefly in 2008 and 2011, in line with episodes of massive capital spending on infrastructure projects . The rise in (G) can be attributed to the expanding role played by the government. The transfer of wealth effect during the high oil price cycle enjoyed between 2005-2014 enabled the government to expand its consumption expenditure over the years. This has allowed the government to increase current spending on the economy to very high levels, while simultaneously accumulating significant cash reserves.

(C) and (G) have been the largest and most stable contributors towards overall GDP growth between 2011 and 2014.

In 2015, annual growth in current spending by the government was reduced to just 0.3 percent…

(C) and (G) expenditure have been the largest and most stable contributors towards overall GDP growth between 2011 and 2014 (Figures 14). During this period, current spending by the government on wages, goods, subsidies, and operations and maintenance rose by an average of 10 percent, year-on-year. The relationship between current public spending from the fiscal accounts and government expenditure is clear (Figure 15). In 2015, however, annual growth in current spending by the government was reduced to just 0.3 percent,

Figure 14: Contribution to real GDP

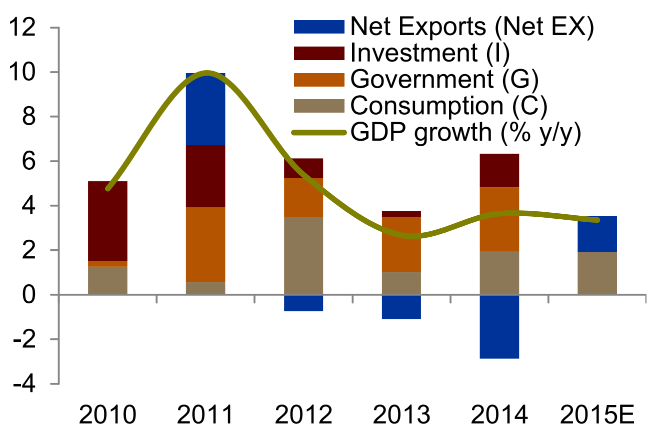
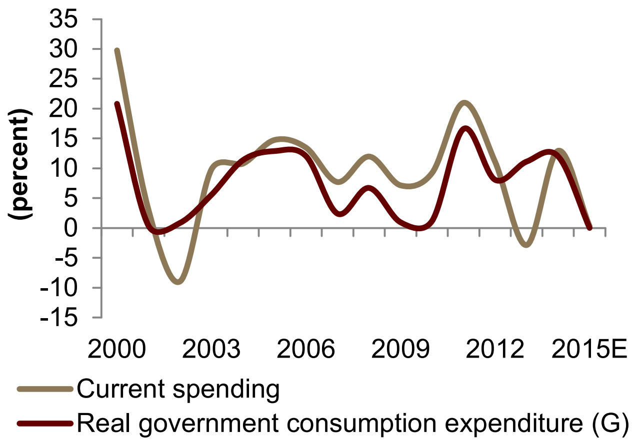


Figure 15: Government current expenditure
(year-on-year change)



...leaving (C) and Net EX as the main contributors to overall real GDP growth.

likely causing (G) to grow marginally, leaving (C) and Net EX as the main contributors to overall real GDP growth in 2015. The rebound in net exports was mainly due to higher exports of oil (rising by 300 thousand mbpd, year-on-year in 2015).

Looking ahead, we think that the contribution of (C) towards overall growth in GDP will rise in the next few years.

Looking ahead, we think that the contribution of (C) towards overall growth in GDP will rise in the next few years. While (G) has likely fallen in 2015, the more rigid part of current spending on wages and salaries, as well as on operations and maintenance should continue rising (see fiscal policy section), pushing up growth in (G). Nevertheless, we expect that in the near future, the willingness to privatize state-owned enterprises will mean a shrinking contribution from (G), as private consumption expenditure will likely play an increasing role in future growth to overall GDP. (I) will not fare as well in the short-term since a large part of this component is made up of public expenditure (37 percent in 2014). Fiscal deficits will result in significant cuts in public investment spending over the next few years, which will mean that growth in investment expenditure will be mainly determined by activity in the private sector. Privatization initiatives may also contribute to growth in (I) as likely improvements in efficiency at newly privatized entities may help free up more capital for investment.

Non-oil private sector GDP is forecast to grow by 2.6 percent in 2016…

...compared with an average of 6.6 percent for the last five years.

PMI averaged 57.3 in 2015, falling from the 58.9 average for 2014.

Non-oil private sector GDP is forecast to grow by 2.6 percent in 2016, compared with an average of 6.6 percent for the last five years. The latest economic data highlights that the economy has maintained a positive but slower performance. PMI averaged 57.3 in 2015, falling from the 58.9 average for 2014, but still indicating that the private sector remained in an expansionary mode (Figure 17). Cement sales, a good gauge of construction activity, continued to be at higher levels in 2015 compared to the previous year. This shows that construction has maintained a positive level of activity despite the impact of lower investment spending by the government . Indicators of consumer spending such as cash withdrawals from ATMs also point to a slower but still positive growth in consumption in recent months. Central Bank data shows that bank lending rose at a slower rate during 2015, with net credit issued reaching SR116 billion in 2015; a SR17 billion fall in new credit compared to 2014. Nevertheless, the positive growth in total credit points to the willingness and ability of banks to support economic activity despite the prospect of lower investment spending by the government.

Figure 16: Real GDP growth by expenditure type
(year-on-year change)

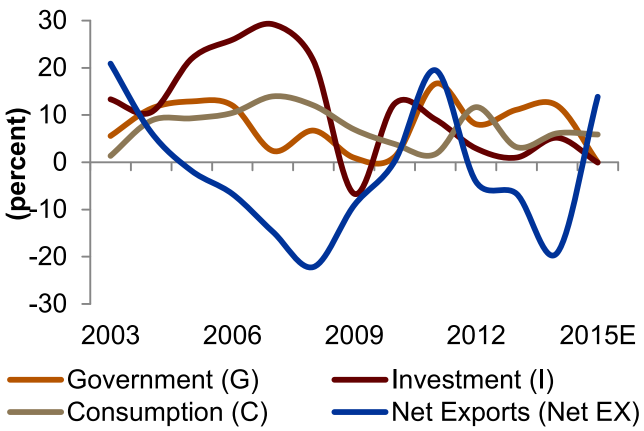
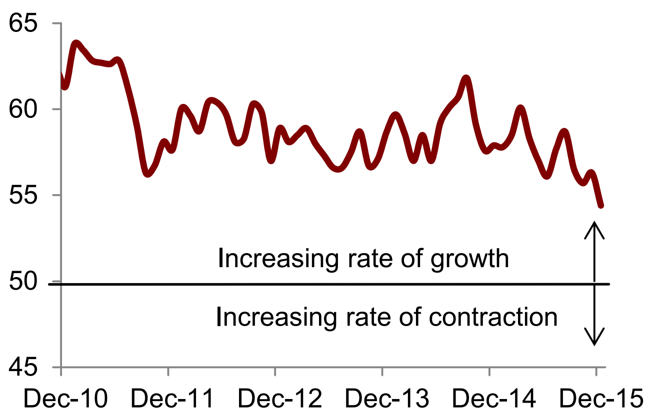


Figure 17: Purchasing Managers' Index



The oil sector is forecast to maintain about the same rate of growth in 2015.

Whilst domestic demand for crude will increase…

...higher domestic energy prices and increases in gas output will help keep consumption of crude oil flat year-on-year, at 2.9 mbpd.

Non-oil manufacturing growth is forecast to decelerate slightly to 2.6 percent in 2016…

... down from 3.2 percent in 2015.

A number of high value projects will enter the operational phase in 2016…

...including the completion of the $3.4 billion Kemya Elastomers plant…

While we expect a slowdown in overall GDP growth, both the oil and non-oil sectors should maintain positive growth. Our expectations for growth in the main sectors are as follows:

The oil sector , the largest sector of the economy, accounting for around 42 percent in real terms at the end of 2015, is forecast to maintain about the same rate of growth owing to a marginal increase in oil production (see oil market in 2016 above). The rise in Saudi crude production in 2015, to 10.2 mbpd from 9.7 mbpd in 2014, was not wholly related to the strategy of increasing market share but also due to rising refinery consumption. Since 2014, two refineries (Satorp and Yasref) have come on-line, adding 0.8 mbpd to domestic consumption. Going forward, we expect Saudi crude exports to average 7.3 mbpd in 2016, in line with the average during the previous four quarters of 2015, as competition for market share continues. Domestically, whilst demand for crude will increase as three new crude oil-powered electricity plants come online, higher domestic energy prices and increases in gas output will help keep consumption flat year-on-year, at 2.9 mbpd. The Hasbah and Arabiyah gas fields will produce non-associated gas processed by the Wasit plant. According to Saudi Aramco, the Wasit gas plant will add around 1.75 billion cubic feet of sales gas per day (bcf/d), which we expect will replace the use of more expensive industry diesel and crude oil in generating electricity.

Non-oil manufacturing growth is forecast to decelerate slightly to 2.6 percent in 2016, down from 3.2 percent in 2015. We expect that a significant number of manufacturing plants will commence operations in 2016. This will offset any chances that could lead to a further slowdown in the sector, including the persistence of subdued global demand and knock-on effects from energy price reform. Some delays to commissioning of the Sadara petrochemicals complex in 2015 means that production will likely commence in early 2016, with a capacity of around 400 thousand tons per year (t/y) of Propylene and 1.5 million t/y of Ethylene. In addition, a number of high value projects will enter the operational phase in 2016, including the completion of the $3.4 billion Kemya Elastomers plant. Kemya is a joint venture between SABIC and ExxonMobil Chemical, which will have the capacity to produce up to 400 t/y of carbon rubber and thermoplastic specialty polymers. Petrorabigh's $500 million refining and petrochemicals complex expansion is another high profile project expected to commence operations in early 2016. The

Figure 18: Exports of petrochemicals and plastics

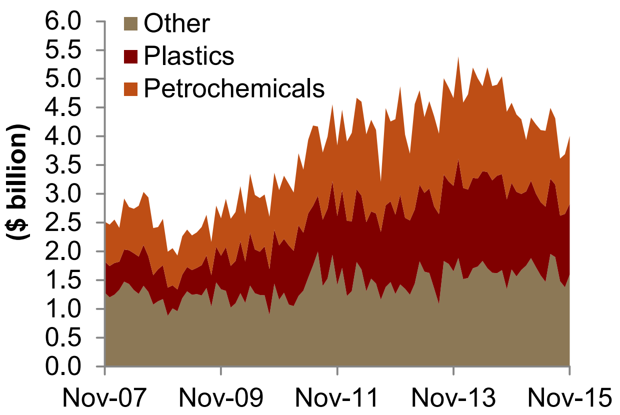
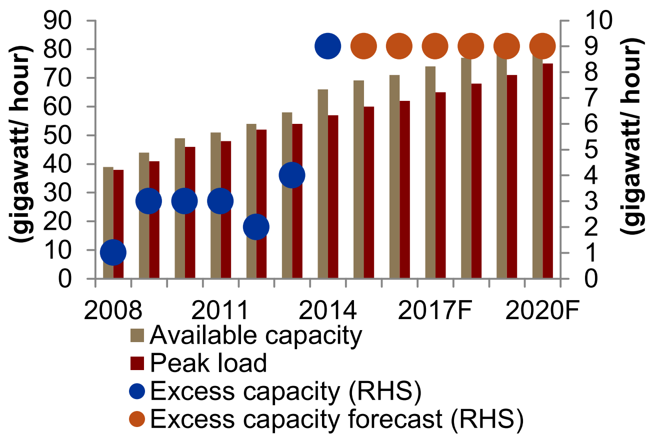


Figure 19: Peak load and excess capacity



Source: ECCRA and Jadwa Investment

...Petrorabigh's $500 million refining and petrochemicals complex expansion…

… and Saudi Steel Pipes Company's $430 million, 3,350 t/y polysilicon plant.

Despite the significant number of capacity additions, we project a continuation of weak global demand for manufactured goods

Year-to-November 2015 exports of petrochemicals and plastics were 29.4 percent, and 19.8 percent lower, year-on-year.

Higher domestic energy prices will likely lead to lower potential growth for the sector as well.

expansion is part of the "Rabigh II" project, which will result in an increase in current production of petrochemicals from 2.4 million t/y to more than 7 million t/y. Other high profile projects to commence in 2016 include Saudi Steel Pipes Company's $430 million, 3,350 t/y polysilicon plant, and SABIC's $400 million, 50 thousand t/y polyacetal plant, both located in Jubail.

Despite the significant number of manufacturing plant additions, we project a continuation of weak global demand for manufactured goods, particularly for petrochemicals in 2016. Year-to-November 2015 exports of petrochemicals and plastics were 29.4 percent, and 19.8 percent lower, year-on-year, and are expected to remain sluggish for 2016 as well (Figure 18). The downside risk stemming from a gradual recovery to the global economy will hamper a return to more robust growth levels previously enjoyed by the manufacturing sector.

Table 1. Real GDP growth
(percent, year-on-year)

	2012	2013	2014	2015 E	2016 F
Agriculture	1.3	1.9	1.8	0.8	0.5
Manufacturing	4.1	3.4	9.5	5.8	2.0
- Petroleum refining	4.1	-47	19.6	12.9	0.6
- Other	4.1	6.3	6.3	3.2	2.6
Electricity, gas and water	5.9	1.6	4.8	5.1	4.0
Construction	4.8	7.8	6.7	5.6	2.0
Wholesale & retail trade	6.0	6.6	6.0	3.9	3.6
Transport & communication	4.9	6.4	6.2	6.1	3.3
Finance	7.5	9.2	3.3	2.6	1.8
Non-oil private sector	**5.5**	**7.0**	**5.4**	**3.7**	**2.6**
Oil	5.1	-1.6	2.1	3.1	0.9
Government services	5.3	5.1	3.7	3.3	2.5
Total	**5.4**	**2.7**	**3.6**	**3.4**	**1.9**

Energy price increases for domestic consumers resulted in a number of petrochemical and cement companies reporting higher-than-expected costs in 2016. Higher energy prices will likely lead to lower potential growth for the sector this year. In the near future, we expect further increases to energy prices in, which should mean the impact will extend beyond 2016 (See Box 2).

Figure 20: New LOCs: building materials

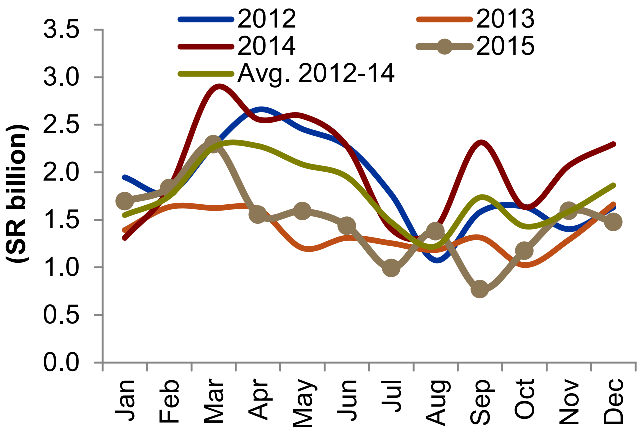
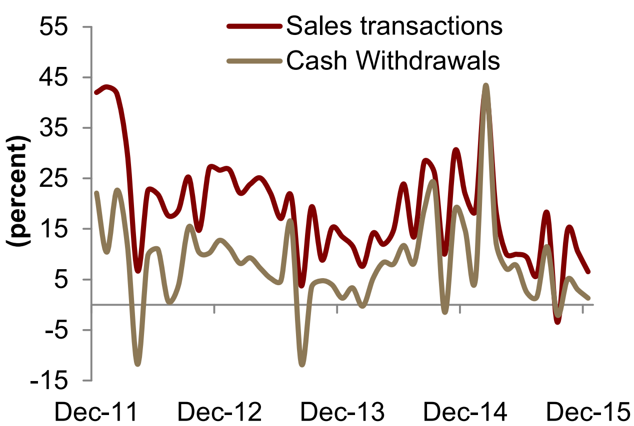


Figure 21: Growth in consumer spending
(year-on-year change)



Electricity, gas and water will be spared from major spending cuts.

The rapid growth in demand for power and water will continue to be met with continuous project expansion.

Construction is forecast to slow down to 2 percent.

While contractors are expected to continue being impacted by public investment spending cuts

the sector will likely benefit from stimulated demand from the private sector, and particularly real estate development.

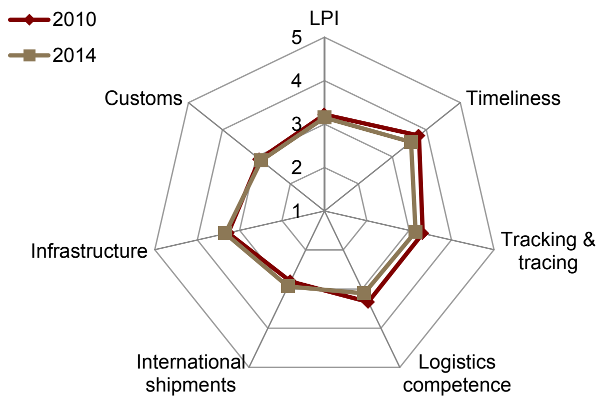
Wholesale and retail sector growth slowed to 3.5 percent in 2015 compared to 6 percent in 2014.

Electricity, gas and water will be spared from major spending cuts and will continue to record robust growth over the next year. The rapid growth in demand for power and water will continue to be met with continuous project expansion to maintain growth in electricity and water distribution. According to the Electricity and Co-generation Regulatory Authority (ECRA), available capacity for electricity generation stood at 66 gw/h in 2014, while peak loads will rise from 57 gigawatt/ hour (gw/h) in 2014 to 75 gw/h by 2020. We estimate that in order to maintain the excess capacity of 9 gw/h in 2014, available capacity would have to be increased by 18 gw/h over the next five years (Figure 19). Over $20 billion worth of power and water projects are expected to enter operation during 2016. One of the largest projects to be completed will be the $3.1 billion, 2,600 mega watts (mw) power plant in Jeddah, which is expected to meet growing regional demand. Another project to commence operations is the $2 billion oil-fired power and desalination plant in Yanbu, with a capacity of 2,500 mw of power and 550 thousand cubic meter a day (cm/d) of desalinated water. 2016 will also see the introduction of multiple solar power projects, including the 605 mega watts (mw) Duba 1 integrated solar power plant in Tabuk, and the 100mw solar power plant in Mecca.

Construction is forecast to slow down to 2 percent. While contractors are expected to continue being impacted by public investment spending cuts, the sector will likely benefit from stimulated demand from the private sector, and particularly real estate development. The imposition of fees on undeveloped land plots will likely encourage land owners to either develop their plots or to sell them off to real estate developers. This will result in an uptick in construction activity and therefore boost the sector. Data on construction activity point to a mixed picture; cement sales grew by 8.7 percent in 2015 , compared to 2.5 percent in 2014, while annual steel production fell by 6.7 percent in 2015. That said, 2015 new letters of credit opened for imports of building materials, stood at $4.7 billion, 28 percent lower than the previous year , pointing to a likely slowdown in construction activity in 2016 (Figure 20).

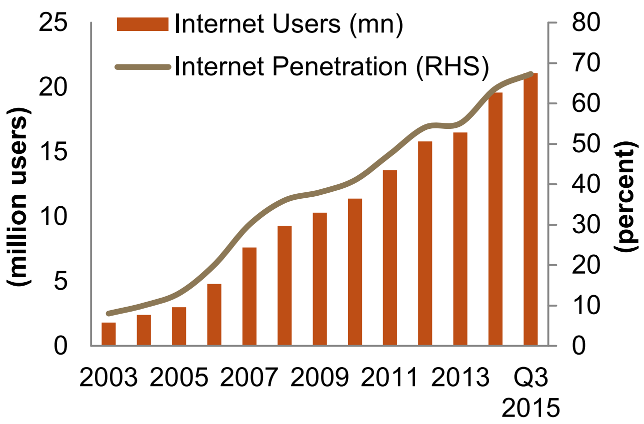
Wholesale and retail sector growth slowed to 3.5 percent in 2015 compared to 6 percent in 2014. One major factor contributing to the slower growth is a slowdown in consumer credit, which was in part due to newly implemented consumer credit rules imposed by SAMA. Other factors also include negative sentiment associated with the

Figure 22: Logistics Performance Index (LPI)



Source: The World Bank and Jadwa Investment

Figure 23: Internet services penetration



Source: CITC and Jadwa Investment

2015 data on cash withdrawals from ATMs shows that growth in consumer spending has slowed.

In 2016, we expect the sector to marginally slow down…

... as price increases to energy products will reduce the average consumer's disposable income.

drop in oil prices, as well as eroding wealth effects stemming from the fall in the Saudi stock market (TASI) during 2015. Full-year 2015 data on cash withdrawals from ATMs shows that growth in consumer spending has slowed, growing by 7.6 percent year-on-year, compared with 9.7 percent in 2014. In 2016, we expect the sector to marginally slow down as price increases to energy products will reduce the average consumer's disposable income, which may result in lower spending on retail products. Nevertheless, we think that the increase in energy prices will have a small impact on consumer spending, since prices of domestic energy products remain among the lowest globally. Although energy prices will likely rise further in the next five years, putting further pressure on disposable income.

We expect the growth of telecoms and transport to slow to 3.3 percent in 2016…

...down from 6.1 percent in 2015.

According to the World Economic Forum, the Kingdom was ranked 49 in the 2014 LPI.

Telecoms are expected to continue benefiting from growth in internet and broadband services.

We expect the growth of **telecoms and transport** to slow down from 6.1 percent in 2015 to 3.3 percent in 2016. A fewer number of development projects is expected to enter the operational phase in 2016. Also, the persistence of subdued demand for both imports and exports will mean that the growth in movement of equipment and materials around the Kingdom will be slow, but sufficient to continue fueling activity in the sector. According to the World Economic Forum, the Kingdom was ranked 49 in the 2014 logistics performance index (LPI). The Kingdom saw a small decline in its LPI between 2010 and 2014 (Figure 22). LPI measures a country's performance on trade logistics and what it can do to improve its performance. Privatization initiatives will likely commence in 2016. The General Authority of Civil Aviation (GACA) announced that King Khalid Airport will be privatized in 2016, with privatization of more airports to follow in 2017. This will lead to more efficient management of airports and boost medium-to-long term growth in the sector. Telecoms are expected to continue benefiting from growth in internet and broadband services, which still have plenty of room for expansion. The penetration rate for internet services is at 67 percent as of Q3 2015 (Figure 23), still low compared to other GCC countries with similar income per capita such as Oman (70 percent and Bahrain (91 percent) .

2015 claims on the private sector fell to single digit growth for the first time in five years.

Finance, insurance, and business services growth is closely correlated with private sector activity. 2015 claims on the private sector fell to single digit growth for the first time in five years, at 9.2 percent (Figure 24). We think that the sector will continue to slow down in line with the slower growth forecasted for the private sector.

Figure 24: Credit to the private sector

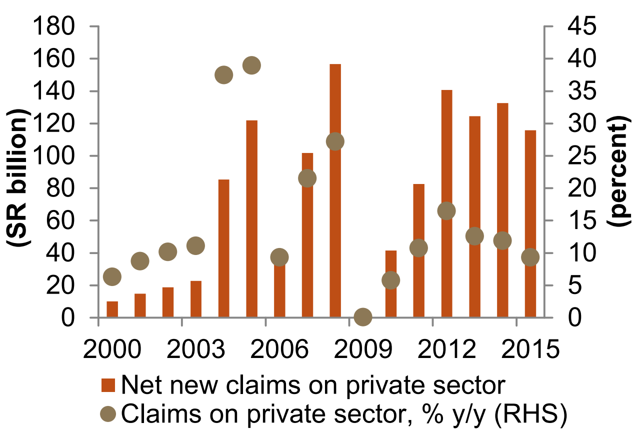
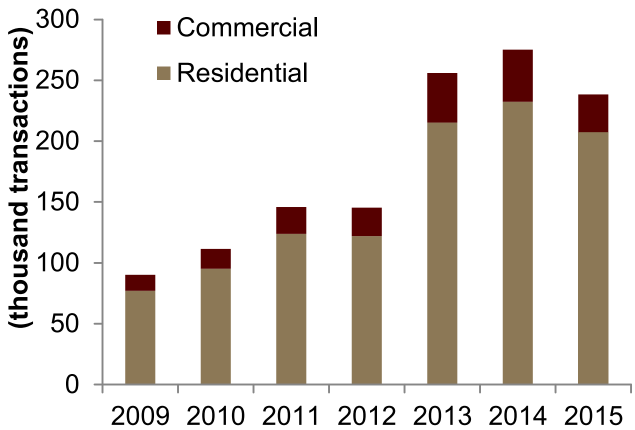


Figure 25: Total number of land transactions



We think that the sector will benefit from an increased supply of land plots as a result of the anticipated imposition of undeveloped land fees...

...as businesses benefit from the broader pick-up in real estate development

We think this will intensify towards the end of the year and beyond, as a deadline to tax undeveloped land plots approaches.

Downside risks exist on demand for credit as a result of higher interest rates, though we expect this to be limited (see monetary and financial developments section). On the upside, we think that the sector will benefit from an increased supply of land plots as a result of the anticipated imposition of undeveloped land fees. Business services such as legal, marketing, and consultancy (which are captured in the finance sector) will benefit from the greater use of financial services and the broader pick-up in real estate development. We think this will intensify towards the end of the year and beyond, as a deadline to tax undeveloped land plots approaches. The increased availability of developed plots will also lift the value added generated by real state services, and contribute to higher growth in ownership of dwellings (another sub-sector under finance). Previous incidences show a lag of around two years between the time when the number of land transactions either rise/ fall, and when growth in ownership of dwellings picks up/falls. However, growth in the number of land transactions could also be prone to speculative trading activity (Figure 25).

Current Account

We expect the current account to record its second consecutive deficit at 12 percent of GDP.

We forecast non-oil exports to grow by 7.6 percent in 2016…

...compared with an average annual growth of more than 36 percent between 2005-2014.

Total exports are forecast to fall by 26 percent and reach $151 billion.

We expect the current account to record its second consecutive deficit as it continues to be dragged by lower oil export revenues. The deficit is forecast to be larger in 2016, reaching 12 percent of GDP, up from 6.3 percent of GDP in 2015 (Figure 26). In dollar terms, the deficit is expected to amount to $72 billion, with revenues continuing to decline. Sluggish growth in non-oil exports is not expected to provide strong support to overall exports due to weak external demand. We forecast non-oil exports to grow by 7.6 percent in 2016, compared with an average annual growth of more than 36 percent between 2005-2014. Import quantities will rise in response to a strong Riyal (which is pegged to the US Dollar) vis-à-vis other currencies, causing the value of imports to remain unchanged compared to 2015. The deficit in the invisible accounts, which consists of flows of remittances, incomes, and payments and receipts for services, will remain the main source of outflows from the current account.

Oil revenues constitute 75-80 percent of total export revenue, so the continued decline in oil prices we are forecasting for 2016 ($33pb for Brent) will result in a 26 percent fall in total exports. In nominal terms, we expect total exports to decline to $151 billion in 2016,

Figure 26: Current account balance

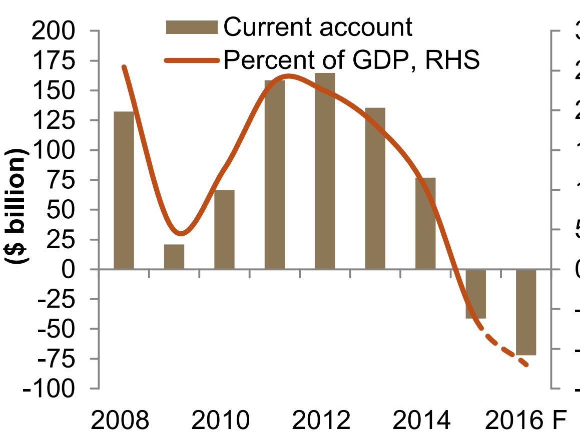
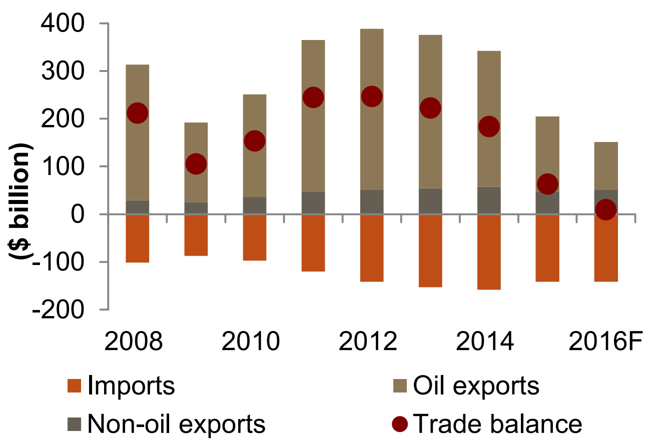


Figure 27: International trade



The gradual recovery in the global economy is expected to dictate the trend of non-oil exports.

down from $205 billion in 2015 (Figure 27). The gradual recovery in the global economy is expected to dictate the trend of non-oil exports. While we expect demand for petrochemical and plastic products to remain weak in 2016, major capacity additions, including the Sadara complex, will help boost different varieties of non-oil export during the year. The decline in oil prices is likely to sustain the pressure on Saudi petrochemicals in the short-term, given that lower oil prices would reduce the competitive advantage of Saudi petrochemical companies relative to their international peers. Petrochemicals and plastics already account for more than 60 percent of the Kingdom's non-oil exports.

Table 3: Current account
($ billion)

	2012	2013	2014	2015	2016 F
Oil Exports	337	322	285	158	101
Other Exports	51	54	57	47	51
Imports	142	153	158	142	142
Trade balance	247	223	184	63	9
Invisibles balance	-82	-87	-107	-103	-80
Current account balance	**165**	**135**	**77**	**-41**	**-72**
(percent of GDP)	22.4	18.2	10.2	-6.3	-12.0

We anticipate the same level of imports as in 2015, at $142 billion.

We anticipate the same level of imports as in 2015, at $142 billion. This is because we expect higher demand for import quantities as a result of a strengthening Riyal vis-à-vis currencies of major trade partners. Demand for imports will also be dictated by the growth in the private sector, with risks tilted towards the downside as a further slowdown in private sector activity could lead to lower imports in 2016.

We expect workers' remittances to continue to grow, but at a slower pace.

We expect workers' remittances –the main source of outflows from the invisible accounts- to continue to grow, but at a slower pace. Factors that support slower growth include the general slowdown in private sector activity. Lower payments to foreign companies providing construction and related services has already resulted in a falling trend in monthly remittance outflows (Figure 28). Foreign providers of other services, such as communications, insurance, and financial services will be the main source of growth in outflows in the longer-term as the economy expands. We also expect that the

Figure 28: Growth in worker's remittances

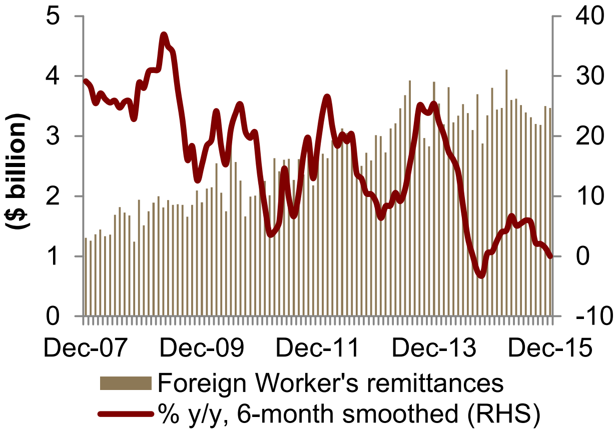
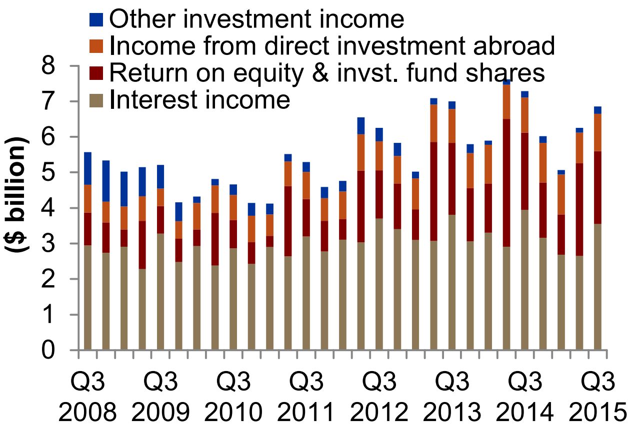


Figure 29: Sources of foreign investment income



The main source of non-trade revenues will continue to be returns on the government's investment portfolio.

We think the recent tendency towards preserving FX reserves could be followed by a strategy to create a sovereign wealth fund for the Kingdom…

...with increased returns to investment income playing a major part in improving non-trade revenues.

government services account will record much lower deficits in 2016, owing to an expected reduction in the level of external financial aid and assistance granted to other Middle Eastern countries.

The main source of non-trade revenues will continue to be returns on the government's investment portfolio, the bulk of which is being invested in sovereign bonds, primarily in the US. We expect further incremental increases to US interest rates by the Fed in 2016 to have a positive effect on the returns from interest income to the portfolio. Looking ahead, we think the recent tendency towards financing public spending with bond issuance, and preserving FX reserves could be followed by a strategy to create a sovereign wealth fund for the Kingdom, with increased returns to investment income playing a major part in improving non-trade revenues (Figure 29).

Fiscal policy

The 2016 budget outlines a small reduction in the level of spending compared to 2015…

...down by SR20 billion to SR840 billion.

The 2016 budget outlines a small reduction in the level of spending compared to 2015, down by SR20 billion to SR840 billion, underscoring the government's determination and ability to support economic activity despite the prevailing subdued oil pricing environment. It further highlights the strong focus on economic diversification as spending on physical and social infrastructure has likely been kept at elevated levels. We also believe the 2016 budget numbers are more conservative than previous years, judging by the underlying assumptions on oil prices and historical patterns of government overspending.

We expect the government to demonstrate an increasing tendency to monitor capital spending.

The Kingdom has budgeted for a second consecutive fiscal deficit, amounting to SR326 billion in 2016.

We expect the government to demonstrate an increasing tendency to monitor capital spending. We also anticipate the NTP to be announced in the first half of 2016. One objective of this plan is likely to focus on speeding up the diversification process, including government income and the role of the private sector. We also expect this plan to be carried out through a number of targets and key performance indicators which increase the efficiency of public sector spending. That being said, the Kingdom has budgeted for a second consecutive fiscal deficit, amounting to SR326 billion in 2016, compared with SR145 in 2015. With uncertainty still clouding the outlook for global oil market, the budget foresees a further

Figure 30: Revenues, expenditures, and budget balance

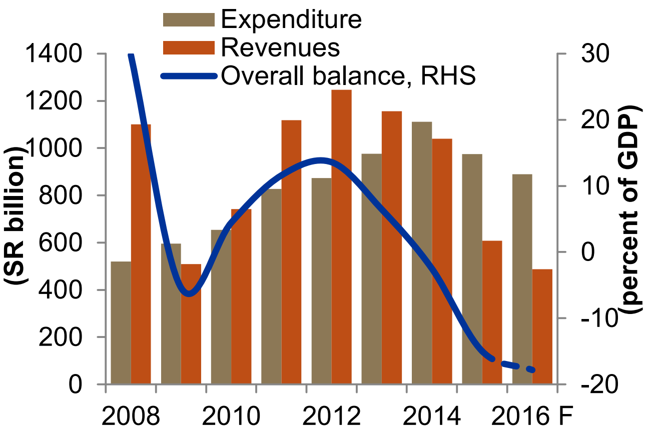
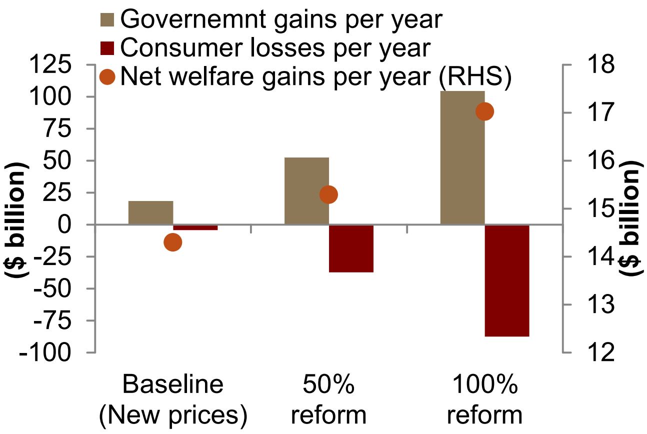


Figure 31: Economic gains under price reform
(2016-35 avg. difference from "pre-2016" prices)



contraction in revenues by 28.1 percent and negative growth of 2.3 percent in expenditure compared to last year's budget.

We think that financing this deficit is straightforward in the short-term.

We think that financing this deficit is straightforward in the short-term, as it can be done by drawing down the stock of foreign assets built up in recent years and the financial capacity to issue debt. According to the 2015 year-end data, foreign reserves at SAMA stood at $612 billion (SR 2,295 billion). Also, the series of sovereign bond issuance (around SR20 billion per month since June 2015) provides the government with more room to continue financing strategic projects, such as key infrastructure developments including transport, housing, power and water, and to support the private sector where necessary. We think the government will increasingly rely on bonds to finance its future spending, which will result in less FX reserves drawdowns. That said, the 2016 budget statement pointed to both domestic and foreign borrowing options in order to avoid crowding out credit to the private sector.

According to the 2015 year-end data, foreign reserves at SAMA stood at $612 billion.

Box 2. Energy price reform: A net welfare gain

The 2016 Saudi budget included price increases for domestic energy products.

The 2016 Saudi budget included price increases for domestic energy products. Gasoline, diesel, crude oil, natural gas, fuel oil, and electricity tariffs were all raised. This points to the start of a new trend of reform in domestic economic policymaking, and will likely be followed by similar actions during the next few years. We think that an effective reform program can have significant welfare gains to the Saudi economy. Also, it is well established that energy pricing intervention creates a drag on public finances (in the form of foregone revenue), and encourages inefficient energy consumption.

We think that an effective reform program can have significant welfare gains to the Saudi economy.

We estimate total domestic consumption of crude oil cost $10pb for the period (2006-2015).

There is limited publicly available information on the cost of a barrel of oil to local consumers. The data that is available shows that the cost is very low. We estimate total domestic consumption of crude oil (excluding electricity) cost $10pb for the period (2006-2015). However, following the recently revised energy prices, we believe that the average price sold domestically has risen to $16pb. We base this on the breakdown of Saudi demand by refined product and crude type over the course of 2015, applying the recent price rise to each type of fuel proportionally.

Following the recently revised prices, we believe that the average price sold domestically has risen to $16pb.

In order to determine the long-term economic gains/losses resulting from such reform, we ran our energy price reform model to compare

Figure 32: Energy efficiency gains
(consumption difference from "pre-2016 prices")

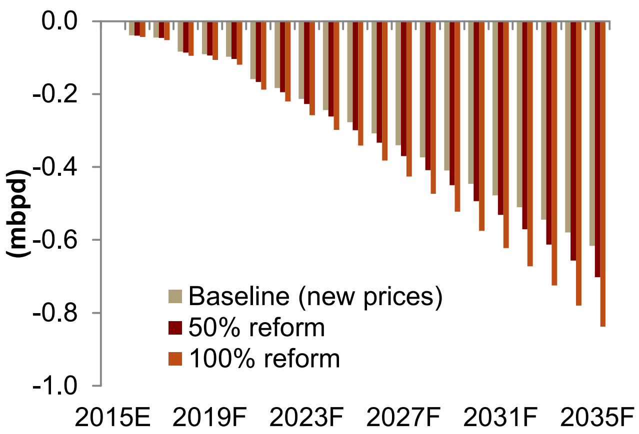
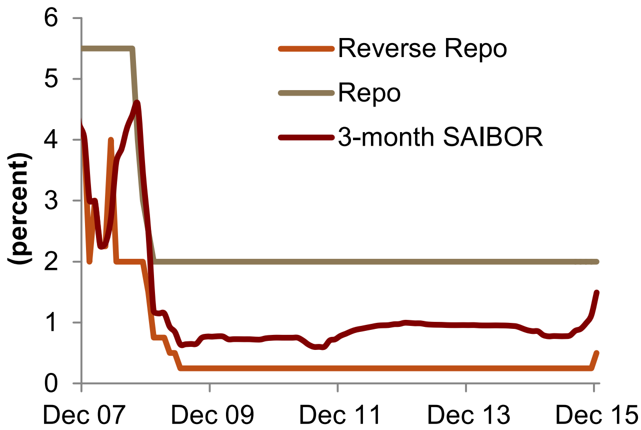


Figure 33: Saudi policy and market rates



We ran our energy price reform model for the period (2016-2035)…

...and compared three different price scenarios with the pre-2016 domestic prices ($10pb).

We base the responsiveness of domestic energy consumption to changes in pricing at -0.4.

Based on the model, the newly introduced prices will enable the government to increase its revenues, on average, by an additional $18 billion per year for the period (2016-2035).

The cost to domestic consumers will be considerable, but not larger than the gains to be enjoyed by the government.

the recently revised domestic energy prices ($16pb) with the pre-2016 domestic prices ($10pb). We also added to two other reform scenarios to our model:

- **50 percent reform scenario:** An instant 50 percent increase towards international prices.
- **100 percent reform: scenario** An instant 100 percent increase towards international prices (elimination of price distortions).

We base the responsiveness of domestic energy consumption to changes in pricing, otherwise known as price elasticity of energy demand, at -0.4.This price elasticity is based on a study conducted by the IMF covering 66 countries, which found that the long-term price elasticity of energy demand ranges between -0.3 and –0.5, suggesting a high responsiveness to energy price reform.

Other assumptions implied in our energy price reform model include:

- A gradual rise in Brent oil prices to $125pb by 2035.
- 2035 Saudi oil production and consumption will rise to 13 mbpd and 5.6 mbpd respectively.

By running our energy price reform model, and using $10pb as our “pre-2016” scenario for domestic energy prices, we find that the recent reform to prices will enable the government to increase its domestic oil revenues, on average, by an additional $18 billion per year for the period (2016-2035), rising from $7 billion in 2016 to $36 billion in 2035. This gain can rise up to an average of $104 billion per year if the differentials between domestic and international energy prices are completely eliminated (100 percent reform scenario). These potentially large gains can have a significant impact on the budget, and prolong the Kingdom’s fiscal buffers for many additional years. The government can also utilize the excess revenues for other more efficient uses, including capital spending on energy diversification, or investing more in other industries which may help achieve the economic goal of export diversification.

The cost to domestic consumers will be considerable, but not larger than the gains to be enjoyed by the government. Under the recently revised prices, consumers would lose, on average, $4 billion per year. This means the average net welfare gain to the economy (net

Figure 34: Net credit issued by sector
(year-on-year change)

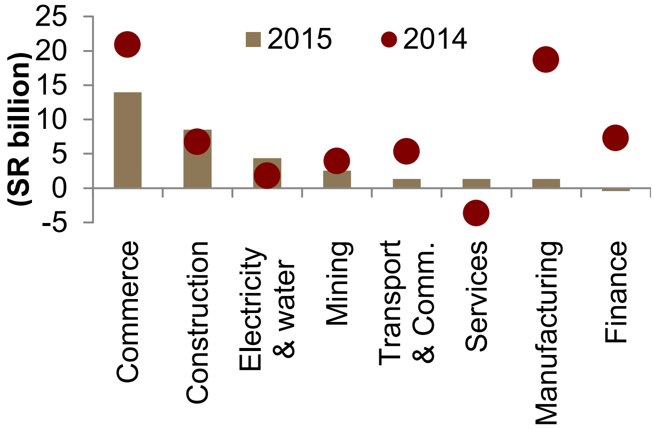
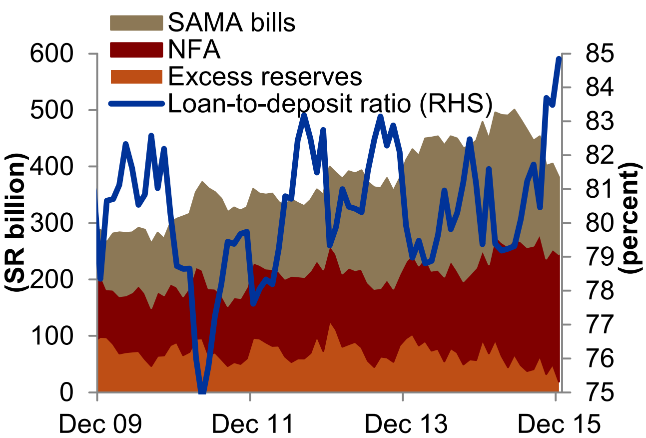


Figure 35: Bank liquidity indicators



Embedded in this model is the efficiency gain from lower domestic oil consumption.

government gains minus domestic consumer losses) will be $14 billion per year, and can rise up to $17 billion if domestic and world price differentials are completely removed (Figure 31). Embedded in this model is the efficiency gain from lower domestic oil consumption. Based on the results of the model, the newly introduced energy prices would mean lower oil consumption by around 616 thousand barrels per day (tbpd) by 2035, compared to the scenario where pre-2016 prices remain until 2035. This difference could go as high as 838 tbpd if the differential between domestic and international prices is completely eliminated (Figure 32).

Monetary and financial developments

Monetary indicators recorded a notable slowdown during 2015.

The pace of the slowdown will likely moderate this year…

...as the private sector gradually adjusts to the new norm of fiscal deficits and lower spending by the government.

As we anticipated in our *Saudi economy in 2015 report,* monetary indicators recorded a notable slowdown during 2015. The pace of the slowdown will likely moderate this year, as the private sector gradually adjusts to the new norm of fiscal deficits and lower spending by the government. Inter-bank rates have already risen notably even before the hike in domestic policy rates. This followed an end to the lengthy period of monetary easing set by the US Fed, which is also mirrored in domestic policy rates due to the Saudi Riyal's peg to the US Dollar. Nevertheless, we think that previous incidences show that interest rate pass-through effects had proven to be minimal on demand for credit, and have usually meant little in the face of a robust private sector in Saudi Arabia.

In December, SAMA raised its key policy reverse repo rate from 0.25 percent to 0.5 percent, for the first time since 2009.

In December, SAMA raised its key policy reverse repo rate from 0.25 percent to 0.5 percent, for the first time since 2009, while the repo rate remained unchanged (Figure 33). As mentioned earlier, the Saudi economy maintained an expansionary stance during 2015 with healthy liquidity levels, strong, but slowing credit growth, and muted inflationary pressures. Annual money supply growth in 2015 slowed to 2.6 percent compared to 11.9 percent in 2014. Credit to private sector increased by 9.2 percent year-on-year, falling from its double digit growth rates enjoyed in previous years. A breakdown of credit by sector showed a fall in net new credit issued to most sectors within the non-oil economy compared to 2014 (Figure 34).

During the second half of 2015, banks significantly reduced their holdings of SAMA bills…

During the second half of 2015, banks significantly reduced their holdings of SAMA bills in order to free up liquidity for the purchase of the newly issued government bonds. Nevertheless, we believe that

Figure 36: Inflation

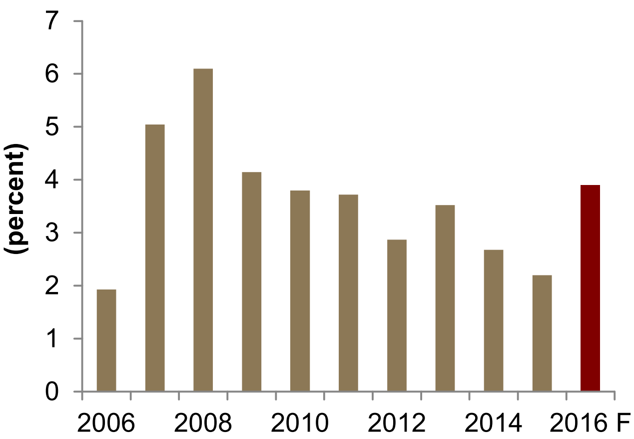
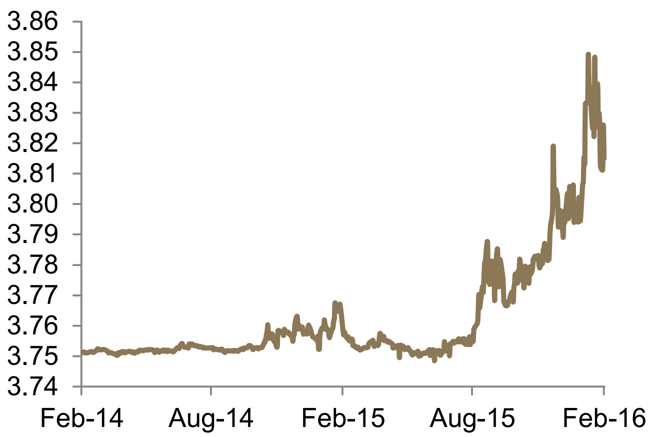


Figure 37: One year forward US Dollar/Riyal rate



...in order to free up liquidity for the purchase of the newly issued government bonds.

Banks' combined holdings of excess reserves, net foreign assets, and SAMA bills stood at SR381 billion by the end of 2015.

liquidity remains at very strong and healthy levels for banks to continue extending more credit to the private sector. Banks' combined holdings of excess reserves, net foreign assets, and SAMA bills stood at SR381 billion by the end of 2015 (Figure 35), enough to finance the monthly sovereign bond issuances for a comfortable period of time. Further, we think that the issuance of sovereign bonds should serve as a key liquidity management instrument for SAMA to conduct more prudent monetary policy. These bonds should also contribute to having a benchmark for the immature corporate debt market, launched in 2009.

Rising domestic energy prices will be the major source for inflationary pressure in 2016.

We expect an accelerating trend in inflationary pressures, leading to an average headline inflation rate of 3.9 in 2016.

Rising domestic energy prices will be the major source for inflationary pressure in 2016, with the housing, utilities, fuels, and the transport components likely to feel the first round effects of the price rises. Other components will also rise eventually, as a second round of effects results in higher prices for other consumer goods, leading to an upward trend in inflation during the year. The slow progress in government housing initiatives means that the shortage in supply of homes should persist through 2016, and thus continue to put upward pressure on home prices and rents. The Ministerial approval to impose empty land fees will have an impact on inflation only in the longer-run. The impact will particularly be felt in a second round effect following the announcement and implementation of a detailed mechanism for imposing such fees. Rising food prices will be less of a concern, as domestic foodstuffs continue to be impacted by the ongoing deflationary trend in international food prices. The sluggish global economic recovery and falling import costs due to a strengthening US dollar mean the risks of external inflationary pressure in the Kingdom are firmly on the downside, with rising interest rates likely to put further downward pressure on prices. Nonetheless, overall, we expect an accelerating trend in inflationary pressures, leading to an average headline inflation rate of 3.9 in 2016 (Figure 36).

In 2016, we expect a slower increase in credit and money supply growth.

In 2016, we expect a slower increase in credit and money supply growth, mainly due to a psychological response to a number of domestic and external factors. The broader economic factors – mainly lower oil prices and government deficits– are likely to play a role in the cooling off of domestic economic demand and activity. We believe that higher interest rates will not have a major implication on credit growth given its low pass-through effect on demand for credit.

Figure 38: Foreign reserves imports coverage

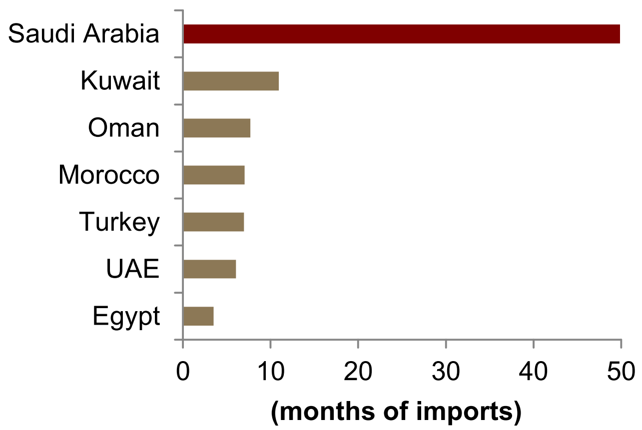
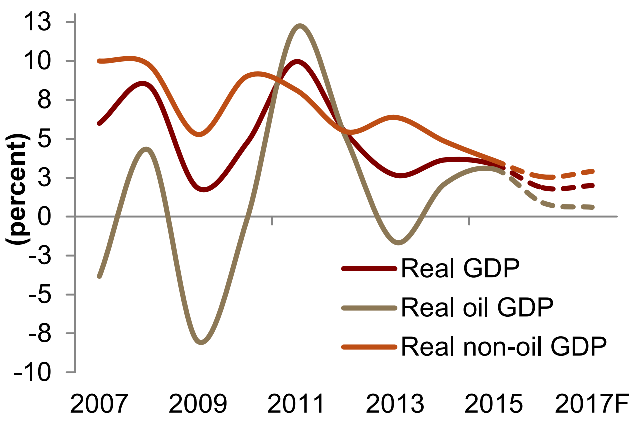


Figure 39: Real GDP growth
(year-on-year change)



During 2016, although we do see the dollar/riyal peg remaining under speculative pressure…

...we still maintain that there is no risk to the peg that has been in place for 30 years.

During the course of 2015, speculative pressure continuously built up on the Dollar/Riyal forward rate peg, culminating in forward rates rising to highest level in nearly 17 years on the back of regional geopolitical tensions in early 2016. The Kingdom's strong economic fundamentals and more disciplined expenditure approach, outlined in the 2016 Saudi budget, and a clear policy commitment by the SAMA to maintain the peg will ensure there is no devaluation. During 2016, although we do see the dollar/riyal peg remaining under speculative pressure, as we have outlined on numerous occasions, we still maintain that there is no risk to the peg that has been in place for 30 years and which, as the IMF has pointed out, is appropriate for the structure of the economy .

The outlook for 2017

The Fed has suggested that it will be embarking on a gradual interest rate tightening cycle, over three years.

The Fed has suggested that it will be embarking on a gradual interest rate tightening cycle, over three years, with inflation featuring prominently in any future decision to raise interest rates further. Concurrently, although there have been some results from the ECB QE , the challenge of ensuring that liquidity flows to the non-financial sector to promote investment raises the possibility that the program will run beyond the September 2016 deadline into 2017. Long term problems in re-inflating the Japanese economy, and the potential for continued looser monetary policy, and no major jump expected in emerging market growth all point to the dollar maintaining strength in 2017.

IMF data suggests that global economic growth will pick up slightly in 2017.

Although demand will continue to remain modest, we expect tighter global oil markets by 2017.

IMF data suggests that global economic growth will pick up slightly in 2017 as improved growth from emerging markets (helped mainly by modest positive GDP growth in Russia and Brazil, plus stronger growth in India), will provide some uplift. The US economy is expected to maintain its growth at around current rates with marginally better growth from the Eurozone and Japan. Of course the major downside threat will still be the Chinese economy. The continued transition in the Chinese economy poses the risk of pushing growth below IMF's forecast of 6 percent, which would increase weakness in other major emerging markets, leading to spillover effects on global growth. Overall, 2017 will continue in the footsteps of 2015 and expected 2016 growth rates, modest but with risks to the downside.

Global oil surpluses are expected to be reduced substantially and stock levels should begin falling back to their long term average.

Real GDP growth is forecast to rise marginally to percent.

Although demand will continue to remain modest, we expect tighter global oil markets by 2017. Global oil surpluses are expected to be reduced substantially and stock levels should begin falling back to their long term average. Cuts in upstream capital expenditure, which began in 2014, will be felt more acutely during the year with continued year-on-year declines in shale oil. As result, we expect to see a sharp rise in prices and predict an average of Brent at $44 pb over the course of 2017.

Growth in the oil sector will slow to 0.6 percent.

The non-oil economy will rebound to 3.0 percent.

Real GDP growth is forecast to rise marginally to 2.0 percent. Growth in the oil sector will slow to 0.6 percent, mainly owing to a lower growth in oil production. The non-oil economy will rebound to 3.0 percent. More opportunities will be found in the private sector, while the government will enjoy improving efficiency in the way it delivers services. We expect several initiatives, including the opening up the retail sector to foreign investors, privatization (mainly in transport), and the imposition of land fees to contribute to the higher

Total oil revenues are expected to be higher than in 2016, as both prices and production increase.

The government will maintain a level of spending that is necessary to ensure positive growth in the non-oil economy.

growth in the non-oil private economy. Initiatives aimed at the public sector, such as raising public sector workers' efficiency, and more prudent management of capital projects, will help reduce the fiscal deficit.

Total oil revenues are expected to be higher than in 2016, as both prices and production increase, while the growth in consumption will be curbed as a direct result of the energy price reforms already in place. The government will maintain a level of spending that is necessary to ensure positive growth in the non-oil economy. Both the current account and fiscal deficits will shrink slightly, as gradual fiscal consolidation continues. Fiscal buffers will remain strong, with domestic debt continuing to rise, while the rate of net withdrawals form FX reserves slows. We do not foresee any change to the exchange rate peg to the US Dollar.

Key Data

	2009	2010	2011	2012	2013	2014	2015E	2016F	2017F
Nominal GDP									
(SR billion)	1,609	1,976	2,511	2,752	2,791	2,827	2,450	2,254	2,509
($ billion)	429.1	526.8	669.5	734.0	744.3	753.8	653.2	601.0	669.0
(% change)	-17.4	22.8	27.1	9.6	1.4	1.3	-13.3	-8.0	11.3
Real GDP (% change)									
Oil	-8.0	-0.1	12.2	5.1	-1.6	2.1	3.1	0.9	0.6
Non-oil private sector	4.9	9.7	8.0	5.5	7.0	5.4	3.7	2.6	3.0
Government	6.3	7.4	8.4	5.3	5.1	3.7	3.3	2.5	2.6
Total	1.8	4.8	10.0	5.4	2.7	3.6	3.4	1.9	2.0
Oil indicators (average)									
Brent ($/b)	61.7	79.8	112.2	112.4	109.6	99.4	52.1	32.8	43.6
Saudi ($/b)	60.4	77.5	103.9	106.1	104.2	95.7	49.4	30.3	40.6
Production (million b/d)	8.2	8.2	9.3	9.8	9.6	9.7	10.2	10.2	10.2
Budgetary indicators (SR billion)									
Government revenue	510	742	1,118	1,247	1,156	1,040	608	488	568
Government expenditure	596	654	827	873	976	1,111	975	890	901
Budget balance	-87	88	291	374	180	-71	-367	-402	-333
(% GDP)	-5.4	4.4	11.6	13.6	6.5	-2.5	-15.0	-17.8	-13.3
Domestic debt	225	167	135	99	60	44	142	263	503
(% GDP)	14.0	8.5	5.4	3.6	2.2	1.6	5.8	11.6	20.1
Monetary indicators (average)									
Inflation (% change)	4.1	3.8	3.7	2.9	3.5	2.7	2.2	3.9	4.6
SAMA base lending rate (%, year end)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.8	3.4
External trade indicators ($ billion)									
Oil export revenues	166.9	215.2	317.6	337.5	322.0	285.2	157.6	100.7	127.5
Total export revenues	192.3	251.1	364.7	388.4	375.9	342.3	204.6	151.3	182.0
Imports	87.1	97.4	120.0	141.8	153.3	158.5	141.8	141.9	143.1
Trade balance	105.2	153.7	244.7	246.6	222.6	183.9	62.7	9.4	38.9
Current account balance	21.0	66.8	158.5	164.8	135.4	76.9	-41.3	-72.1	-48.6
(% GDP)	4.9	12.7	23.7	22.4	18.2	10.2	-6.3	-12.0	-7.3
Official reserve assets	410.1	445.1	544.0	656.6	725.7	732.4	611.9	499.8	411.4
Social and demographic indicators									
Population (million)	26.7	27.6	28.4	29.2	30.0	30.8	31.5	32.2	32.9
Saudi unemployment (15+, %)	11.5	12.4	12.1	11.7	11.7	11.7	11.7	11.6	11.4
GDP per capita ($)	16,095	19,113	23,594	25,139	24,816	24,499	20,723	18,637	20,304

Sources: Jadwa estimates for 2015 and forecasts for 2016-17. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics & Information and Jadwa estimates for oil, social and demographic indicators.

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