



Glut in global oil markets persists

Implications on Saudi Macroeconomic Outlook

Summary

- The widening of global oil surplus to 2 million barrels per day (mbpd) led to Brent prices dropping by 29 percent, quarter-on-quarter, to \$54 per barrel in Q1 2015. Oil markets will continue to see large surpluses in Q2 & Q3 2015.
- Slower shale oil growth and improved global economic growth will result in a more sustained rise in price but only in the last quarter of 2015. As a result we see full year Brent crude now averaging \$61 per barrel, down from \$79 per barrel previously.
- As the latest Saudi refinery, Yasref, reaches full capacity we estimate total Saudi oil consumption will rise to 2.7 million barrels per day (mbpd) in 2015 with rises in gas output limiting some growth of crude consumption in the domestic energy mix.
- Saudi crude continues to face intense competition in key foreign markets which will keep exports at similar levels to last year, at around 7 mbpd. This combined with higher domestic consumption means we now project Saudi production rising to 9.8 mbpd in 2015, up from 9.6 mbpd in our previous forecast.
- We revised our forecast for the kingdom's 2015 GDP growth upwards to 3.3 percent year-on-year, because we believe oil sector growth will be higher than previously anticipated. We also forecast a larger than anticipated fiscal deficit, with the current account now projected to record a deficit.
- We believe the government is preparing to start issuing sovereign debt in order to finance the majority of its deficit. This new financing strategy should reduce the pressure on foreign reserves as the main deficit financing tool.

For comments and queries please contact:

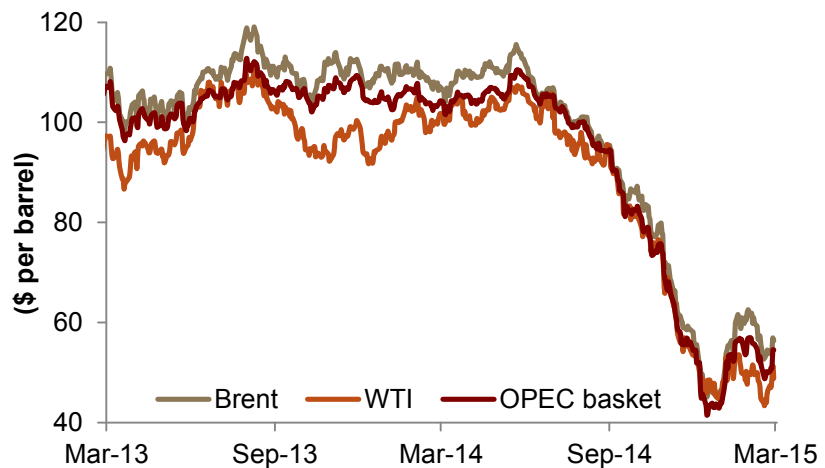
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Figure 1: Oil prices volatile in Q1 2015





Oil demand growth in 2015 will be driven by non-OECD countries...

...only Canada and the US are contributors to growth in demand from OECD countries.

Rising US oil demand will not support international oil prices as shale oil leads to import declines.

Improvements in fuel economy standards and disparate economic growth will result in European oil demand declining in 2015.

Japanese oil demand will remain lackluster as liquefied natural gas (LNG) will compete with crude oil for power generation.

Oil Demand

According to OPEC data global demand rose by 1.2 mbpd in Q1 2015, year-on-year, supported entirely by non-OECD countries. Weak oil demand growth in the EU and Japan cancelled out consumption rises amongst OECD Americas. Flat demand growth in OECD countries is expected to continue into the second quarter of 2015 and the rest of the year with the Middle East (up 3.5 percent, year-on-year), China (up 3 percent, year-on-year) and India (up 2.9 percent, year-on-year) being the main drivers of growth in 2015.

In the US, the combination of a growing economy and lower gasoline prices will continue to spur oil demand in Q2 2015 and beyond. Lower crude benchmark prices have resulted in US retail gasoline prices dropping dramatically, with a gallon of gasoline costing consumers \$2.3 now, the lowest in five years, down from \$3.6 in June 2014 (Figure 2). Rising US oil demand will not, however, support international oil prices, primarily because year-on-year growth in domestic supply of crude, in 2015, will result in a decline in US imports (Figure 3).

Oil demand was flat in Europe in Q1 2015, year-on-year, and is likely to show only modest growth in Q2 2015. The region's long term oil demand trend has been downward due to continuing improvements in fuel economy standards and, together with disparate economic growth during the year, oil demand is expected to decline in 2015 as a whole, year-on year.

Since the Japanese economy slipped into recession in Q3 2014 there has been some improvement in GDP, which rebounded to 2.7 percent, year-on-year, in Q4 2014. Whilst there is some optimism that the economy will recover further, this is not likely to lead to growth in oil demand. Preliminary Q1 2015 data shows that crude oil imports were down by 300 thousand barrels per day (tbpd) or 8 percent, year-on-year, and this decline is expected to continue in Q2 2015 as refineries cut back on processing crude in line with seasonal maintenance. Looking further ahead in 2015, Japanese oil demand will remain lackluster as liquefied natural gas (LNG) will compete with crude oil for power generation (Figure 4). Since LNG prices are

Figure 2: US gasoline prices

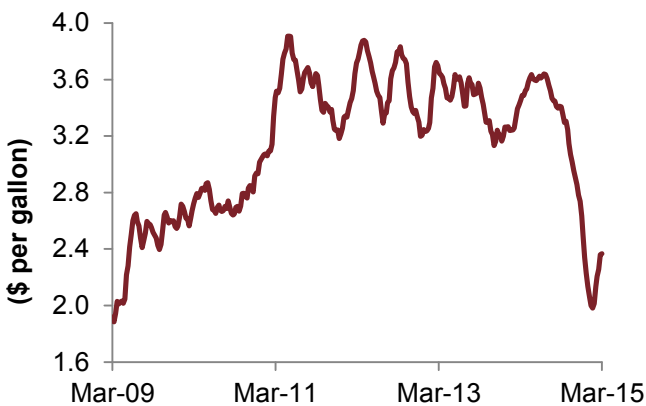
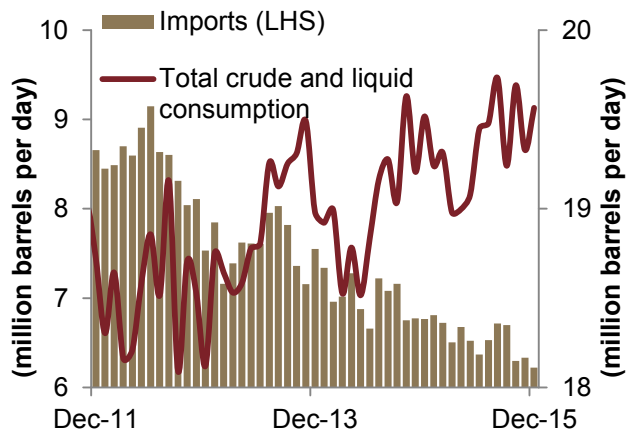


Figure 3: US liquid consumption and imports





Chinese oil demand is likely to remain positive, year-on-year, in 2015 due to China's efforts to boost commercial crude stocks...

...since it has been a long-term strategy of the Chinese government to buy crude for stocks at times when prices are low.

Russian GDP will see negative growth in 2015 and we expect oil demand growth will be meagre throughout 2015.

linked to oil prices, the price of the former has also dropped recently. The government is also in the process of reactivating nuclear plants, with two reactors given the go-ahead to reopen during 2015.

Chinese oil demand grew by an estimated 7.4 percent in Q1 2015, year-on-year, despite the economy facing some economic headwinds. The rise was mainly due to higher seasonal demand linked to Chinese new year celebrations. Chinese oil demand is likely to remain positive in Q2 2015 with support for oil demand provided by China's efforts to boost commercial crude stocks. It has been a long-term energy strategy of the Chinese government to buy crude for stocks at times when prices are low. China currently has around 31 days' worth of crude imports in stock, but has targeted around 100 days by 2020, which would represent a further 700 million barrels, or 0.4 mbpd. For the same reasons we see oil demand remaining at around current levels in Q2 2015 and for the rest of 2015. Downside risks to demand do exist, however, due to a structural transition in the economy. As China goes through a period of broader based economic growth and implements stricter fuel emission standards, the use of oil will be less intensive than previous phases of growth. According to the Strategic Action Plan for Energy Development, published by the Chinese government in December 2014, China is targeting a decline in the share of oil in its energy mix from 18 percent in 2014 to 13 percent by 2020, with gas and renewable energy making up the deficit.

As oil prices have dropped, Russia's economic problems have mounted. The ruble is still vulnerable against the dollar, albeit after recovering slightly in early 2015. The US and EU are still applying sanctions over the conflict with Ukraine. These factors have hit the Russian economy hard with capital outflows from the private sector in 2014 totaling \$151.5 billion, up from \$61 billion in 2013. The IMF has predicted that Russian GDP will see negative growth in 2015, at minus 3 percent and as such we expect oil demand growth will be meagre in Q2 2015 and throughout 2015.

Indian oil demand will grow by around 2-3 percent in Q2 2015 as government reforms pick up momentum. De-bottlenecking of stalled investments and rising exports will also push the economy forward. The IMF has forecasted GDP growth of 6.3 percent for India in 2015

Figure 4: Japanese crude vs. LNG imports

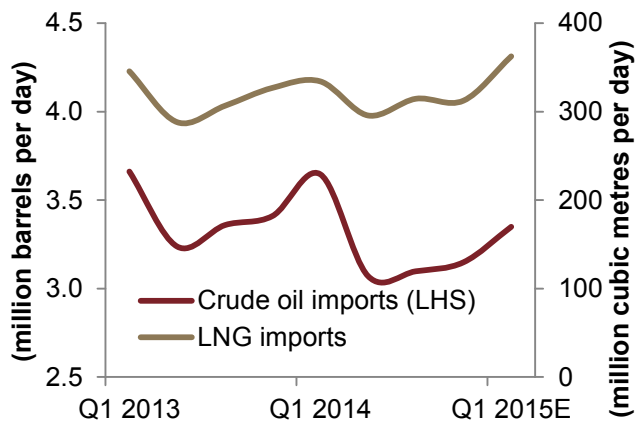
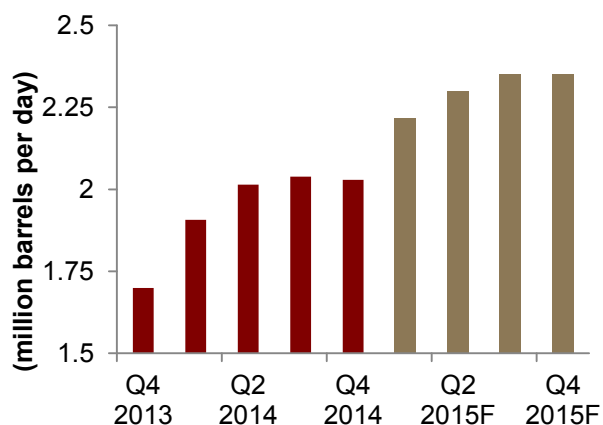


Figure 5: Saudi refinery intake levels





The IMF has forecasted GDP growth of 6.3 percent for India in 2015 which would translate into healthy oil demand growth too.

Jadwa estimates that Saudi refinery intake increased by 13 percent, year-on-year, in Q1 2015, as a result of the staggered start-up of the Yasref refinery...

...which will see domestic consumption rise to 2.7 mbpd in 2015, up from 2.5 mbpd in 2014.

Non-OPEC supplies grew by 2.1 mbpd in Q1 2015, year-on-year...

...and will grow by 1 mbpd, year-on-year, in 2015, with US shale oil making up the majority of growth...

which would translate into healthy oil demand growth too, especially if the government's stated plans to build up strategic crude stocks by 7.3 million barrels for 2015 go ahead. Since India's crude production is limited and around 80 percent of oil is imported, any growth in Indian oil demand should lend some support for oil prices.

Jadwa estimates that Saudi Arabian refinery intake increased by 13 percent (or 201 tbd), year-on-year, in Q1 2015, as a result of the staggered start-up of the 400 tbd Yasref refinery at the end of 2014. The Yasref refinery will be at full capacity by Q2 2015 and this will push up refinery intake to 2.2 mbpd for the remainder of 2015 (Figure 5), compared to an estimated 2.1 mbpd in Q1 2015.

However, we think that forthcoming increases in domestic gas production should take up some of the burden from oil as the fuel for domestic energy consumption. The main growth in gas output will come from the Hasbah and Arabiyah fields in the east of Saudi Arabia and from the Shaybah field in the Empty Quarter. There is however a risk that the impact of these fields will be limited due to delays in bringing the projects on-line and we have therefore revised domestic consumption for 2015 upwards to 2.7 mbpd in 2015, compared to previous estimates of 2.6 mbpd, and compared to 2.5 mbpd of domestic consumption in 2014.

Oil Supply

Non-OPEC supplies grew by 2.1 mbpd in Q1 2015, year-on-year, largely as a result of increased US oil production. In Q2 2015 there will be continued output increases from non-OPEC sources amounting to 1.4 mbpd, year-on-year, with output again led by the US. Supply increases are also expected from Russia and Iraq. Looking further ahead into 2015, OPEC data shows that non-OPEC oil supply will grow by 1 mbpd, year-on-year, in 2015, with US shale oil making up the majority of growth. We also see the potential for some upside in production from OPEC in 2015, regardless of the over supplied market, with the main source of increases coming from Iraq, geo-political risks notwithstanding.

According to the latest Energy Information Agency (EIA) data, total US oil production was expected to have risen by 15 percent in Q1

Figure 6: Yemeni crude supply

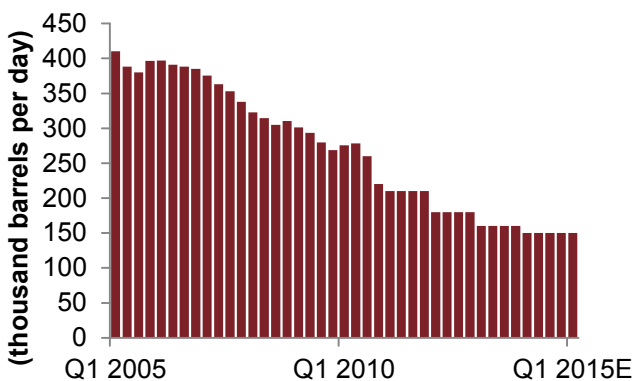
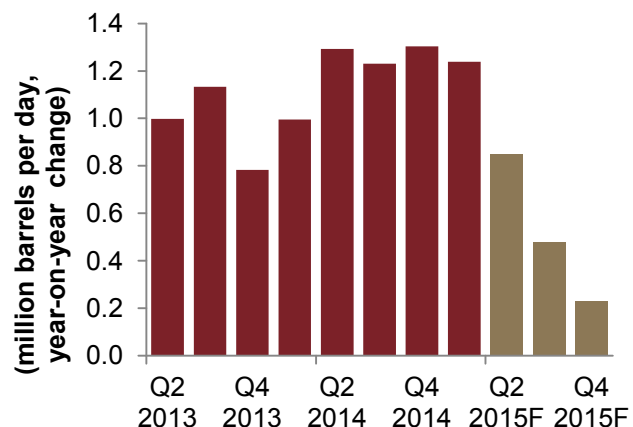


Figure 7: US oil production growth





...and with US crude oil production growth continuing to decelerate at a more rapid pace in the second half of 2015.

Russian crude oil exports are expected to remain at Q1 2015 levels throughout the rest of the year.

Yemen's importance as an oil producer is limited, with production averaging around 150 tbpd in 2014.

The main risk comes from shipping in the Gulf of Aden and Red Sea...

...although the increased presence of western navies to repel Somali pirates means this is not a highly likely event.

2015, year-on-year, as shale oil output continued regardless of the bearish oil price market. The EIA expects slightly lower growth in Q2 2015, at 10 percent, year-on-year, with growth decelerating at a more rapid pace in the second half of 2015 (Figure 7). Total US crude production averaged 8.59 mbpd in 2014 and this will, according to the EIA, rise to 9.32 mbpd in 2015, resulting in an increase of 0.7 mbpd, year-on-year, in 2015, down from an increase of 1.1 mbpd in 2014.

Preliminary data on Russian exports point to a rise in Q1 2015 to 4.7 mbpd, up 6 percent year-on-year, as exporters took advantage of the new tax regime introduced for 2015. Tax changes instituted by the Russian government have lowered export duties on crude oil, resulting in around a 40 percent drop in duties compared to 2014. Russian crude oil exports are therefore expected to remain at Q1 2015 levels throughout the rest of the year.

Box 1: Yemeni crisis

Brent spiked to \$60 per barrel during March after Arab coalition forces intervened in the Yemeni civil war. The immediate spike brought back the potential of a risk premium in oil prices similar to that seen during civil unrest around the Middle East from 2011 onwards. Although Yemen's importance as an oil producer is limited, with production averaging around 150 tbpd in 2014 (Figure 6), there are wider repercussions for the global oil market if the conflict seriously deteriorates. Currently around 4 mbpd of crude (and 0.9 mbpd equivalent of LNG) flows through the Bab al-Mandeb Strait, close to Aden. All of this supply could be diverted around Africa adding to transport times and costs if the security situation around southern Yemen falls dramatically.

Despite these risks, at the time of writing there were no reports of disruption to Yemeni supply and no threats to supplies through the Bab al-Mandeb Strait. Because of historical threats from Somali pirates there is already a high presence of western navies and security personnel meaning that a negative impact on oil supplies and prices is highly unlikely. This seemed to be reflected in the market place as Brent prices return to mid \$50's (per barrel) a few days after the intervention.

Figure 8: Top four Iranian crude oil importers

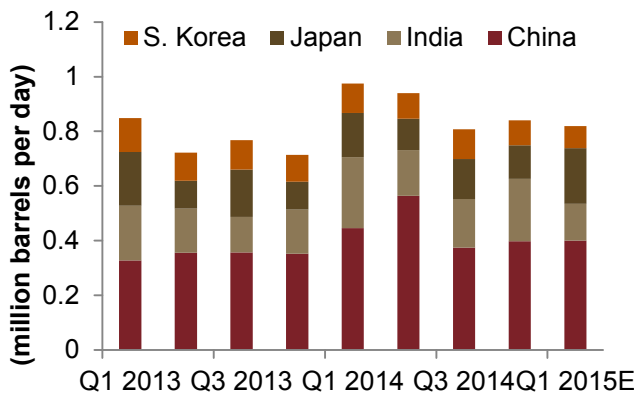
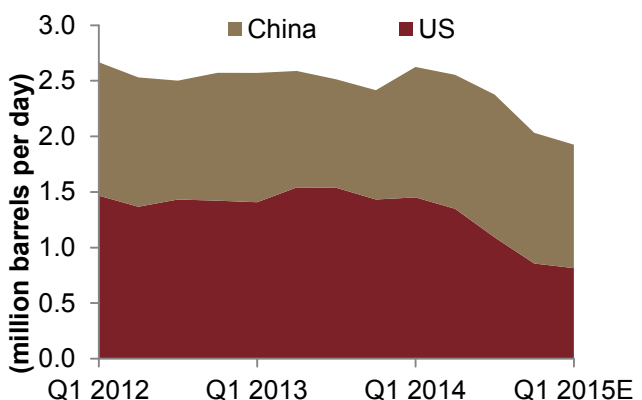


Figure 9: Saudi exports to China and the US





Total output from OPEC was marginally down in Q1 2015, year-on-year.

Iraqi crude production fell due to bad weather limiting oil exports.

Libyan supply was down due to a drastic deterioration in the security situation.

Iran's crude output also decreased as sanctions continued to limit growth in production.

Iran and the five permanent members of the UN Security Council plus Germany (P5+1) reached a framework agreement.

If the P5+1 and Iran move ahead on 30th June only the EU and US sanctions will be lifted.

Total output from OPEC was marginally down in Q1 2015, year-on-year, dropping by 1 percent, largely as a result of falls in production from Iran, Iraq, Libya and Nigeria. A large increase from Angola, up 14 percent year-on-year, and Saudi Arabia, up 9 percent year-on-year, made up for most of the losses. In Q2 2015 we expect OPEC supply growth to be flat, year-on-year, as falls in Libyan supply cancel out gains made from Iraq.

Latest OPEC data shows that Iraqi crude production fell by 8 percent - year-on-year- in Q1 2015, to 3 mbpd as bad weather hampered oil exports. A recent oil export agreement between the Kurdistan Regional Government (KRG) and the central government has paved the way for a ramp up in exports to potentially 2.9 mbpd in Q2 2015, compared to an average of 2.5 mbpd in 2014. There are significant downside risks to targeted exports, including continued fighting in the northern part of the country, infrastructure constraints in the south, and a delicate political resolution between the central government and the KRG breaking down.

A drastic deterioration in the security situation in Libya resulted in oil production dropping by around 9 percent year-on-year in Q1 2015 to 300 tbpd. The continued political problems facing the country will make it difficult to sustain production at above 700 tbpd in Q2 2015 and for the remainder of 2015.

Iran's crude output decreased 8 percent year-on-year in Q1 2015 as sanctions continued to limit any growth in production, tying current output levels at 3 mbpd. In April 2015 the US and its allies (P5+1) reached a framework agreement which, if implemented in June 2015, would lift a number of financial and energy-related sanctions on Iran (Box 2). Looking ahead to Q2 2015, we do not see significant additional crude exports from Iran, with only slight increases in Q3 2015. If the two sides (Iran and P5+1) do come to an agreement in June 2015, we do not expect to see Iranian crude oil flooding the market, but more a gradual easing of sanctions on Iran's oil exports leading to the potential for up to 1 mbpd increase over a 6-12 month period being.

Box 2: Iranian nuclear talks

On April 1, Iran and the five permanent members of the UN Security Council plus Germany (P5+1) reached an agreement that provides the framework for the lifting of some, but not all, financial and energy-related sanctions when they all meet again on 30th June. Iran provisionally agreed to cut its nuclear enrichment plan, decrease current low-grade nuclear stockpiles and not build any further nuclear enrichment facilities for 15 years. Iran also has to demonstrate that all of the above strict P5+1 measures are being adhered to before sanctions can be lifted. Currently there are three separate sanctions, one each from the UN Security Council, EU and the US. If the P5+1 and Iran move ahead on 30th June only the EU and US sanctions will be lifted, with the UN Security Council sanctions coming about at some future undetermined date. From the viewpoint of the oil markets, the EU sanctions are the most relevant since if these are lifted, potentially 600 tbpd of Iranian crude could flow to the EU, similar to pre-sanction levels.

The potential lifting of some of the sanctions related to Iran in June is



The potential lifting of some of the sanctions in June is not expected to add significant amounts of crude to oil markets in 2015...

...since it could take Iran between 6-12 months to fully comply with all the terms before sanctions can be lifted.

We see Iranian crude exports only rising by 150 tbpd, year-on-year, by the Q4 2015.

Oil production from Nigeria decreased by 5 percent as it is frequently affected by theft and sabotage.

not expected to add significant amounts of crude to oil markets in 2015. In the recent past the Iranian government has said that it can add 800 tbpd of production within a few months of sanctions being lifted. This is quite feasible, in theory, considering that Iranian oil exports have been down by 1.3 mbpd since late 2011, before sanctions came into effect. In practice, however, the lifting of sanctions is not expected to happen very quickly, with the US Secretary of State, John Kerry, warning that it could take Iran between 6-12 months to fully comply with all the terms before sanctions can be lifted. Nevertheless, there is a possibility that some increases could come about beforehand via Iran's four main customers. China, India, South Korea and Japan imported a total of around 800 tbpd in Q1 2015 and the potential for some additional purchases, especially from China and India, could add more crude to markets than the P5+1 permit (Figure 8). Iran also has around 30 million barrels in storage which it can release immediately if sanctions permit. But Iran needs higher oil prices itself, fiscal breakeven stood at \$127 per barrel at the end of 2014, so the more prudent option would be to export these gradually without depressing prices further.

It is important to highlight that the current framework will not include the lifting of the UN Security Council resolution, which means that if Iran does not comply with the P5+1 guidelines there is scope to terminate all previous nuclear-related agreements and add even more additional restrictive sanctions than previously applied. It is for this reason we see crude exports only rising by 150 tbpd, year-on-year, by Q4 2015, but this is based on the assumption that all sides can agree on a final nuclear deal by 30th June deadline. A number of political obstacles remain, including a possible US Congress veto on the deal, which could see the deal collapsing.

Oil production from Nigeria decreased by 5 percent during Q1 2015, year-on-year. Nigeria's production is frequently affected by theft and sabotage especially in the Niger Delta, the country's main oil-producing region. On top of this, Nigerian crude is one of the biggest casualties of the shale oil expansion from the US, as exports of Nigeria's main crude variety, light sweet crude, which were previously supplied to the US, are now struggling to find long-term

Figure 10: OECD commercial crude stocks

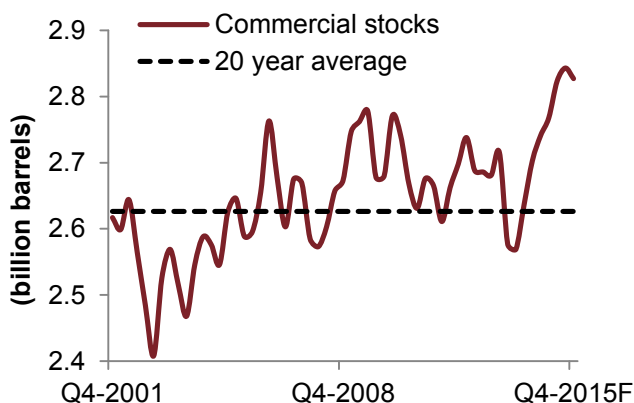
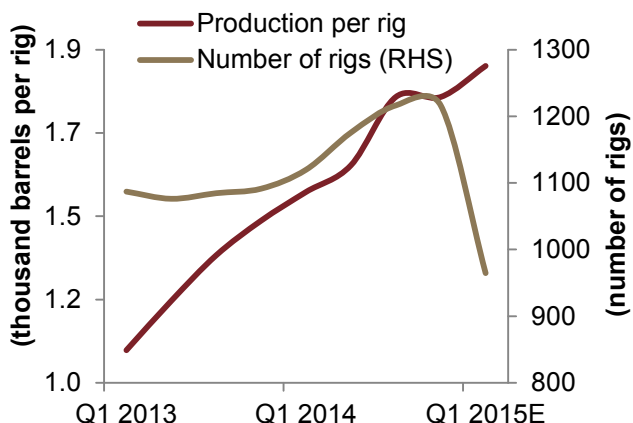


Figure 11: US rig count and production per rig at the five largest shale plays in the US





Preliminary data shows that Saudi Arabian crude production was flat in Q1 2015, year-on-year, at 9.7 mbpd.

Exports to both China and the US have come under pressure...

...as a result we see no change in Saudi exports, year-on-year, as it battles to win back market share.

We now see full year average Saudi production in 2015 at 9.8 mbpd, up from a previously estimated 9.6 mbpd.

We have adjusted our full year Brent crude oil forecast to \$61 per barrel for the following reasons:

i) Crude stockpiling is expected to continue resulting in further rises above the OECD 20-year average.

ii) Current dollar strength is likely to continue for the foreseeable future.

contracts. These challenges together with theft and sabotage and a worsening security situation all point towards, at best, fluctuating and unpredictable output and, at the worst, increased downside risk to the country's oil output for 2015.

Preliminary data shows that Saudi Arabian crude production was flat in Q1 2015, year-on-year, at 9.7 mbpd. Saudi Arabia's response to the fall in oil prices since mid-2014 has been marked by more aggressive pricing via its official selling price (OSP) in order to maintain market share. In Q1 2014, both China and the US together accounted for 34 percent of total Saudi exports, but a year later, in Q1 2015, they only accounted for 26 percent (Figure 9). In the US, Saudi's supply of heavier crude has come under pressure from Canadian imports, whilst competition in China has meant that Saudi crude has seen intense competition from Iraq, Iran and Russia.

As a result we see limited year-on-year change in Saudi crude exports, which we see remaining at around 7 mbpd in 2015, and the trend in lower OSPs continuing as the Kingdom maintains market share. The combination of rising year-on-year domestic consumption plus limited change in Saudi exports means we now see full year average Saudi production in 2015 at 9.8 mbpd, up from a previously estimated 9.6 mbpd.

Oil Prices

Brent prices dropped 29 percent in Q1 2015, to \$55 per barrel, quarter-on-quarter. Looking ahead into Q2 2015, the combination of a large global oil surplus and record crude stocks plus lower seasonal demand due to refinery maintenance could see some major volatility in oil prices before consistent upward movement in H2 2015. As a result we have adjusted our full year Brent crude oil forecast to \$61 per barrel, down from \$79 per barrel previously. The downward adjustment is due to the following factors: i) rising commercial crude stockpiles ii) persistence of a strong dollar iii) US shale oil resilience and iv) record oil surpluses until Q4 2015.

i) Rising commercial crude stocks:

The glut in global oil markets has resulted in OECD commercial crude stocks rising to record levels in Q1 2015. The majority of crude stockpiling has come about in the US, where the combination of continued rises in US shale output and an embargo on crude oil exports has seen record stockpiling at storage depots around the US with more than 63 million barrels added to storage this year. Crude stockpiling is expected to continue into Q2 & Q3 2015 resulting in further rises above the OECD 20-year average (Figure 10) with some reduction in commercial stockpiles expected in Q4 2015. The implications of such a large commercial stockpile is that oil prices will not be supported as soon as demand picks up. Rather stocks are likely to be drawn down initially, thereby limiting the need for additional oil production.

ii) Strong dollar:

The dollar rallied to 12 year highs against a basket of currencies in Q1 2015, which, in turn, has also contributed to downward pressure on oil prices. Oil prices and the US dollar exchange rate have a negative correlation since the global market for crude oil is generally



iii) Even though shale oil producers are cutting back on capital expenditure...

...shale plays have actually seen production per rig rise...

...underlining the resilience in the US shale oil industry.

Furthermore we expect a price ceiling in the future as the number of drilled uncompleted wells (DUCs) rises...

...these DUCs can be brought online very quickly as oil prices rise...

...with ramp up in production putting downward pressure on prices.

iv) Global oil balances are forecasted to remain above 2 mbpd only falling into small deficit by Q4 2015...

priced in dollars. The current dollar strength is likely to continue for the foreseeable future until the Federal Reserve (Fed) increases US interest rates, which is expected to occur only after mid-2015.

iii) Resilience in US shale output:

Latest data show that the total US oil rig count fell by 621 (or 42 percent) at the end of Q1 2015, year-on-year, with the current oil rig count, at 866, the lowest since Q2 2011. Shale oil producers are cutting back capital expenditure (capex) as a result of being hit by lower WTI prices, which averaged \$48 per barrel in Q1 2015, compared to \$99 per barrel a year earlier. However, according to the EIA, even with capex cuts the five largest shale plays have actually seen production per rig rise by 22 percent in Q1 2015, year-on-year, underlining the resilience in the US shale oil industry (Figure 11). Rising production per rig in an environment of capex cuts has been achieved through focusing on low capital-efficiency areas of the shale portfolio, which has resulted in limited production declines. That is, spending cuts have focused primarily on new wells which have not reached their peak production levels, resulting in proportionally lower cuts in production vis-à-vis capex cuts.

As pointed out earlier, shale output growth is expected to decelerate, with EIA data showing zero year-on-year growth in Q1 2016. Slowdown in growth, however, will be accompanied by a large number of drilled uncompleted wells (DUCs) which, in effect, acts as form of oil inventory. DUCs have risen sharply in North Dakota, the site of the Bakken shale formation, by around 200 in the three months to January 2015. We see the build-up of DUCs as maintaining a ceiling on prices going forward since shale operators are likely to complete these wells as soon as oil prices rebound, resulting in a surge in supply which puts downward pressure on prices.

iv) Large oil balance surplus in H1 2015:

The global economy is forecast to grow at a gradual pace in 2015. According to IMF forecasts, global year-on-year GDP growth will reach 3.5 percent in 2015, up from an expected 3.3 percent in 2014. This recovery is only expected to build momentum in H2 2015 meaning that oil demand is also likely to pick up then. The combination of higher oil demand growth and slower year-on-year

Figure 12: Global oil balances in 2015

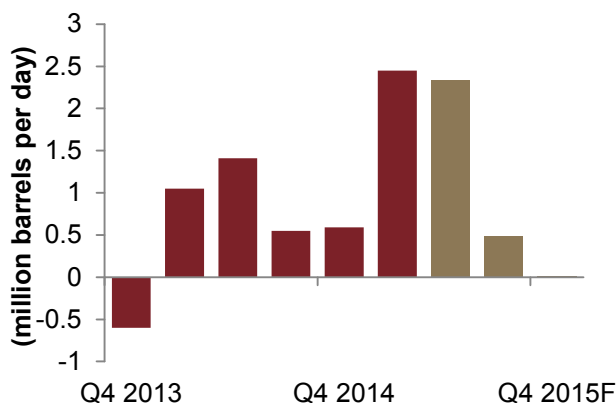
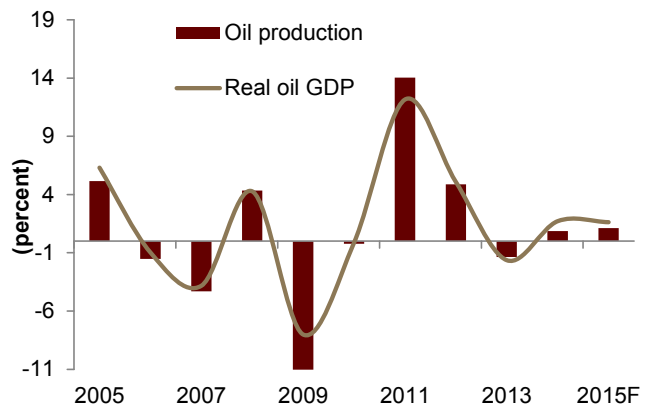


Figure 13: Oil production and oil sector GDP





...therefore triggering a more sustained rise in price in the final quarter of 2015.

We have revised our forecast for 2015 GDP growth upwards from 2.5 percent to 3.3 percent year-on-year.

The sustained low oil price environment will reduce government revenues by a third of its 2014 level.

We forecast public debt to increase to 9.6 percent of GDP by the end of this year...

...as the government shifts its financing strategy to raising debt.

growth in non-OPEC output will push global oil balances from a large surplus to a much smaller surplus by the end of 2015. Global oil balances are forecasted to remain above 2 mbpd in Q2 2015, slowly declining to 400 tbpd in Q3 2015 and finally falling to a minor surplus by Q4 2015 (Figure 12), triggering a more sustained rise in price in the final quarter of 2015.

Implications for the Saudi economy

With the above upward revision to Saudi crude oil output, we have revised our forecast for 2015 GDP growth upwards from 2.5 percent to 3.3 percent year-on-year. Our 2015 annual forecast for oil sector growth is now 1.6 percent, up from our previous forecast of -0.6 percent (Figure 13). We also made a few adjustments to the growth in the non-oil sector.

While we expect the government to maintain its expansionary fiscal strategy, the net effect of lower oil prices and higher oil output is a deeper deficit on the fiscal budget. With our current forecasts of \$57 per barrel for Saudi crude and a production of 9.8mbpd as an average for this year, oil revenues will fall by a third when compared to the 2014 level. The fall in oil revenues will lead to a fiscal deficit of SR 397 billion, or 15.6 percent of GDP in 2015. The current account is also heading for its first deficit since 1998, although it is expected to be small, at \$23.1 billion, or 3.4 percent of GDP (Figure 14).

Despite the prospect of recording twin deficits in 2015, large foreign reserves of SR 2.7 trillion (\$714 billion) held by SAMA, as the end of February 2015, should provide enough confidence for the government to sustain an elevated level of spending during 2015 and beyond (Figure 15). Furthermore, we see plenty of room for the government to raise debt given its strong credit ratings and record low debt levels. We forecast public debt increasing to 9.6 percent of GDP by the end of this year as the government shifts its financing strategy from using foreign reserves to raising debt to finance its deficit.

The government is now expected to issue debt as part of its deficit financing strategy. This change of strategy comes as the Kingdom

Figure 14: Current account and fiscal balances

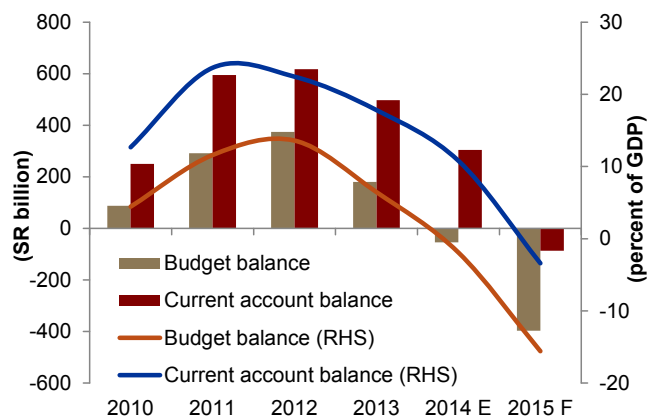
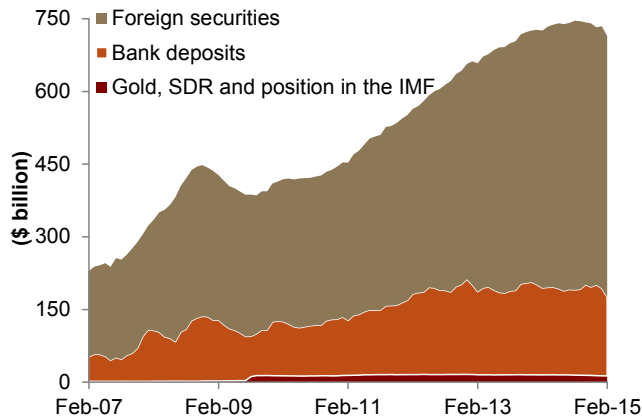


Figure 15: Reserve assets





We see that the timing of debt issuance is ideal given the Kingdom's record low debt level.

Debt issuance will reduce the pressure on foreign reserves as the main deficit financing tool.

The elevated level of government spending, will sustain a high level of confidence in the private sector.

Lower oil revenues will cause the Kingdom's external position to move into a deficit.

takes advantage of its solid credit profile, which has been affirmed by the major rating agencies. We see that the timing of this issuance is also ideal given the Kingdom's record low debt level (1.6 percent of GDP) and ample reserves (97 percent of GDP), as well as the current low interest rate/high liquidity environment. The new financing strategy will reduce the pressure on foreign reserves as the main deficit financing tool, and will in turn make debt issuance a comfortable financing alternative to sustain an expansionary fiscal policy. The issuance of sovereign debt will also contribute to more prudent conduct of monetary policy by providing an additional and useful tool to manage domestic liquidity. Further, debt issuance will effectively contribute towards the development of the debt capital market in the Kingdom.

The elevated level of total government spending, including the recent royally-decreed salary bonus, is an important factor behind sustaining a high level of confidence in the private sector. Early economic data for 2015, covering the first three months, is positive. PMI remained above 55 for the first three months, reaching 60.1 in March, and indicating healthy growth in the non-oil private sector. Data for consumer spending and cement sales showed a healthy rise on the same period last year and in line with or above the fourth quarter level. Cash withdrawals from ATMs showed a spike in February, which reflected a strong response to the two months salary bonus (Figure 16). Cement sales were up by 16 percent and 14 percent year-on-year in January and February respectively, while steel production reached an all time high in January. We forecast non-oil private sector to grow by 5 percent year-on-year in 2015.

Lower oil revenues will cause the Kingdom's external position to move into a deficit. We are projecting a current account deficit of \$23.1 billion, or 3.4 percent of GDP. Data on January non-oil exports show a 9.1 percent year-on-year decline, which was mainly due to subdued external demand. Imports are likely to record healthy growth, boosted in part by the two month salary bonus announced in the January Royal decrees. Letters of credit opened for new imports also indicate that a rise in imports is likely in coming months.

The subdued prices of commodities globally means that the risk remains low for external inflationary pressures on the Kingdom. In fact, CPI inflation in the Kingdom has decelerated during the first two

Figure 16: Indicators of consumer spending

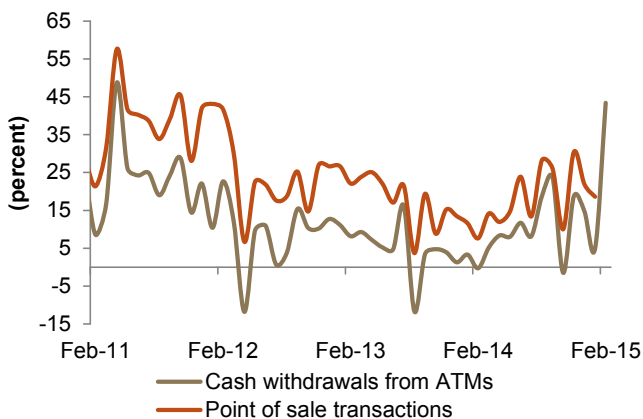
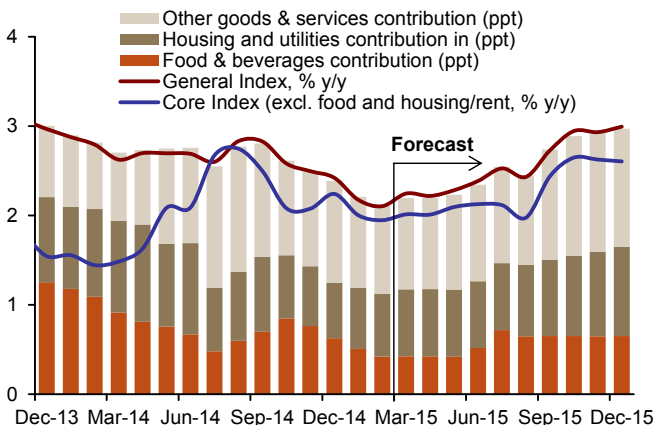


Figure 17: Inflation Forecast





Inflation has been consistently falling for six consecutive months to reach 2.1 percent in February.

However, the risk on inflation for the remainder of the year is on the upside...

...driven mainly by domestic inflationary pressures.

The risks to our economic forecast remain from the external environment...

...with regional political uncertainty to continue to cast a shadow over the economy.

months of this year, consistently falling for six consecutive months to reach 2.1 percent in February (Figure 17). The continued deflationary trend in international food prices has meant that prices for foodstuffs remained below 2 percent year-on-year. A strengthening US dollar also played a part in adding to downward pressure on import costs, and consequently, inflation. Since the beginning of the year, the US dollar continues to strengthen against most other major currencies (Figure 18). Nevertheless, we see an upside risk to inflation for the remainder of the year, driven mainly by domestic inflationary pressures. The liquidity injection as a result of the January royal decrees have already pushed up monetary aggregates, and are likely to contribute to further inflation in the short-term (Figure 19). This should leave housing inflation as the major source for inflationary pressure during 2015 as rents rise due to the continued shortage in housing units. We expect inflation to average 2.5 percent this year.

The risks to our economic forecast remain from the external environment. Heightened regional tensions, particularly in bordering countries, constitute key risks. Optimism around the nuclear deal between the P5+1 and Iran could lead to further strains in regional diplomatic relations (Box 2). A significant slowdown in global growth could also instill a sustained period of lower oil prices, which would lead to a higher-than-forecasted fiscal and current account deficits. We think, however, that these factors would have a minimal impact on the private sector, as the momentum of growth in the Kingdom remains dependent upon the government maintaining a high level of spending that can be comfortably afforded. Regional political uncertainty will continue to cast a further shadow over the economy and have a sentimental impact over business and consumer confidence.

Figure 18: Major currencies vs. the US dollar
(percent change, year-to-date)

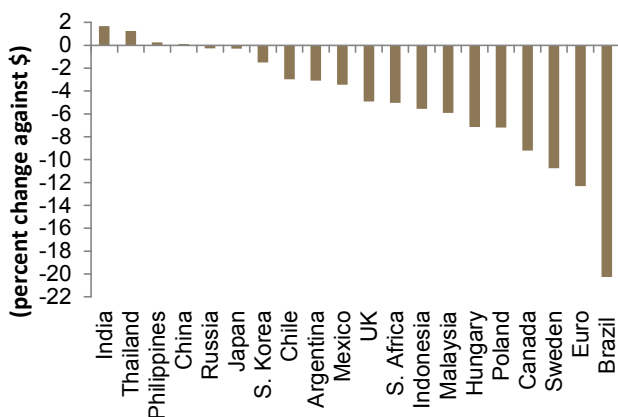
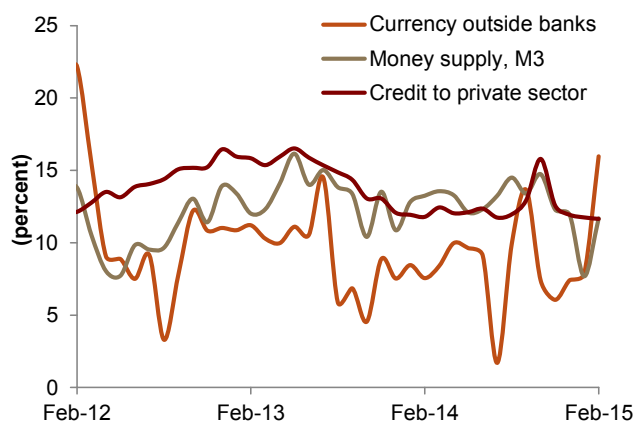


Figure 19: Monetary aggregates
(year-on-year change)





Key Data

	2008	2009	2010	2011	2012	2013	2014 E	2015 F	2016 F
Nominal GDP									
(SR billion)	1,949	1,609	1,976	2,511	2,752	2,791	2,822	2,548	2,720
(\$ billion)	519.8	429.1	526.8	669.5	734.0	744.3	752.5	679.3	725.4
(% change)	25.0	-17.4	22.8	27.1	9.6	1.4	1.1	-9.7	6.8
Real GDP (% change)									
Oil	4.3	-8.0	-0.1	12.2	5.1	-1.6	1.7	1.6	-0.8
Non-oil private sector	11.1	4.9	9.7	8.0	5.5	7.0	5.7	5.0	4.7
Government	6.2	6.3	7.4	8.4	5.3	5.1	3.7	3.5	3.3
Total	8.4	1.8	4.8	10.0	5.4	2.7	3.6	3.3	2.1
Oil indicators (average)									
Brent (\$/b)	97.2	61.7	79.8	112.2	112.4	109.6	99.4	61.0	68.0
Saudi (\$/b)	94.0	60.4	77.5	103.9	106.1	104.2	95.7	57.0	64.0
Production (million b/d)	9.2	8.2	8.2	9.3	9.8	9.6	9.7	9.8	9.7
Budgetary indicators (SR billion)									
Government revenue	1,101	510	742	1,118	1,247	1,156	1,046	694	644
Government expenditure	520	596	654	827	873	976	1,100	1,091	971
Budget balance	581	-87	88	291	374	180	-54	-397	-326
(% GDP)	29.8	-5.4	4.4	11.6	13.6	6.5	-1.9	-15.6	-12.0
Domestic debt	235	225	167	135	99	60	44	244	344
(% GDP)	12.1	14.0	8.5	5.4	3.6	2.2	1.6	9.6	12.6
Monetary indicators (average)									
Inflation (% change)	6.1	4.1	3.8	3.7	2.9	3.5	2.7	2.5	2.9
SAMA base lending rate (% , year end)	2.5	2.0	2.0	2.0	2.0	2.0	2.0	2.4	3.4
External trade indicators (\$ billion)									
Oil export revenues	284.1	166.9	215.2	317.6	337.5	323.1	265.1	171.8	162.6
Total export revenues	313.5	192.3	251.1	364.7	388.4	376.0	320.6	229.8	226.1
Imports	101.5	87.1	97.4	120.0	141.8	153.2	149.5	160.1	159.3
Trade balance	212.0	105.2	153.7	244.7	246.6	222.7	171.1	69.8	66.8
Current account balance	132.3	21.0	66.8	158.5	164.8	132.6	81.3	-23.1	-25.6
(% GDP)	25.5	4.9	12.7	23.7	22.4	17.8	10.8	-3.4	-3.5
Official reserve assets	442.7	410.1	445.1	544.0	656.6	725.7	732.4	710.0	685.0
Social and demographic indicators									
Population (million)	25.8	26.7	27.6	28.4	29.2	30.0	30.8	31.5	32.3
Saudi unemployment (15+, %)	10.0	10.5	11.2	12.4	12.0	11.7	11.7	11.3	11.1
GDP per capita (\$)	20,157	16,095	19,113	23,594	25,139	24,816	24,454	21,548	22,484

Sources: Jadwa estimates for 2014, Jadwa forecasts for 2015 to 2016. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.



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