جدوى للإستثمار
Jadwa Investment

25 December 2016

Saudi Arabia's 2017 Fiscal Budget

The government's budget for the 2017 fiscal year (31 December 2016 to 30 December 2017) was endorsed by the Council of Ministers on 22nd December. It points to an expansionary stance (Figure 1) and is also in line with the National Transformation Program's (NTP) target of reaching a balanced budget by 2020. The highlights include:

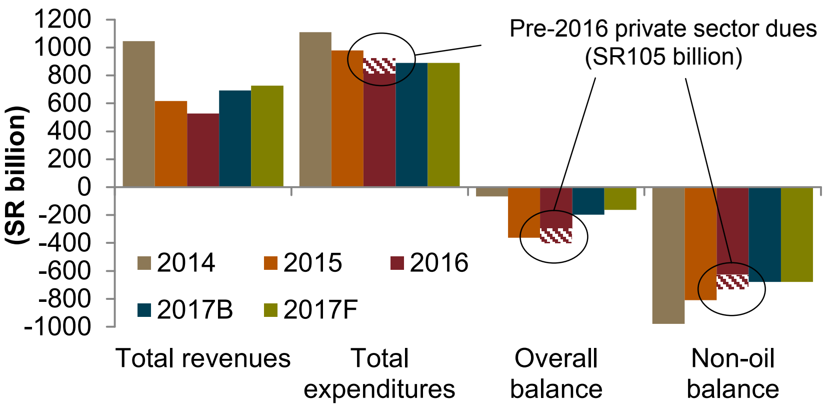
- The government has reaffirmed its commitment to support the economy by budgeting for SR890 billion in spending compared with 2016's budget of SR840 billion. Based on revenues of SR692 billion, the government is budgeting for a lower deficit at SR198 billion. This deficit will continue to be financed by using a combination of government deposit withdrawals as well as both domestic and international debt.

- The budget statement highlighted plans to issue SR120 billion in new bonds, which we estimate will put the 2017 year-end public debt level at SR433 billion (16.4 percent of GDP), up from SR317 billion in 2016. In October, government accounts with the Saudi Arabian Monetary Authority (SAMA) reached SR216 billion, while SAMA net foreign assets declined by $72.6 billion, year-to-October, to reach $544 billion (85 percent of GDP).

- As part of realizing the targets of NTP 2020 and Vision 2030, the Kingdom has budgeted for a higher level of spending in 2017 compared to both the 2016 budgeted and actual amounts. However, taking into account the SR105 billion in spending on delayed payments, actual 2016 spending reached SR930 billion, implying that spending in 2017 will be lower.

- This year's budget statement included an unprecedented level of detail and transparency with regards to functional distribution of expenditure. Education and healthcare remain the focus of government spending, at 36 percent of total spending. Whilst spending on military and security services constitutes the largest single share at 32 percent.

Figure 1: An expansionary fiscal stance returns in 2017



Note*: 2017B refers to MoF budget. 2017F refers to Jadwa Investment's forecasts.

For comments and queries please contact:

Fahad M. Alturki
Chief Economist and Head of Research
falturki@jadwa.com

Asad Khan
Senior Economist
rkhan@jadwa.com

Rakan Alsheikh
Research Associate
ralsheikh@jadwa.com

Head office:

Phone +966 11 279-1111
Fax +966 11 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com

- We estimate that budgeted capital spending has been raised significantly to SR260 billion in 2017, compared to SR76 billion in 2016's budget. This highlights the strong focus and drive by the government to support growth in the private sector, with spending on NTP initiatives also budgeted at SR42 billion, of which SR30 billion is under capital expenditure.

The 2017 budget statement included details of the Fiscal Balance Program.

- The 2017 budget statement included details of the Fiscal Balance Program, one of the programs highlighted in Vision 2030. This program contains all reforms relevant to reaching a balanced budget by 2020 and includes units designated for promoting non-oil revenue, and enhancing efficiency in fiscal spending. The budget statement included a description of several other promising initiatives that are in line with Vision 2030.

- The government has budgeted for non-oil revenue to reach SR212 billion, showing a strong growth of 17.8 percent and 6.5 percent over 2016's budgeted and actual figures, respectively. The primary source of revenue growth in 2017 will likely be investment income, with the Public Investment Fund (PIF) set to enhance investment returns given the active approach in managing sovereign wealth. Other service fees and charges, including excise taxes on harmful goods, are also budgeted for significant growth in 2017.

The budgetary performance in 2016 came close to our forecasts with a deficit of SR297 billion.

- The budgetary performance in 2016 came close to our forecasts with a deficit of SR297 billion, or 12.4 percent of GDP (Jadwa Investment forecast: SR265 billion, 11.2 percent of GDP). This was an improvement over the record budget deficit seen in 2015, at SR362 billion, with 2016 actual spending reaching SR825 billion, resulting in a lower-than-budgeted total 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 overspend of 24.4 percent. Meanwhile, annual growth in non-oil revenue was strong, mainly owing to a doubling of investment returns from SAMA. However, lower oil prices resulted in total revenue falling by 14.3 percent compared to 2015.

Preliminary 2016 economic data shows that the economy continued to slow, with 2016 real GDP growth of 1.4 percent.

- In line with our expectations, preliminary 2016 economic data shows that the economy continued to slow in 2016 with real GDP growth of 1.4 percent (Jadwa Investment forecast: 1.1 percent). Non-oil private sector growth slowed to 0.1 percent year-on-year (Jadwa Investment forecast: 0.7 percent), with the highest growth in the finance and transport sectors. For the first time, the budget statement included a forecast for 2017 GDP growth, at 2 percent (Jadwa forecast: 0.4 percent).

We see a price of $55pb for Brent to be consistent with the revenue projection contained in the budget.

- We calculate that a Saudi export price of $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. We believe the government is budgeting for a compliance with OPEC cuts, agreed back in October, thereby reducing year-on-year production by 300 thousand barrels per day (See Box 3). 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. Accordingly, 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.

The 2017 budget outlines a return to an expansionary stance.

The 2017 Budget

The 2017 budget outlines a return to an expansionary stance with budgeted spending up by SR50 billion, year-on-year to SR890 billion (Figure 2). 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 assumptions 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.

2016 total spending reached SR825 billion…

...coming out lower-than-budgeted for the first time since 1998.

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 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 (see Figure 6 on page 6).

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

Figure 2: Budgeted expenditure

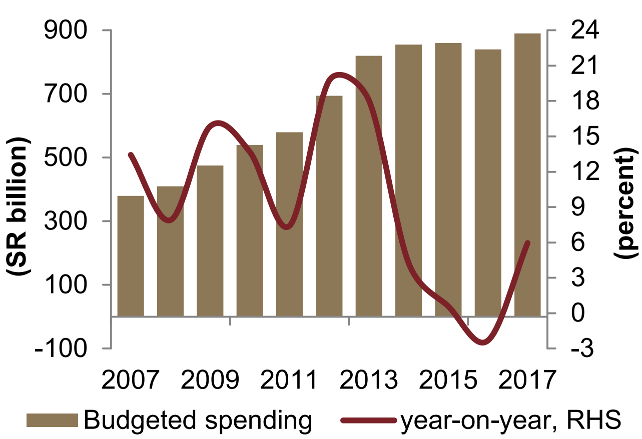
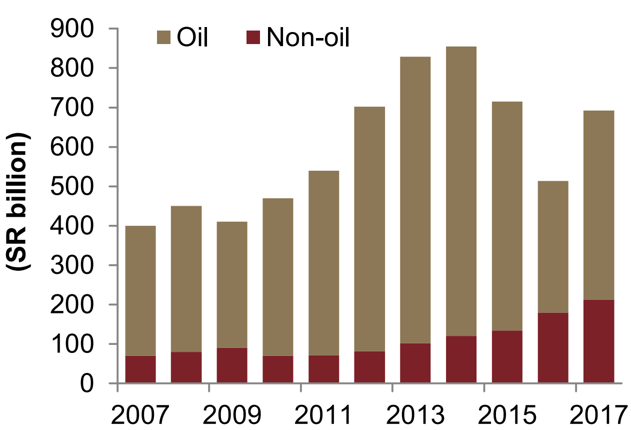


Figure 3: Budgeted revenue



The Kingdom has budgeted for a third consecutive fiscal deficit, amounting to SR198 billion in 2017.

fiscal deficit, amounting to SR198 billion in 2017, compared with SR145 billion in 2015 and SR326 billion in 2016. With optimism regarding the outlook for global oil market, and a strong drive to increase non-oil revenue (Figure 3), 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.

The budget statement explicitly states that the government will raise a further SR120 billion in new debt instruments 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). 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. We believe that financing the 2017 deficit will continue to include the simultaneous drawing down of the stock of government deposits in addition to raising domestic and international debt.

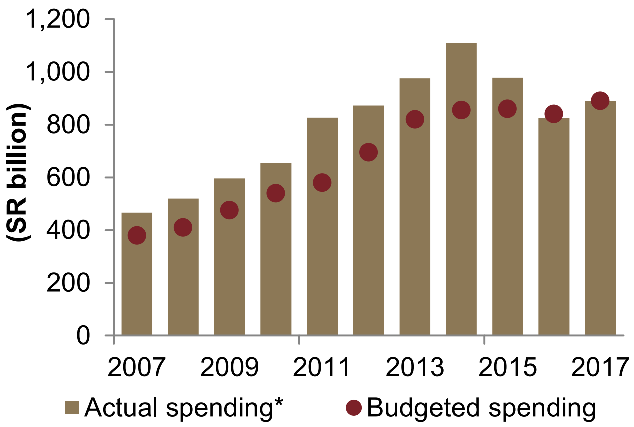
According to latest data available, net foreign assets at SAMA stood at $536 billion (SR2,028 billion), at the end of October. The huge stock of assets that the government can call upon gives the Kingdom an advantage over most other commodity-dependent countries in alleviating the impact of lower oil prices. Also, the transfer of SR100 billion from government accounts with SAMA to the Public Investment Fund (PIF) in November highlights the willingness by the government to maximize investment returns and further protect sovereign wealth.

The series of sovereign bond issuance (around SR20 billion per month from January to September), coupled with the first and highly successful $17.5 billion international sovereign bond issuance in October, 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 see the government increasingly relying on bonds to finance its future spending.

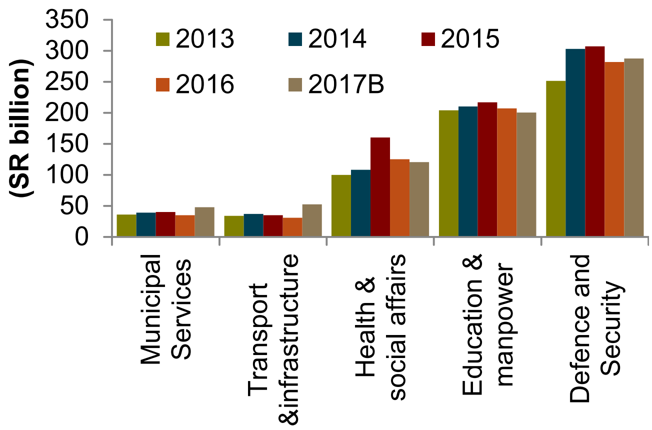
We see the government increasingly relying on bonds to finance its future spending, as the NTP targets gross public debt to reach 30 percent of 2020 GDP, up from 13.2 percent in 2016, equivalent to an annual average issuance of SR163.3 billion (both international and domestic) for the period 2017-2020. It is important to highlight that although the government has room to raise debt to these levels on

Figure 4: Budgeted versus actual spending



Note*: 2017 Actual spending corresponds to Jadwa Investment forecast

Figure 5: Budgeted allocations by sector



an annual basis, it has chosen to raise a smaller amount in 2017, at SR120 billion. Also, the government is expected to recommence its domestic bond program, which is likely to be priced by the market, and lead to the establishment of a credible yield curve.

Expenditure

Total expenditure is budgeted at SR890 billion in 2017.

Total expenditure is budgeted at SR890 billion in 2017. This is higher than the amount budgeted in 2016. This increase in budgeted spending, amidst a still subdued level of oil prices, reflects the government's willingness to support the economy and realize the objectives highlighted under the NTP. We believe that the budget's focus on the implementation of NTP initiatives sends an important message to the private sector that the reform plans will enter the implementation stage in 2017. This is psychologically important for the private sector, in our view, as it can reverse the negative sentiment which arose when the government deferred its spending to service providers during 2016.

When compared to actual spending, and including the SR105 billion in delayed payments during 2016, the budgeted amount shows a declining trend from actual levels in the previous three years, which totaled SR1,110 billion, SR978 billion, and SR930 billion in 2014, 2015, and 2016, respectively. We view this as a determined effort to curtail actual spending, given that the government has consistently overrun its budgeted spending by an average of 24 percent over the past decade (Figure 4). Stripping out the SR105 billion in delayed payments during 2016, the 2017 budget shows an expansionary stance, comparing it with both 2016's budgeted and actual levels of SR840 billion and SR825 billion, respectively. That said, budgeted spending as a share of non-oil GDP is slightly lower than historical levels, at an average of 47.5 percent.

We estimate that budgeted capital spending has been increased significantly.

The 2017 budget did not show a breakdown by type of expenditure. Following a significant year-on-year reduction in actual capital spending (down from SR275 in 2015 billion to SR165 billion in 2016), we estimate that budgeted spending on this category has been increased to SR260 billion. This type of expenditure can have positive implications over the growth in the non-oil private sector, since capital spending normally leads to higher demand for services from some of the largest sectors in the private economy, including construction, transport, and utilities.

Lower spending on allowances should contribute to a reduced wage bill in 2017.

We estimate an increase of 8.4 percent in budgeted current spending (the more rigid part of expenditure) to SR630 billion. Lower spending on allowances should contribute to a reduced wage bill in 2017, which implies that the majority of the increase in current expenditure will go to more growth-enhancing parts of the economy. Wages and salaries are the largest component of spending, constituting 40 percent of total expenditure in 2015, the most recent year were data is available. However, following the allowance reduction, we expect budgeted wage bill expenditure to decline significantly in 2017. We expect the government to continue with prudent supervision in order to curb any excessive growth in this type of spending.

NTP initiatives' budgeted cost is put at SR42 billion for 2017.

NTP initiatives' budgeted cost is put at SR42 billion (4.7 percent of total spending). The cost for these initiatives is distributed between current and capital spending, with SR12 billion budgeted as current expenditure, while the remaining SR30 billion going to capital spending. This spending will likely include the set up of the Saudi household benefits program, as well as part of the SR200 billion five-

While budgeted expenditure in 2017 spans all sectors, the priorities are consistent with recent years.

year private sector incentive program managed by the Ministry of Commerce and Industry.

While budgeted expenditure in 2017 spans all sectors, the priorities are consistent with recent years (Figure 5). Military and security services has been allocated 32 percent of the budget, the largest among all allocations. Education is allocated the second biggest share, at 23 percent of total spending, followed by the health and social affairs with 14 percent. That being said, we expect these allocations to be close to the actual spending levels in 2017, following a relatively small variation in budgeted versus actual expenditure amongst most sectors during 2016 (Figure 6)

Table 1. 2017 Budget Allocation
(SR billion)

Budget Allocation	2016 B	2016 A	2017 B	Difference (2016B-2017B)
Expenditures	840	825	890	50
Education and Training	207	206	200	-6.8
Health & Social Development	125	101	120	-4.4
Municipality Services	35	25	48	13.3
Military and Security Services	282	305	288	6.0
Infrastructure & Transport	31	38	52	21.3
Economic Resources	37	38	47	10.5
Public Administration	24	27	27	3
Public Programs Unit	96	84	108	11.9

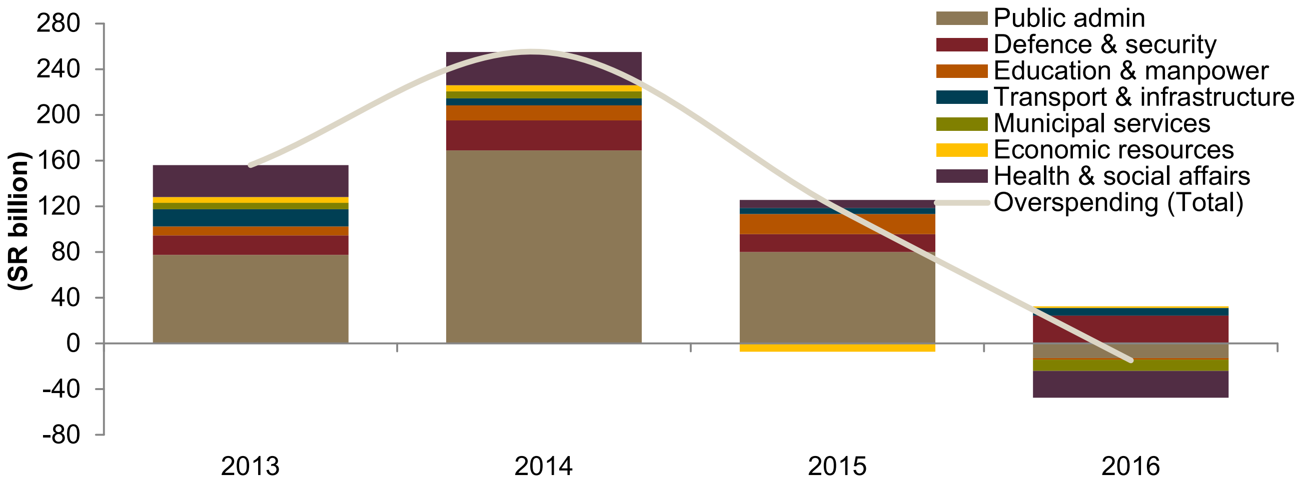
Note: "B" refers to budgeted spending, "A" refers to actual spending

Allocation under Military and Security Services item is the largest total budget allocation...

Box 1: Budget Allocation 2017

The most significant change from the 2017 budget was the withdrawal of a 'Budget Support Provision' which was introduced last year, for one year only. Besides that, after coupling the separate allocations for military and security, we can see that the combined allocation under **Military and Security Services** item represented the largest total budget allocation of 32 percent at SR287 billion and includes establishment of naval bases for border guards and improving security in the Two Holy Mosques. **Education and Training**, the second largest budget item, was allocated SR200 billion in 2016, representing a decline of 3 percent year-on-year from the budgeted total of SR207 billion in 2016. **Health and Social**

Figure 6: Overspending is trending down, in line with measures to stick to budgeted levels
(Actual versus budgeted spending)



...Education and Training, the second largest budget item, was allocated SR200 billion in 2016…

...Health and Social total allocation was SR120 billion

Development dropped by 4 percent year-on-year to SR120 billion, which includes the building and development of 38 new hospitals with a total capacity of 9,100 beds. **Municipality Services**, which made up 5 percent of the total allocation, declined by 38 percent or SR13 billion, year on year. **Economic Resources,** which includes budget for works on the Grand Mosque**,** represents 5 percent or SR47 billion of budgeted expenditure in 2017, up 28 percent year-on-year. **Public Administration** totaled SR26 billion, down marginally by 6 percent year-on-year, and includes funding to help implement the NTP initiatives related to the Ministries of Justice, Hajj and Umrah and Civil Service. **Infrastructure and Transportation** budget was raised 6 percent year-on-year, to SR52 billion for helping to develop roads, ports, railways, airports, postal services and the industrial cities of Jubail and Yanbu and Ras Al-Khair Industrial Mining. Lastly, although there is no direct mention of the SR107 billion budget for **Public Programs Unit** in the sectorial breakdowns, it is mentioned later in the budget statement in reference to prioritizing investment in development projects for citizens.

Fiscal and Structural Reform

Part of the 2017 budget also provided an update on the MoF objectives…

...including…

Part of the 2017 budget also provided an update on a set of fiscal and structural reform objectives outlined for the MoF in the previous year's budget. The overall aim of the objectives were to consolidate expenditure over the course of next three to five years, which also incorporate a number of NTP targets. The updates are categorized below:

...maintaining the Kingdom's credit ranking of AA2…

Financial strategy and projections:
This refers to the government's commitment to work towards a balanced national budget in 2020 by increasing non-oil revenue, thereby reducing dependence on more volatile oil revenue. It also reiterates the national debt strategy which includes national debt not rising above 30 percent of GDP with a credit ranking of AA2 for the Kingdom. It also includes plans to diversify debt issuance to include Sukkuk instruments as well debt in differing currencies.

... establishment of a General Fiscal Unit…

Budgetary oversight:
The establishment of a General Fiscal Unit within the MoF which ensures that allocated budget ceilings are adhered to.

...increasing the level of disclosure related to the national budget

Enhanced transparency:
Increasing the level of disclosure related to the national budget with more frequent updates alongside international best practices. According to the latest Open Budget Index (2015), the Kingdom was joint last, along with Qatar, as having the least transparent budget and this ranking has been specifically targeted to be improved in this year's statement.

...increasing the efficiency of capital and operational expenditures...

Operating and capital expenditure efficiency:
Additional initiatives aimed at increasing the efficiency of capital and operational expenditures. In the case of the latter, the statement reports that a Spending Rationalization Office had been set-up to review the five highest spending government ministries, all of which were not named, resulting in savings of around SR 80 billion.

...reducing 'red tape' for the private sector...

Privatization initiatives:
Emphasis on reducing 'red tape' for the private sector whilst improving co-operation with the public sector and, quite crucially, identifying a range of sectors and economic activities for privatization through the National Centre for Privatization (NCP). The NCP will also determine 85 project's suitability to cooperation between the public and private sectors.

...all government agencies moving to accounting practices to rely on the accrual principle…

Accrual accounting:
Under the statement, all government agencies will move to accounting practices to rely on the accrual principle, a method that records revenues and expenses when they are incurred, regardless of when cash is exchanged.

...and prioritizing investments in development projects which benefit citizens.

Development projects:
Prioritizing investments in development projects will also be central to ensuring a higher standard of living for all citizens, including the establishment of a rental and accelerated mortgage market at the ministry of Housing.

Box 2: Energy prices and cash transfers

Domestic energy prices are planned to be linked to an unspecified benchmark price through to 2020…

...with low- and middle-income households safeguarded from these reforms through a Cash Transfer Program.

Government net cumulative savings would be equal to SR144 billion per annum.

The 2017 budget did not announce any specific price hikes in domestic energy prices but it did reiterate that the Kingdom would continue reforming energy prices with the plan of linking domestic energy prices to an unspecified benchmark price through to 2020. Concurrently, the government intends on establishing a Cash Transfer Program (CTP) to safeguard low- and middle-income households from the effect of these energy price reforms. Any households eligible for the CTP will be expected to register from February 2017 onwards, with the first round of allowances scheduled to be paid in June 2017, just before the initial round of energy price increases in July 2017. According to statements made by the Vice Minister for Labor and Social Development, disbursements through the CTP program will start from SR22.5 billion in 2017 to reach SR65 billion in 2020. In comparison, according to calculations within the government's Fiscal Balance Program, the cumulative annual saving through raising domestic energy prices would be SR209 billion. By 2020, as result of intended energy price reform, government net cumulative savings would be equal to SR144 billion per annum (Figure 7).

Revenue

We anticipate that around 69 percent of total revenue will come from oil.

Total revenue is budgeted at SR692 billion. We anticipate that around 69 percent of total revenue will come from oil. As is the norm, the oil price and production projections used to derive the revenue

Figure 7: Domestic energy price rises and CTP

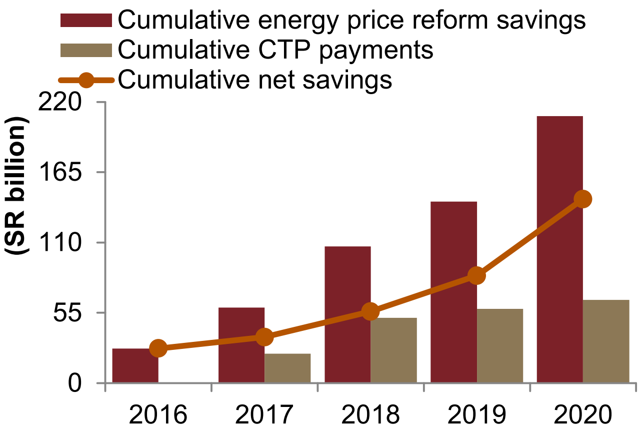
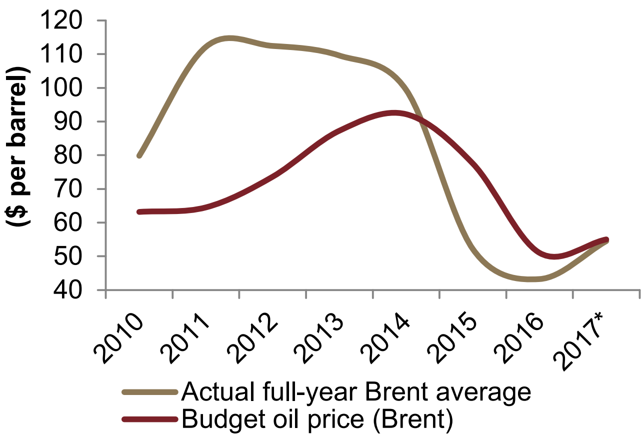


Figure 8: Budget oil price becoming less conservative (Brent prices)



*2017 actual Brent full-year average refers to Jadwa Investment's forecast

The budget oil price for 2016 was $51pb for Brent...

figure were not disclosed. We calculate that oil production of 10.1 mbpd at a price for Saudi export crude of $52pb (equivalent to around $55pb for Brent) is consistent with the oil revenue projection in the 2017 budget. We believe the government is budgeting for a compliance with the OPEC agreement to cut production, thereby reducing crude oil production by 300 thousand barrels per day (tbpd), year-on-year.

...and we think that the Brent oil price assumption for 2017's budget was increased again to $55pb.

The government has consistently based its previous budgets on conservative oil price assumptions. Over the period between 2010-14, the actual oil price has averaged more than 30 percent higher than the one used for the budget. However, with the improvement in the budget process, the government started to become less conservative in its oil price assumption. The budget oil price for 2016 was $48pb, higher than the $40.8pb year-to-date average price for Saudi crude. In 2017, the government continued to be less conservative in its oil price assumption, with Brent crude currently trading at $55pb, we think that the Brent oil price assumption for 2017 was increased again to $55pb (Figure 8).

Non-oil revenues are budgeted for SR212 billion…

...17.8 percent, 6.5 percent higher than 2016's budgeted and actual figures respectively.

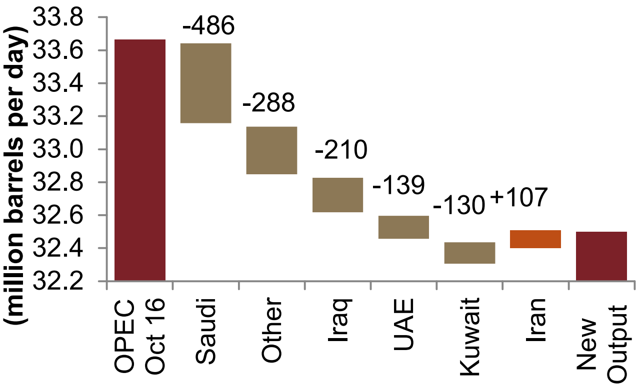
Non-oil revenues are budgeted for 212 billion, 17.8 percent, 6.5 percent higher than 2016's budgeted and actual figures respectively. Returns on government investment vehicles, excise taxes, fees and charges for services, and customs tariffs will be the main sources of non-oil revenue growth. This is in line with multiple initiatives by the government to diversify its revenue, as well as to more carefully monitor income receipts. Investment income (39 percent of 2016 non-oil revenue) is likely to continue being the fastest growing component. Robust activity by public investment vehicles in both domestic and international investment during 2016 is likely to continue, boosted by additional liquidity as a result of a recent SR100 billion transfer from SAMA to PIF in October.

Box 3: Jadwa's oil market outlook for 2017

The oil market in 2017 will be shaped by the actions of OPEC and non-OPEC members following their proposed cuts…

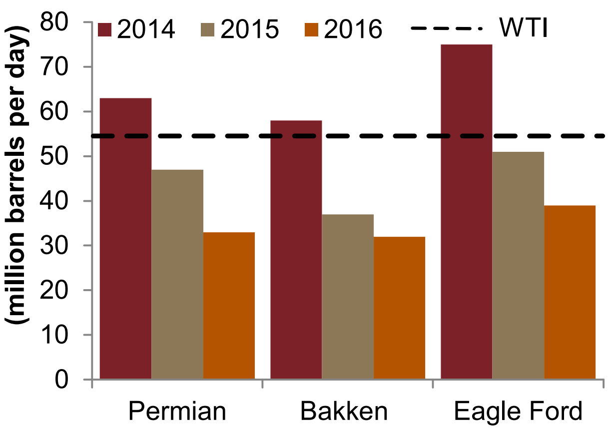
The oil market in 2017 will be shaped by the actions of OPEC and non-OPEC members following their proposed cuts, and the reaction to these cuts by US oil producers. Since OPEC agreed to cut its own production by 1.2 million barrels per day (mbpd) last month (Figure 9), a number of non-OPEC countries have joined in proposing cuts as well, with a total cut of 558tbpd committed in separate meeting in early December. The combined OPEC and non-OPEC joint

Figure 9: OPEC agreed to cut production by 1.2 mbpd from October 2016 levels*



*Other includes: Angola, Ecuador, Gabon, Qatar, Venezuela

Figure 10: Well-head breakeven prices at US shale basins current WTI oil price*



*Permian Delaware

...with full cuts resulting in oil markets falling into deficit by 200 tbpd in Q2 2017, compared with a surplus of 1.5 mbpd, with no cuts.

reduction equals around 1.8 mbpd, 2 percent of global oil supply. If we disregard the hurdles to the current deal, and assume that there are disciplined cuts at agreed levels, then we would expect to see oil market balancing being more aggressive than previously, by Q2 2017, when the deal expires. In fact, oil markets could fall into deficit by 200 tbpd in Q2 2017, compared with a surplus of 1.5 mbpd, with no cuts. Such a turnaround in oil market balances would have a positive effect on Brent oil prices. We would expect to see Brent oil prices averaging around $60 pb for the first half of 2017.

Although higher oil prices could also lead to higher oil output, specifically from US shale oil.

Higher oil prices could also lead to higher oil output, specifically from US shale oil. Many financially vulnerable US shale oil companies would be encouraged to out hedges at current oil prices, which are around $55 pb, and this would easily cover well-head (or half cycle) operating costs since the three major US shale basins break-even prices are at $45 pb (Figure 10). These hedges would not only provide financial relief for US producers, they would also raise overall US oil output levels, which have already seen sizable revisions since mid-2016 (Figure 11).

Another risk to proposed cuts is of course is non-compliance by OPEC and/or non-OPEC in applying the cuts…

Another risk to proposed cuts is of course is non-compliance by OPEC and/or non-OPEC in applying the cuts. As we pointed out in our December publication [Quarterly oil Market Update (Q3 2016): Are Oil Markets better off with OPEC cuts?,] OPEC has a poor record in complying with its own targets. Looking back at OPEC production data since 2001, there has been limited compliance with the organizations targets, with total production consistently exceeding production ceilings. Additionally, Russia itself 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.

Saudi Arabia's year-to-November average crude oil production is at 10.5 mbpd, which is likely to result in a higher full year 2016 average than our currently forecasted 10.3 mbpd. We see this higher production as result of significantly higher year-on-year crude oil exports as well as higher refined product exports (Figure 12). Going forward, there are obvious implications for Saudi crude oil production following the OPEC deal but, at this point in time, we have chosen not to change our current forecast. 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

Figure 11: Upward revision in US oil production seen in recent months

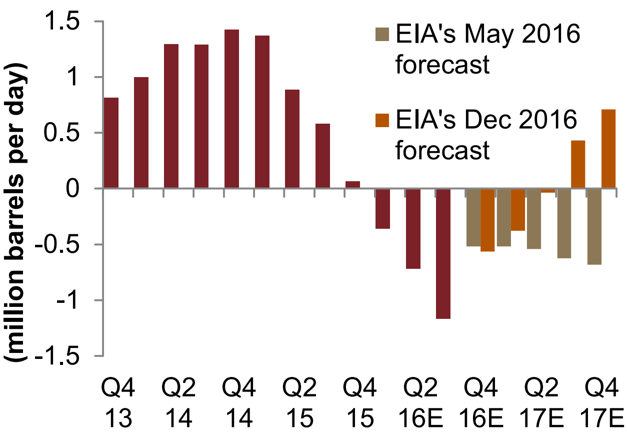
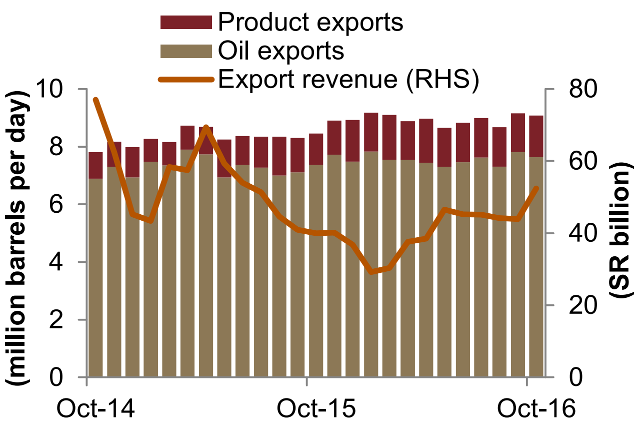


Figure 12: Higher year-on-year Saudi crude oil and refined products exports



...which is why we have chosen not to change our Saudi production forecast for 2017, at 10.4 mbpd, for now.

from the Saudi oil minister which stated that the Kingdom was willing to cut production beyond its currently agreed amount. However, as noted above, this does not guarantee that other countries will follow through on their agreed cuts. If non-compliance from other OPEC member did occur, we would expect to see Saudi production rebounding pretty quickly to current levels of around 10.6 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, if not sizable, differences between the two, with direct communication output being consistently higher. Due to all the above factors, our full year Saudi forecast remains at 10.4 mbpd for 2017.

Similarly, we also maintain our current Brent oil price forecast at $55 pb for 2017.

Similarly, whilst the OPEC cuts represent an up-side risk to oil prices, due to the hurdles mentioned above, namely risks to implementation and a rebound in US shale, we also maintain our current Brent oil price forecast at $55 pb for 2017.

Jadwa Investment's 2017 budget forecast

We forecast a budget deficit of SR162.3 billion in 2017 (6.1 percent of GDP).

We forecast a budget deficit of SR162.3 billion in 2017, equivalent to 6.1 percent of estimated GDP. On the revenue front, we expect oil prices to be similar to those used in the budget, but with higher oil production, leading to higher-than-budgeted oil revenues. We forecast total oil revenues contributing SR516 billion to the budget. Meanwhile we expect non-oil revenues to equal the budgeted figure of SR212 billion.

We expect actual spending to equal the budgeted level.

We also expect actual spending to equal the budgeted level. Revenues generally provide the base from which expenditure is calculated; less conservative budgetary assumptions on oil prices and a commitment to keep budgeted spending elevated in the last few years have contributed to lower levels of overspending. Over the last ten years actual government spending has averaged 24 percent higher than the budgeted amount. However, in 2016, the overspending ratio turned negative for the first time since 1998 as the government curbed its spending. In 2017, we expect a prudent monitoring of spending to play a role in controlling expenditure. That said, and given our expectation of an improvement in budgeting as part of the ongoing reforms, we forecast total expenditure to equal the budgeted figure of SR890 billion.

We see the 2017 fiscal breakeven oil price at $77pb for Saudi export crude.

The oil price level necessary for revenues to balance our forecast level of government spending, known as the fiscal breakeven oil price, is $77pb for Saudi export crude (equivalent to around $80pb for Brent). This is significantly lower than the $91pb fiscal breakeven for 2016 and is based on our production assumption of 10.4 mbpd and an oil export/revenue transfer ratio of 85 percent. We also assume a marginal 1 percent growth in domestic oil consumption to 2.83mbpd in 2017. We think that lower consumption growth is due to three factors; the relatively subdued level of economic growth in 2017, the impact of additional gas introduced in 2016, and the additional energy price hikes in 2017.

Budgetary Performance in 2016

Actual oil revenues have come out slightly lower than budgeted…

…the result of a low crude oil revenue to exports ratio (67 percent).

The recent announcement by the Ministry of Finance (MOF) also reveals that the preliminary 2016 fiscal outturns were not significantly different than the 2016 budget projections, and in line with our projections. Actual oil revenues have come out slightly lower than budgeted; the result of a low crude oil revenue to exports ratio (67 percent). Spending was lower than the budgeted projection, leading to a deficit of SR297 billion, SR65.2 billion lower than in 2015, and equivalent to 12.4 percent of GDP (Jadwa Investment: SR265 billion, 11.2 percent of GDP). That said, an additional SR105 billion in delayed payments from 2015 has been disbursed, but was not added with the SR825 billion total expenditure for 2016. The budget statement emphasized the need to separate such spending in order to stand on the actual budgetary performance in 2016.

Revenue totaled SR528 billion (Jadwa Investment: SR585 billion). It was 3 percent higher than the budgeted level, but 14.3 percent lower than its 2015 level. We estimated that the 2016 budget was based on a price for Saudi oil of $39.2 pb and production of 10.3 mbpd. Actual price of Saudi oil averaged $40.6pb in 2016, 18 percent lower than its level in 2015, and 16 percent lower than that used in the budget. The actual year-to-November level of oil production was above our forecasts, at 10.5mbpd.

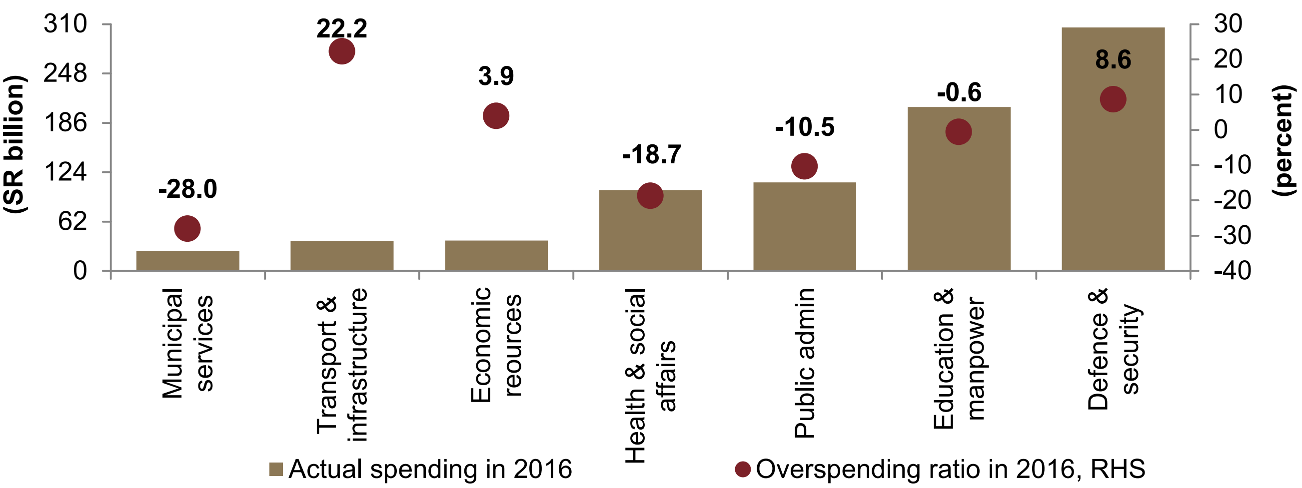
Non-oil revenues were SR199 billion, up by 17.4 percent on the 2015 total.

Non-oil revenues were SR199 billion, up by 17.4 percent on the 2015 total, and rising to an all-time high. The growth in non-oil revenue reflects a doubling of investment income from SAMA. The willingness to invest more in assets with potentially higher-returns has resulted in a 76 percent growth in investment income, from SR35.4 billion in 2015 to SR62.2 billion 2016. Furthermore, the introduction of a number of new and higher fees on tobacco, telecom royalties, and other income source resulted in a tripling of revenues.

Expenditure amounted to SR825 billion,1.8 percent, and 15.7 percent lower than the 2016 budgeted and 2015 actual levels.

Expenditure amounted to SR825 billion (Jadwa Investment: SR850 billion), 1.8 percent, and 15.7 percent lower than the 2016 budgeted and 2015 actual levels. This was the second consecutive year-on-year decline in actual spending. Even when factoring in the SR105 billion, actual spending is still 5 percent lower than in 2015. In nominal terms, the SR825 billion in expenditure represents a decline of SR15 billion, and 153 billion compared to 2016 budgeted and 2015 actual levels. That said, including the SR105 billion in delayed

Figure 13: Actual spending and overspending ratio by sector in 2016



payments would result in SR930 billion worth of spending, meaning a record deficit of SR402 billion in 2016 (16.8 percent of GDP).

From a sectoral allocation viewpoint, spending on some sectors was higher than budgeted, including the military and defense, transport, and economic resource. Meanwhile other sectors saw a lower-than-budgeted allocations (Figure 13). That said, we maintain our view that major cuts to capital spending, and partial impact of reduction to public sector worker's allowance accounted for a large share of the lower level of total spending during 2016. It is important to keep in mind that the initial estimates of government spending and revenues contained in the budget statement tend to be revised. In general, both are higher, with the rise in spending usually larger than that for revenue.

Current spending was reduced by SR10 billion, year-on-year…

...but was significantly higher when deducting one-off payments from 2015.

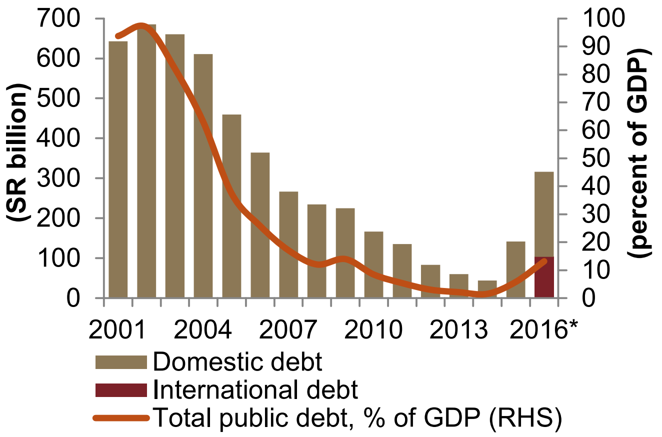
Current spending was reduced by SR10 billion, year-on-year to reach SR660 billion in 2016. However, 2015 included SR88 billion in exceptional one-off payments in additional salaries to public sector employees and military personnel. If we exclude these one-off payments, then the year-on-year increase in current spending comes to SR78 billion in 2016, the second largest increase in such spending on record. The largest increase to current expenditure was in 2011, at SR95 billion, a year in which the government introduced two fiscal packages amounting to 26 percent of GDP. Nevertheless, recent efforts to curb the growth in the wage bill highlights the strong willingness to reduce future budget rigidities, allowing more room for future spending on more growth-enhancing areas of the budget. Further, the government has previously noted that its efforts to rationalize current spending will continue.

Capital expenditure was reduced by 46 percent, year-on-year to reach SR165 billion in 2016.

Capital expenditure was reduced by 46 percent, year-on-year to reach SR165 billion in 2016. This puts capital spending at 20 percent of total expenditure, the lowest since 2006. That being said, the reduction in capital spending is more reflective of the efforts by the government to enhance its efficiency specifically in this area of expenditure. As highlighted in the fiscal balance program, capital projects in the pipeline account for SR1,400 billion, of which SR220 billion have been reviewed for enhanced efficiency.

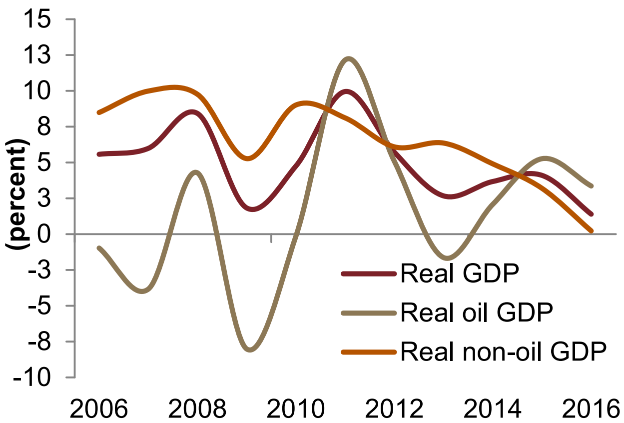
As a result of the budget being in deficit, the government has started a series of international sovereign bond issuance, replacing the year-to-September monthly series of domestic issuance. The public debt

Figure 14: Government debt



Note: * From the official budget statement.

Figure 15: Real GDP growth
(year-on-year change)



increased from SR142 billion in 2015 to SR317 billion (13.2 percent of GDP) by the end of 2016 (Figure 14). Foreign debt made up 32.6 percent of the total amount, and we expect more international issuances in 2017 and beyond. In November, MOF highlighted that it is willing to resume the domestic issuances in 2017, allowing the government to balance between the different financing sources, and also to work on developing primary and secondary local debt markets. Commercial bank holdings of government bonds, the closest proxy to their holdings of government debt, reached SR176 billion in October 2016. Among the autonomous government institutions, we believe the largest two subscribers were the General Organization for Social Insurance (GOSI) and the Public Pension Agency (PPA).

Table 2. 2016 Budget data
(SR billion)

	Budget	Actual	Difference
Revenues	514	528	14
Expenditures	840	825	-15
Balance	-326	-297	29

Economic Performance in 2016

Overall economic growth fell to 1.4 percent year-on-year, slowing from 4.1 percent year-on-year in 2015.

The budget announcement included preliminary macroeconomic data for 2016, providing insight into economic performance this year and prospects for next year. Data showed that overall economic growth fell to 1.4 percent year-on-year, slowing from 4.1 percent year-on-year in 2015. We had forecasted 1.1 percent GDP growth in 2016.

The oil sector grew by 3.4 percent year-on-year in 2016…

...while non-oil economic growth was at 0.2 percent year-on-year.

According to the data, the oil sector grew by 3.4 percent year-on-year in 2016, (Jadwa Investment: 2.1 percent). Stripping out the oil and gas sector, non-oil economic growth was at 0.2 percent year-on-year with the private sector expanding by 0.1 percent, compared to our forecast of 0.7 percent Inflation accelerated year-on-year, mainly owing to higher domestic energy prices.

Real GDP growth fell to 1.4 percent year-on-year, a trend which we had anticipated (Figure 15). We expected lower economic growth compared to last year as a result of weaker non-oil sector

Figure 16: Non-oil GDP Growth

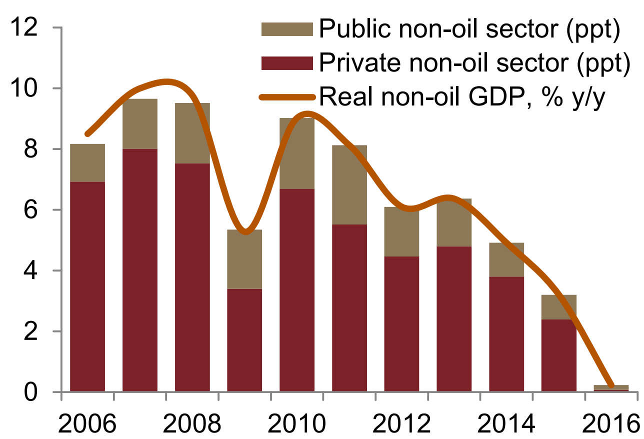
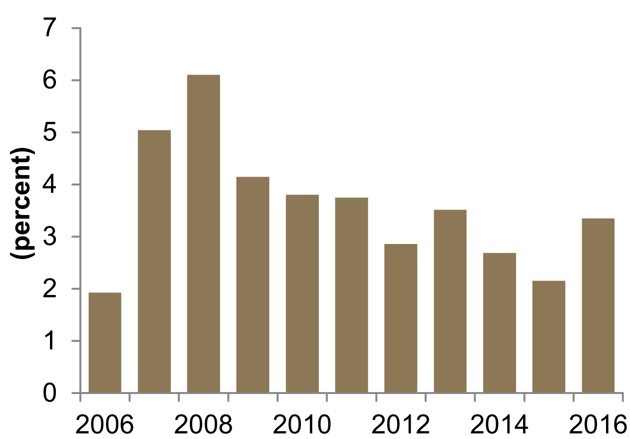


Figure 17: Inflation
(year-on-year change)



performance, while oil sector growth also slowed. The oil sector grew by 3.4 percent year-on-year as the Kingdom increased production levels. Oil production grew by 2.4 percent year-on-year to an average of 10.4 mbpd compared with 10.2 mbpd in 2015. Meanwhile, the pace of growth in the non-oil economy trended down as well, slowing to 0.2 percent (Figure 16). Within the non-oil economy, growth of government services slowed to 0.1 percent.

The non-oil private sector grew by 0.1 percent.

The **non-oil private sector** grew by 0.1 percent. We had anticipated a slowing performance in 2016 as negative sentiment associated with lower oil prices and reduced government spending impacted business and consumer confidence, as well as banks' discomfort in the lending environment. According to our estimates, we see finance and transport as the fastest growing sectors in 2016. We expect a contraction in the construction, wholesale and retail, and non-oil manufacturing sectors in 2016. Contractors underwent a difficult year as the government consolidated spending on the capital side. A notable slowdown in consumer spending even prior to the reduction in public sector worker's allowances in Q4 2016, apparently impacted the wholesale and retail sector. We believe that business specializing in the consumer discretionary sub-sector were particularly vulnerable. Non-oil manufacturers continued to face pressure from intense global competition, while the increase in domestic energy prices will also be a factor leading to negative growth to the sector.

According to our estimates, we see finance and transport as the fastest growing sectors in 2016…

...and expect a contraction in the construction, wholesale and retail, and non-oil manufacturing sectors.

Preliminary 2016 data from budget statement showed **Inflation** averaging 3.4 percent, compared to 2.2 percent in 2015 (Figure 17). This means an acceleration from a nine-year low posted in 2015. That said, inflation started the year from a very high level of 4.3 percent, mainly due to the energy price reform back in January, but has trended downwards in latter months as economic activity weakened, reaching 2.3 percent in November. That said, we expect 2016 inflation to be revised upwards and closer to our forecast of 3.7 percent, as the 3.4 percent figure is still considered preliminary in the budget statement.

Inflation averaged 3.4 percent, compared to 2.2 percent in 2015.

The Economic Outlook for 2017

We expect that the economy will continue to decelerate in 2017, dragged down by slower growth in the oil sector, while non-oil sector growth is expected to rebound but remain subdued. Annual growth in the oil sector is forecast to fall slightly in 2017, mirroring marginally lower oil production. Growth in the non-oil private sector is forecast to accelerate slightly, as the expansionary budget in 2017 stimulates non-oil economic activity. However, we think that downside risks to growth exist in the form of lower consumer spending due to the recent cuts to public sector workers' allowances, and the potential for higher costs for doing business such as energy price increases, and newly introduced fees on municipal, immigration, and other government services. We nevertheless believe the government should maintain a level of spending high enough to continue supporting positive growth in the non-oil private sector. While we expect implementation of NTP initiatives in 2017 to stimulate private sector activity; focusing on initiatives such as the Saudi household Cash Transfer Program, and foreign direct investment promotion, local content development, and regulatory and administrative reform to particularly be growth-enhancing to the private sector.

We expect that the economy will continue to decelerate in 2017…

...dragged down by slower growth in the oil sector…

...while non-oil sector growth is expected to rebound but remain subdued.

We expect oil sector growth to reach -0.3 percent as oil production declines marginally.

The non-oil private sector is expected to expand by 1 percent…

...accelerating from 0.1 percent in 2016.

Economic growth in Saudi Arabia is forecast to slow to 0.2 percent in 2017. Based on the available data, we expect oil sector growth to reach -0.3 percent as oil production declines marginally but remains at 10.4mbpd. Oil sector growth could decline more considerably if OPEC carries out disciplined cuts in production, which means Saudi production declines to 10.1 mbpd, rather than our currently forecasted 10.4 mbpd. Aside from this, the Kingdom is expected to see its first unconventional gas field being operational during 2017. Although this field represents a crucial step in unlocking the Kingdom's potentially vast reserve of unconventional gas, it will be represent only a small addition, at around 50 million cubic feet a day (mcf/d), increasing Saudi total raw gas supply by around 3 percent year-on-year. Within the non-oil sector, we expect the government's real GDP to fall by 0.1 percent year-on-year due to our expected lower year-on-year government spending on wages and salaries, while the non-oil private sector is expected to expand by 1 percent, accelerating from 0.1 percent in 2016. We believe that the private sector will start to benefit from multiple NTP initiatives that will enter the implementation stage in 2017, while lower government spending will limit any potential for an acceleration in growth for some businesses. From a sectorial point of view, we expect non-oil mining, finance and utilities to be the fastest growing sectors of the economy in 2017.

Table 3. 2016 results and 2017 Jadwa Investment forecasts

	2016 Actual	2017 Forecast
Real GDP (% change)	1.4	0.2
Nominal GDP (% change)	-1.9	10.1
Inflation (2007 = 100, %)	3.4	2.0

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

We see an improvement in the current account balance in 2017.

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. The new round of energy price hikes by mid-2017 will push inflation upwards, putting the annual average at 2.0 percent. 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. Oil exports are forecast to improve, while imports will remain unchanged from their 2016 level. Investment income will rise, benefiting from the higher interest rate environment and the move by PIF to invest more in foreign assets with higher returns. This will result in an improvement in the current account balance in 2017.

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The data contained in this Research is sourced from Reuters, Bloomberg, Tadawul, Rystad, EIA, OPEC, JODI and national statistical sources unless otherwise stated.

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