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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- As the global crude oil demand continues to increase while supply, on the other hand, continues to grow only modestly, prices are forecasted at comfortable levels within the USD45 to USD60 a barrel range.

- The JPY is enjoying a bull run on global risk aversion and narrowing interest rate differentials. US fundamentals and political developments are the main drivers in the JPY's risk profile.

- After the two consecutive hikes which took place in March and June, we note that gold prices dipped briefly yet regained an upward momentum on the back of uncertainty.

- The influx of oil revenues given the aforementioned oil narrative, allowed the government to increase their demand deposits to reach SAR89.2 billion, an increase of 31.7% annually.

- Tadawul's disconnect from its international counterparts continued with the headline index registering a year to date decline of around 5%, with 15 out of the 20 subsectors in the negative territory.

- Given the currency peg, SAMA announced a rise in the reverse repo rate from 100bps to 125 bps which is likely to have limited impact on domestic liquidity as the repo rate remained unchanged at 200bps.

- Improving global economic conditions may also have a positive impact on the Kingdom's non-oil export revenue as improving PMIs in the US, China and Europe are key positive indicators.

View of the Month

Our baseline scenario assumes Arabian light spot prices to average around USD50.6/bbl this year, a rise of 24.0% over 2016, undermining the decline in crude production to 10.1MMBD which will result in oil revenues rising to SAR445.8 billion.

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Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016P	2017F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	40.9	50.6
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.4	10.1
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,799.9	2,836.3	2,444.1	2,398.6	2,525.5
GDP at Current Market Prices, USD billion	670.4	734.9	747.6	757.4	652.6	640.5	674.4
Real GDP Growth Rate*	10.0%	5.7%	2.7%	3.7%	4.1%	1.4%	-0.7%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	3.5%	2.5%
External Sector							
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-51.6	-53.4	-35.3
Current Account Balance/GDP	23.6%	22.4%	18.1%	9.7%	-7.9%	-8.3%	-5.2%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	529.3	489.5
Fiscal Sector (Central Government)							
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	612.3	528.0	700.0
Actual Expenditure, SAR billion	826.7	873.3	976.0	1100.0	978.0	825.0	890.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	28.7%	13.7%	-1.8%	0.0%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-55.6	-365.7	-297.0	-190.0
Budget Balance/GDP	11.6%	13.6%	6.4%	-2.0%	-15.0%	-12.4%	-7.5%
Break-Even Oil Price	75.3	73.9	82.6	99.1	82.9	62.6	66.8
Financial Sector							
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	2.6%	0.7%	0.9%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	2.2%	2.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.1%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.7%	1.7%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	134.7	80.0

Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
Note: Saudi Economic Review Data, April 2017 Update (Historical and Projections)

Oil Market
Improving Demand Prospects

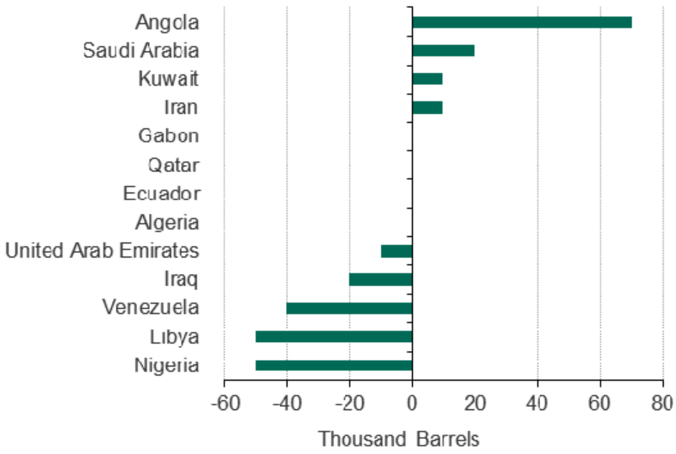
Brent crude oil traded around USD48.0 a barrel for August delivery on the ICE Futures Europe exchange, while WTI crude traded at around USD46.0 a barrel on the NYMEX. Brent and WTI crude oil prices monthly average spot prices were USD1.9 a barrel and USD2.5 a barrel lower in May, respectively, than the April averages. An improved global economic outlook and determined OPEC to rebalance the oil market are expected to lift oil prices though the rest of the year. With less worries about China's economy as it is still maintaining steady growth and the extension of OPEC and non-OPEC agreement production cuts for an additional nine months through Q1 2018, supply is expected to decline. The objective of OPEC's agreement is to reduce inventories to their five-year historical average of 2.7bn barrels from the current level of 3.0bn barrels. While the agreement extension should achieve price stability over the next nine months, it will surely allow the US shale producers to move forward with development plans even through 2018. However, on the assumption of a medium level of compliance by OPEC producers and exceeded expectation of US shale production, still the cuts should be sufficient to rebalance the oil market. As the global crude oil demand continues to increase while supply, on the other hand, continues to grow only modestly, prices are forecasted at comfortable levels within the USD45 to USD60 a barrel range.

Chart 1: Oil Price Developments, YTD

Source: Thomson Reuters

On the supply side with respect to OPEC, the crude oil production level, assuming full compliance, will remain at 32.5mb/d through the end of the first quarter of 2018. However, rising production activities outside of OPEC, particularly in the US shale formations, already support production growth forecasts. After reaching a trough of 316 oil active rigs in May 2016, the US oil rig count has more than doubled to 741 active rigs at the beginning of June, the highest since April 2015, according to Baker Hughes. Given an estimated six-month lag between a change in oil prices and realized production, the higher oil prices in 2017 have the potential to raise US oil production in 2018. According to EIA, US oil production is forecast to average 9.3mb/d in 2017 and 10.0mb/d in 2018. Following nine straight weeks of inventory declines, the EIA reported a surprise increase of inventories in developed economies.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

There is still a risk that shale production, and in turn rising inventories, will offset OPEC efforts in trimming the oversupply in the oil markets. In the beginning of 2018, OPEC producers will be in the same position they were in May, as weather or not to extend the production cuts. If the production cut agreement is not extended, rebuilding of inventories will resume, thus lowering oil prices. On the other hand, if production cut agreement is extended, OPEC including non-OPEC producers' part of the agreement will lose market share to other producers, especially to US shale oil. Moreover, as predicted by EIA, the non-OPEC supply from the US and Brazil will likely be higher in 2018, which will then put further downward pressures on prices again. This may require OPEC not only extending the agreement but increasing production cuts in order to keep prices at current levels, which will be at a further loss of market share. Therefore, the longer that OPEC engages in such market management, the more concerned market participants will become about the eventual end of this agreement.

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Foreign Exchange

The Greenback Softens Against Its Peers

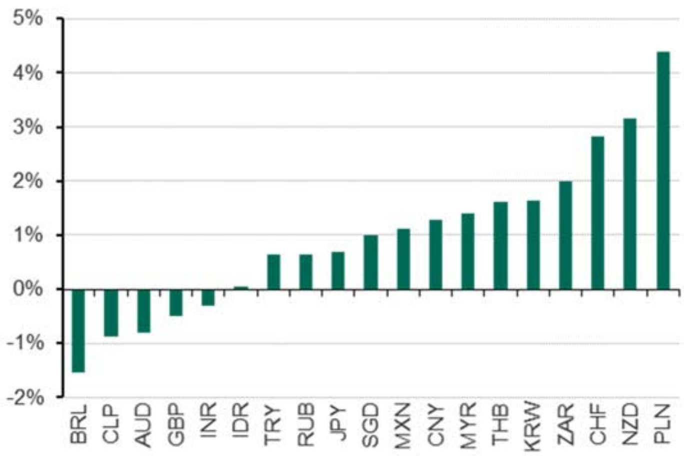
Forex markets maintain a secular bull run for the USD underpinned by strong economic fundamentals in the US. Since April, however, the greenback has been softening against its peers, mainly due to higher outflows from the US and geopolitical risks. By the end of May, the USD retreated back to pre-election levels as investors are concerned with allegations of Russian influence on the outcome of the Presidential election. On the other hand, the divergence between the US and the rest of the global economy has become narrower due to improving macroeconomic conditions and growth prospects. The Fed tightened monetary policy by another 25 bps mid-June, pushing Fed funds rate to the 1%-1.25% range. Despite core PCE falling further below the Federal Reserve target of 2% standing at 1.5% Y/Y in April, the Fed is adamant on trimming its USD4.5 trillion balance sheet. Generally, employment and inflation conditions remain conducive to contractionary monetary policy where unemployment rate in the US recorded 4.3%, touching the lowest level since 2001. Non-farm payroll posted 138,000 jobs showing a moderation compared to the beginning of the year. Moreover, worries of an over-strengthening USD have receded, giving the Fed a lesser deterrent against continuing its normalization policy. By the end of May, the trade-weighted USD stood at 96.9, falling by 5.2% YTD.

Chart 3: Trade-Weighted Dollar and the Euro

Source: Thomson Reuters

The Euro has strengthened broadly against the USD, ending May by a surge of 6.9% compared to January levels. The single currency's performance is the second best among the G10, reflecting the positive economic momentum following the election of president Macron, and higher inflow of capital. Economic fundamentals have certainly improved as inflation stood at 1.4% Y/Y in May, which is indicative that the fear of deflation has subsided. Additionally, unemployment in the Eurozone fell to the lowest levels since the Eurozone crisis, standing at 9.3% in April. We do not expect the targeted long-term refinancing operations (TLTRO) to expire prematurely as a result. Instead, the ECB will most likely continue according to schedule and we are not expecting to see any rate hikes before 2018. Clearing political hurdles is on top of the factors underpinning the EUR's appreciation. The peripheries continue to build on the momentum gained in Q1 and will likely extend beyond Q2. The IHS Composite purchasing managers' index maintained its steady growth, supported by an acceleration in Germany and France. The index posted 56.8, the highest in six years, indicating that the Eurozone is enjoying a relatively strong second quarter, consistent with GDP rising by 0.7%. The outlook for the EUR therefore is tilting to the upside, and the positive spillover from economic and political events should feed into strengthening the single currency. On the other hand, the pound sterling is on the defensive as the current political instability is likely to hamper Brexit negotiations. On a YTD basis, the GBP upturned by 4.5% standing at USD1.28.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The JPY is enjoying a bull run on global risk aversion and narrowing interest rate differentials. US fundamentals and political developments are the main drivers in the JPY's risk profile. With the deflationary period easing in Japan, headline inflation stood at 0.4% Y/Y in April, the highest rate since January. Growth prospects also look strong after real GDP grew in the first quarter by 1.6% Y/Y. Fiscal and monetary stimulus will continue to support the economy and the benchmark interest rate is expected to remain between -0.1% and 0%. The JPY stood at 110.8 for the dollar by the end of May, appreciating by 5.5% YTD.

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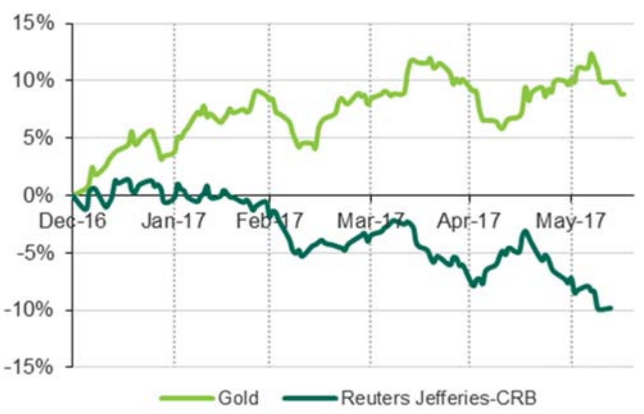
Commodities
A Mixed Outlook

Global commodities are trading on their own fundamentals; with base metals showing a response to lower supply and higher demand, precious metals to global risk, and agriculture to yield prospect. Until visible signs of oil production cut-backs emerge, the composite Reuters/Jeffries CRB index remains downwards sloping from January levels standing at 179.7, down by 6.6% by the end of May. Industrial metals rallied due to supply deficits coinciding with improving global economic conditions relative to 2016. The Fed's decision to hike interest rates and the degree of political uncertainty surrounding the allegations of Russia's involvement in the 2016 elections in addition to Trump's pro-growth policies are directly correlated with the positioning of precious metals such as gold. Political risks that will continue to affect speculative positioning include the Italian constitutional referendum, the Brexit negotiations and the German parliamentary elections. The rise populism in Europe, albeit easing following the French elections, will underpin investors' allocation for gold as they look to hedge against risk. Food grains prospects will hinge on the severity of weather anomalies and the pickup in global demand.

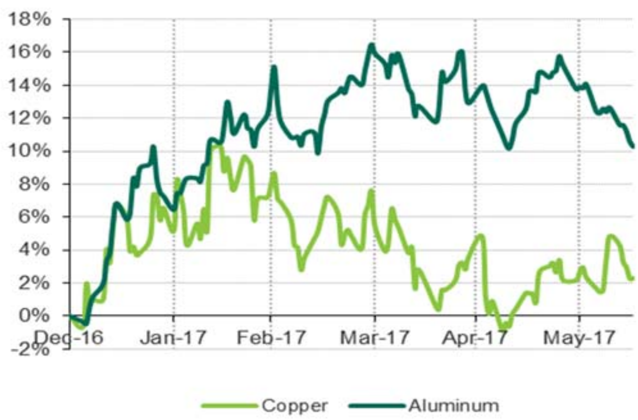
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Copper prices surged by double digits since the beginning of the year, continuing the price appreciation that started in the second half of last year. From a fundamental perspective, it appears that no particular support is found to justify the rally. However, from a speculative perspective, the Chinese infrastructure plans and the USD2 trillion infrastructure plan in the US are main drivers for the bullish sentiment. In addition, policies in favor of banning or reducing the export of ores in several countries such as Indonesia, Malaysia and the Philippines are also helping to increase bets on base metals. Copper rose by 2.6% by the end of May standing at USD5,682/ton. Aluminum prices are supported by strong demand owing to the increasingly diverse industrial use of the metal. Companies such as Alcoa and Norsk Hydro raised their 2017 demand forecast as the Chinese slowdown appears to be moderating. Capacity curtailments are also factored into aluminum prices. Environmentalist pressure is reducing high-polluting smelters in China along-side high-cost smelters. The aluminum smelting capacity in China is expected to be notably reduced as China complies to environmental regulations while the reenactment of the export ban in Indonesia which is aimed at encouraging local processing of raw materials might add to the global impact on aluminum prices. Aluminum prices surged 13.9% YTD by the end of May, standing at USD1,928/ton. Gold prices are upturning after slipping marginally in December following the interest rate hike. After the two consecutive hikes which took place in March and June, we note that gold prices dipped briefly yet regained an upward momentum on the back of uncertainty. The disappointing jobs report in May added to the allure of gold recently and investors are anticipating the yellow metal to touch the USD1,300 target. Despite the June hike being almost shrugged off, political events in Europe are still closely watched, underpinning demand for gold. Gold is likely to remain between the USD1,200/oz—USD1,400/oz range in 2017 with a bias to the upside.

Chart 6: Base Metals



Source: Thomson Reuters

The S&P/ Goldman Sachs agricultural commodity index is volatile due to the various performance of food grains. The El-Nino effect is limited to the Southern hemisphere which is likely to affect crops like soy while the effect on corn and wheat is limited. Corn futures ended May standing at 372 cents/bushel, appreciating by 5.7% YTD while wheat ended the month at 429.3 cents/bushel, rising by 5.2% YTD. On the hand, soybeans futures declined by 2.4% YTD, standing at 284 cents/bushel.

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Money & Inflation
Oil Provides a Monetary Relief

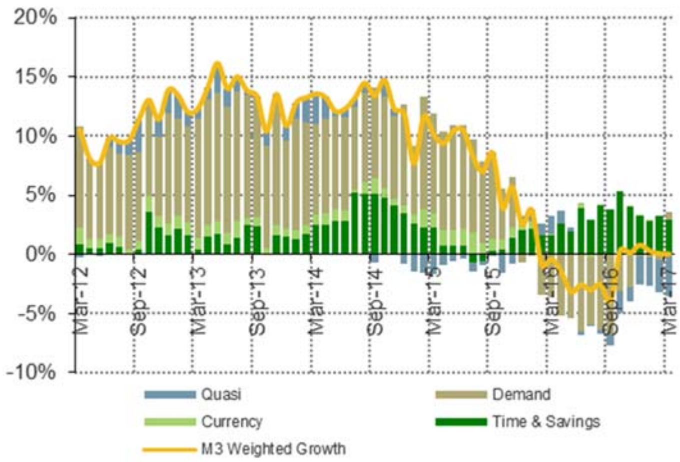
The monetary situation in the Saudi economy found respite following OPEC and non-OPEC's production cut agreement which took effect from the beginning of 2017. The initial agreement aimed to reduce production by a collective 1.8 million barrels during the first half of this year, which was later extended for another 9 months as oil prices faltered near the USD50/bbl level. Nonetheless, average oil prices during the first quarter of 2017 climbed around 70% compared to the average price during 1Q2016. Accordingly, the Saudi Ministry of Finance's recent quarterly budget announcement revealed that the fiscal deficit for the Saudi economy in the first quarter, amounting to SAR26.2 billion, was financed through the current account for the first three months. Domestically, the monetary base (M0) registered a 1.5% annual increase by the end of March to settle at SAR302.7 billion. This was mainly attributed to an rise in deposits with SAMA, which recorded an rise of 4.7% Y/Y. Currency outside banks, the largest component of M0, marginally grew by 0.3% on an annual basis. However, we expect a rise in cash levels during the second quarter of 2017 as it coincides with Ramadan, a seasonal pattern which alters spending behavior.

Chart 7: Growth in Monetary Aggregates

Sources: SAMA and NCB Estimates

Despite stagnating on an annual basis, the broadest measure of money supply (M3) increased by 1.4% M/M to reach SAR1.78 trillion by the end of March. Demand deposits registered an increase of 1.1% Y/Y, breaking a 15-month streak of annual declines. The influx of oil revenues given the aforementioned oil narrative, allowed the government to increase their demand deposits to reach SAR89.2 billion, an increase of 31.7% annually. Meanwhile, time and saving deposits gained 12.7% annually, albeit maintaining their declining trajectory by settling at SAR464.6 billion in March, down from a peak of SAR498.0 in October 2016. Additionally, other quasi-monetary deposits contracted by 29.7% Y/Y. We expect M3 to register 0.9% for 2017 as challenges from oil markets transcend towards domestic liquidity.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

The inflation rate registered a contraction in March by 0.4% annually and is expected to remain in the negative territory for the first half of 2017 as price hikes for electricity and fuel have been delayed for the second half of the year, while supply infrastructure repairs are conditional for further water price increases. The Citizen's Account program, which aims to lessen the burden of the government's fiscal consolidation on Saudis, was planned to launch in June and price hikes to take effect in July. However, it seems the government will postpone the deadline a couple of months as the final policies and regulations are yet to be completed. Meanwhile, the Food and Agriculture Organization (FAO) of the United Nations' food price index has been registering annual declines since 2012. As the Saudi economy's consumption relies heavily on imports, domestic food prices have been in the negative territory for 10 consecutive months. However, FAO's food index has inflected towards the second half of 2016 which is expected to reflect on local prices going forward. Furthermore, rental prices have subdued, registering a gain of 1.0% during March as an expected outflow of expatriates from higher costs of living and the recent crackdown on illegal foreigners reduces demand.

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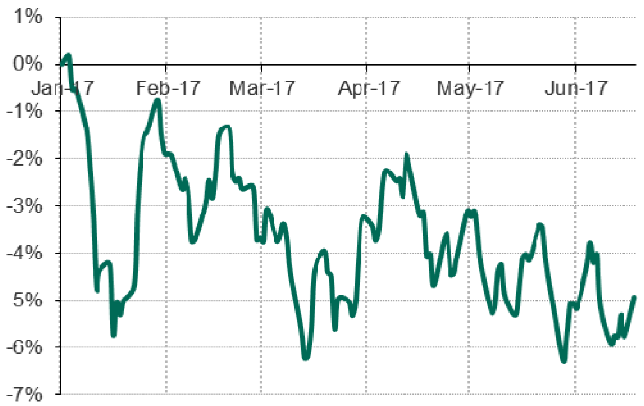
Capital Markets

Profitability Supported by Base Effects

On the global front, equities had maintained their upside momentum, with the benchmark indices for the world, G7 and emerging markets respectively registering year to date gains of around 8%, 10% and 17%, according to the MSCI World indices. Tadawul's disconnect from its international counterparts continued with the headline index registering a year to date decline of around 5%, with 15 out of the 20 subsectors in the negative territory.

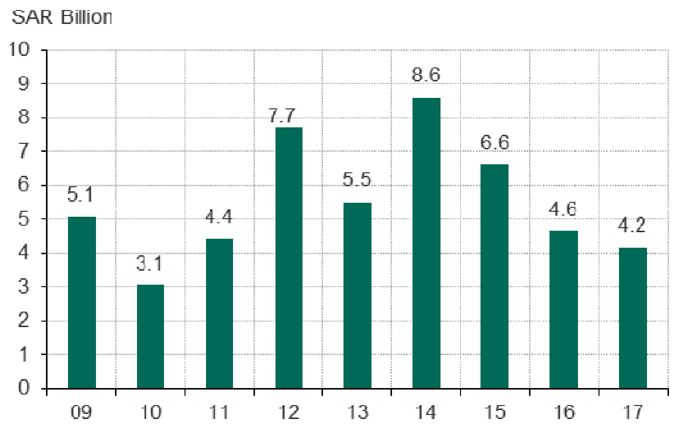
Chart 9: Tadawul All-Share Index



Source: Tadawul

During April, the market rose marginally by 0.17% to close at 7,013.5, which follows a 0.4% increase in March. Yet, in the last few trading days the market had edged once again below the 7,000 mark. Ostensibly, and as mentioned in our previous reports, individuals and businesses have adopted a wait-and-see approach given the anticipated reforms that will kick in starting July. Yet, one of the hanging clouds over the market had dissipated after OPEC members extended the agreed upon crude cuts beyond 2017. This agreement, in our opinion, not only ceased as a downside risk, but can act as a positive driver if oil prices regained their upside momentum as crude stockpiles decline. Regarding the sectoral performance, the heavyweight sectors remained in the red, namely energy, materials, and banks that registered monthly declines by around 10%, 2%, and 5%, respectively, by the end of April. The weakest sector was transportation, recording a decline of around 22% since the beginning of the year, followed by the media and publishing sector, which fell by 18%. Investors' appetite, represented by the average daily trading volumes, fell during April to SAR3.1 bn from SAR3.3 bn a month earlier and last year's average of SAR4.6 bn. The majority of trading continues to be attributed to Saudi individuals, representing around 84%. Individuals and SWAP investors were net sellers while Saudi institutional investors, GCC investors and QFIs were net buyers.

Chart 10: Average Daily Traded Value



Source: Tadawul

On the fundamental side, profitability had edged higher rising by around 35% to SAR30.7 bn. The boost was largely attributed to the petrochemical sector that benefited from higher prices and spreads, registering SAR7.3 bn, which is an annual gain of 94.9%. In addition to the base effect derived from petrochemical companies, the telecom sector's net income grew by 13.4% to register SAR2.4 bn. The utilities sector have also supported corporate profitability mainly due to SEC's bottom-line that posted a significant SAR4.9 bn compared to a loss over the same period last year. Looking ahead, however, there are two points worth mentioning that might derail this impressive showing in profitability. First, SEC's 1Q net income was driven by a one-off gain from the cancellation of municipal fees that amounted to SAR6.1 and as such will not be present in the second quarter. Second, the improvement in petrochemical profitability will not be in the same magnitude especially that the base effect realized in 1Q17 from the multi-year low oil prices seen in 1Q16 will be reduced, given the fact that oil prices had edged higher in 2Q16. We do believe that TASI will remain range-bound during the medium-term, which is a normal state at times of transition.

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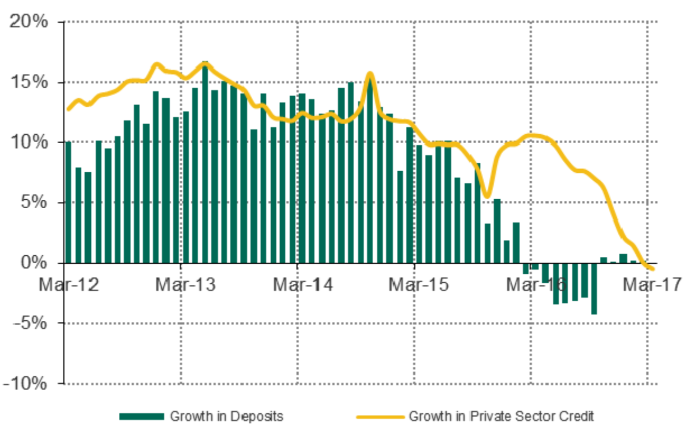
Loans Market

Creative Destruction

The macroeconomic backdrop will pressure the loans market in 2017 and 2018 as tough funding conditions, due to economic restructuring, reduces the need for financing. The banking system utilizes its depositary base to extend credit lines which are conservatively regulated by SAMA to mitigate risks domestically. The transition towards private sector independence from the government has affected businesses and consumers alike. Total deposits in the banking system reached SAR1.61 trillion by the end of March, stagnating on an annual basis due to the government's reduction of foreign currency holdings by a staggering 75.3% over the trailing twelve months. Meanwhile, demand deposits rebounded to register a gain of 1.1% annually, driven by an influx of government deposits which increased 31.7% Y/Y to reach SAR89.2 billion. Additionally, time and savings deposits registered a rise of 12.7% Y/Y in March, yet there has been a noticeable deceleration in the level of interest-bearing deposits. By the end of October 2016, time and savings deposits reached a record SAR498.0 billion, as the money creation cycle relatively contracted, time and savings deposits reached SAR464.6 by the end of the first quarter of 2017.

Chart 11: Private Sector Financing

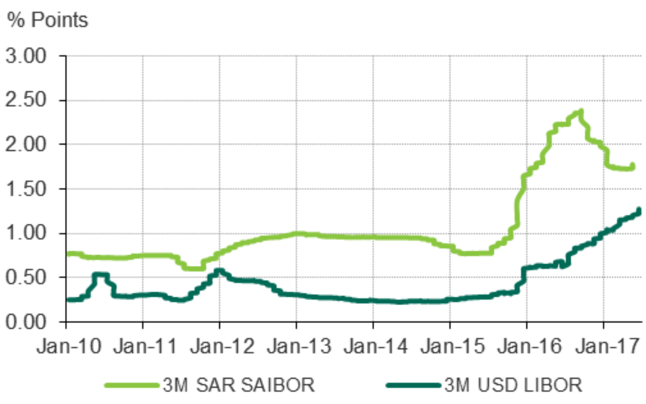


Sources: SAMA and NCB Estimates

As the oil price collapse impacted the depositary base, the credit market's delayed response is attributed to corporate credit which utilized financing to manage their cash flows, however, corporate credit entered the negative territory by registering a decline of 1.3% by the end of the March. Accordingly, total credit of the banking system registered the first contraction, albeit benign, since the global financial crisis, declining by 0.1% on an annual basis. Consequently, the loans-to-deposits ratio reached 88.1% as the utilization of assets remains high in the banking system.

Analyzing credit by sector reveals that the construction sector remains pressured by registering a contraction of 9.3% during the first three months of 2017. On the other hand, the utilities and health sectors gained 20.9% annually as the government overhauls the water supply infrastructure to reduce waste and leakages. Bank credit by maturity remains relatively unchanged with short-term credit representing 49.9% while medium and long-term credit holds a share of 18.7% and 31.4%, respectively.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

Credit to private businesses and individuals reached SAR1.41 by the end of March, adding a mere SAR5.9 billion through the first three months of 2017. Meanwhile, treasury bills reached SAR15.5 billion, a drop of 75.9% annually, an attempt to reduce liquidity constraints on local banks. Additionally, claims on the public sector stagnated in March, yet, an expected pick in April is due to the inaugural debt issuance of USD9 billion sukuk. The "creative destruction" in the private sector is reshaping businesses and pressuring companies to quickly adapt to independence. While some will struggle to cope and survive, a shift in resources will provide new opportunities as well as create new industries as the economy diversifies away from oil. The US Fed raised its benchmark interest rate by 25bps for the third time in six months with another hike expected in December. Given the currency peg, SAMA announced a rise in the reverse repo rate from 100bps to 125 bps which is likely to have limited impact on domestic liquidity as the repo rate remained unchanged at 200bps. The SAIBOR has hovered around 1.75% for the past three months, well below the 2.39% reached in October. SAMA will need to maneuver the Saudi policy in a countercyclical environment going forward as the US continues to diverge from the rest of the world.

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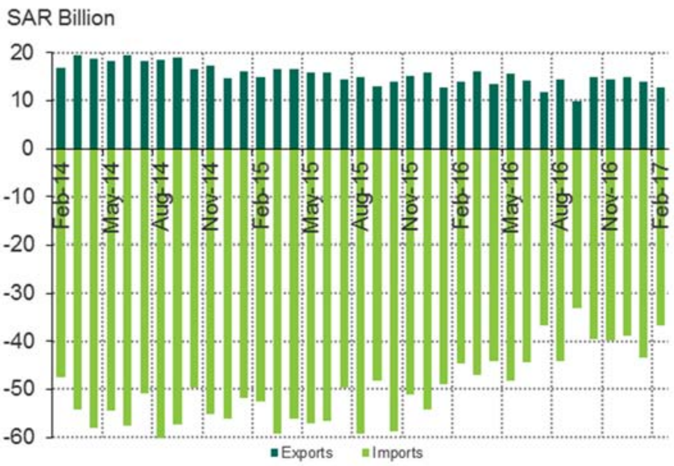
External Trade

Non-oil Trade Remains Pressured

The Kingdom's none-oil trade contracted in the month of February according to the General Authority of Statistics. Non-oil exports contracted by 8.8% Y/Y on the back of declining exports to the GCC, while falling imports from Asia and the EU pressured total imports to decline by 17.9% Y/Y. The rising tension between Qatar and the GCC countries may exacerbate the problem albeit by a few single digits as non-oil exports to Qatar account for about 3% of the Kingdom's non-oil exports by value.

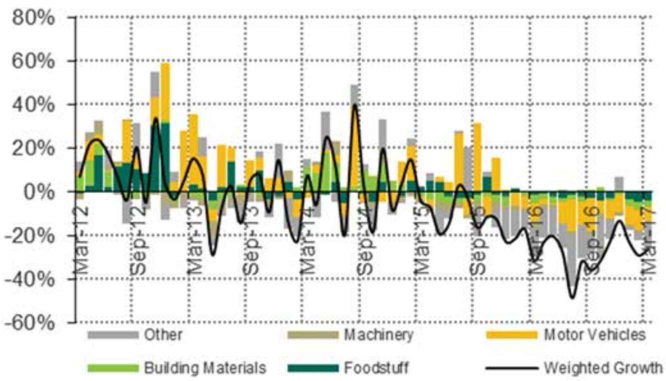
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB

By export components, plastics account for 31.4% with a value of SAR3.9 billion. During February, it declined by a mere 1% Y/Y, indicating a resistance in the sector. Exports of chemical products account for 28.4% of non-oil exports at SAR3.5 billion which declined by 7.4% Y/Y. Furthermore, exports of base metals inched up by 1.1% to SAR1.1 billion, accounting for 9% of the monthly total. Due to the strong correlation between non-oil exports and the oil market as most exports by weight are derivatives of oil, we expect to see a movement mimicking the prices of crude oil. Improving global economic conditions may also have a positive impact on the Kingdom's non-oil export revenue as improving PMIs in the US, China and Europe are key positive indicators. Exports by country show that the UAE remains the largest trade partner for the Kingdom, with a non-oil trade value of SAR1.7 billion accounting for 13.5% of the total during February. On an annualized basis, trade with the UAE declined by 22% although signs of a pick-up in trade activity are emerging. Non-oil exports to China recorded SAR1.2 billion, remaining unchanged from last year's level and accounting for 9.3% of the monthly total. India became the third largest trade partner for the Kingdom with almost SAR0.8 billion worth of exports, accounting for 6.5% of the monthly total.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

On the import side, double-digit declines continue to reflect the country's fiscal balancing efforts. Machinery and electrical equipment which account for about a quarter of imports by value have recorded a 27.1% decline Y/Y at SAR9 billion. Imports of transport equipment fell by 13.5% Y/Y to SAR6.3 billion, accounting for 17.2% of total imports. Imports of chemical products declined by 12.7% to SAR3.8 billion, accounting for 19.9% of imports by value. By country, the US is considered the top source of imports to the Kingdom which were valued at SAR6.1 billion in the month of February, representing about 17% of total imports. Compared to last year, imports rose by 3.1% and the improving pattern of trade ties between the Kingdom and the US is likely to continue after the late bilateral agreements. On the other hand, imports from China tumbled by 21.1% to SAR5.4 billion, accounting for 15% of total imports. Imports from Germany recorded a total of SAR5.4 billion, falling by 17.2% Y/Y. Cost inflation is still favorable for Saudi exports although improving global economic conditions is likely to intensify competition in external markets.

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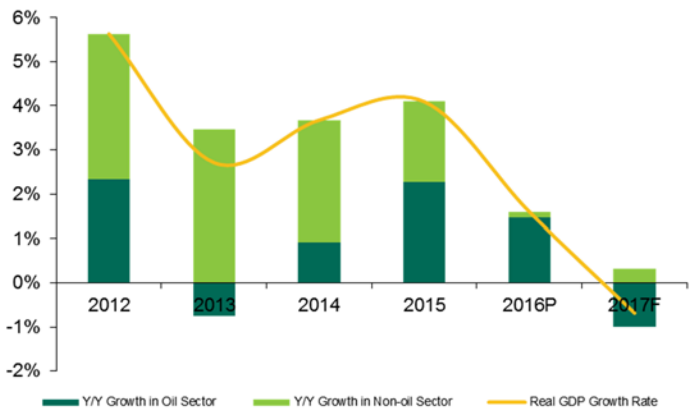
NCB الأهلي

Special Focus:
Transitioning Towards a Balanced Economy

The Saudi government is pushing the private sector to become the main driver for the economy towards achieving 2020 and 2030 targets. However, the structural shift to lessen the dependence on the government has taken its toll on domestic business activities. Business and consumer confidence has been negatively impacted since the oil collapse, although, adopting a gradual and transparent fiscal plan is expected to improve domestic and international sentiment. In 2016, the economy registered a real growth of 1.4%, underpinned by record oil production as the non-oil sector faltered to a halt. Saudi oil production peaked at 10.7MMBD by July as local demand soared due to the summer season, contributing to a rise in oil GDP by 3.4% last year. However, in nominal terms, GDP contracted to SAR2’398.6 billion, declining by 1.9% and registering the second consecutive annual drop. Towards the end of 2016, the surprising inflection in OPEC’s strategy to collectively cut production by 1.2MMBD has defined the outlook for the oil sector this year. Ostensibly, OPEC and non-OPEC’s decision to extend production cuts beyond 2017 will contribute to a shrinkage in oil GDP real growth by 2.3%. Meanwhile, the non-oil sector real growth will marginally rebound to 0.6% due to government expenditure rationalization programs that will tackle SAR1.18 trillion worth of projects over the next few years.

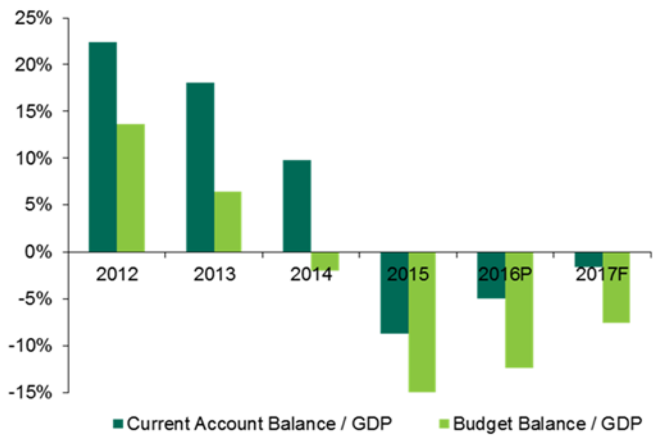
Chart 15: Real GDP Growth, Contribution



Source: GAS and NCB

The fiscal deficit is expected to remain in place for the fourth year running, yet it will fall from the double digits to the single digit at 7.5% of GDP, amounting to SAR190 billion. The government adopted a targeted expansionary fiscal policy for 2017, targeting projects and initiatives that enhance the absorptive capacity of the economy. Our baseline scenario assumes Arabian light spot prices to average around USD50.6/bbl this year, a rise of 24.0% over 2016, undermining the decline in crude production to 10.1MMBD which will result in oil revenues rising to SAR445.8 billion. Additionally, the excise tax on harmful goods, expat dependent’s levy, and energy price reforms will boost non-oil revenues and support total revenues to reach SAR700 billion in 2017. On the expenditure side, we believe the government will enforce a strict budgetary oversight to limit the expense bill at SAR890 billion, increasing 7.9% on an annual basis due to a rebound in capital expenditures which offset the decline in current expenditures.

Chart 16: Twin Balances



Source: SAMA and NCB

The Kingdom utilized a portion of its net foreign assets to plug the fiscal deficits over the past couple of years, yet, USD502 billion as of March 2017 remains a significant buffer for tackling further shocks to the domestic system and provides around 50 months coverage of imported goods. Additionally, capitalizing on Saudi’s sovereign credit rating, the government issued international bonds and Islamic sukuk to reduce the strain on domestic liquidity experienced last year. Going forward, the government is expected to lessen the pace of reserves withdrawal and rely on issuing debt as the former is needed to lock-in low interest rates. Gauging the risks on the banking system through the capital adequacy ratio (tier-1) reveals that banks are comfortably above Basel III requirements at 17.5% by the end of last year. The NPL ratio for the banking system had recently increased, however, the coverage ratio is adequate at 178.3%, effectively mitigating the risks from the construction and manufacturing sectors. Rating agencies have maintained a stable outlook for the Kingdom, as further fiscal discipline and a rebound in revenues throughout 2020 will improve its sovereign financial position.

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