جدوى للإستثمار
Jadwa Investment

28th December 2015

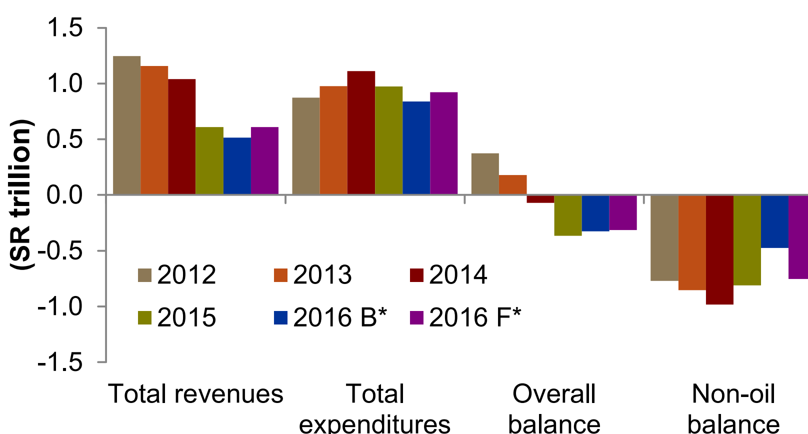
Saudi Arabia's 2016 fiscal budget

The government's budget for the 2016 fiscal year (31 December 2015 to 30 December 2016) was endorsed by the Council of Ministers on 28th December. It points to a sustained commitment in maintaining a high level of spending despite the continued environment of lower oil prices (Figure 1). Despite being reduced slightly, budgeted spending is set to play a vital role in supporting the economy in 2016. The highlights include:

- The government has reaffirmed its commitment to support the economy by budgeting for a SR326 billion deficit in nominal terms, based on revenues of SR514 billion and expenditures of SR840 billion. The deficit will continue to be financed using a combination of Saudi Arabian Monetary Agency's (SAMA) huge stock of net foreign assets, and domestic debt. SAMA net foreign assets totaled $628 billion at the end of November, while public debt rose from a long-term low of SR44.3 billion in 2014 to reach SR142 billion in 2015, yet still low relative to GDP at 5.8 percent.

- Despite the global environment of lower oil prices, the Kingdom has maintained a high level of spending in the 2016 fiscal budget. Education and healthcare remain the focus of government spending, accounting for 35 percent of total spending. Whilst spending on military and security services constitutes the largest single share at 25 percent. A new allocation accounting for 22 percent has been introduced to support the budget and help address shortages in revenue. We estimate that budgeted investment spending has been reduced to SR204 billion in 2016, with spending on key social infrastructure projects maintained. This points to a gradual consolidation in the fiscal stance but also shows the government's sustained commitment on maintaining a high level

Figure 1: Saudi Arabia's budget remains accommodative



Note*: 2016B refers to MoF budget projections, except for the budgeted non-oil balance, which is estimated by Jadwa Investment

*2016F refers to Jadwa Investment's forecasts.

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of spending on human capital and social infrastructure.

The budgetary performance in 2015 came up close to our expectations with a deficit of SR367 billion…

...this is the second consecutive fiscal deficit.

Total revenue fell by 41.5 percent compared to the previous year.

- The budgetary performance in 2015 came close to our forecasts with a deficit of SR367 billion, or 15 percent of GDP (Jadwa Investment forecast: SR403 billion, 16.4 percent of GDP). Despite the deficit being the largest on record, reduced spending has meant a much smaller than anticipated deficit. This is the second consecutive fiscal deficit, and was mainly due to both a steep fall in revenues and a rise in one off expenditures associated with the royal succession. Total revenue fell by 41.5 percent compared to the previous year, reaching its lowest level since 2009 at SR608 billion. We estimate oil revenue to have fallen by 51 percent despite record production (10.2 mbpd year-to -November). Fiscal expenditure was reduced for the first time since 2002 to reach SR975 billion, SR136 billion lower than 2014.

Preliminary economic data shows that the economy continued to slow in 2015.

- In line with our expectations, preliminary economic data shows that the economy continued to slow in 2015 with real GDP growth of 3.4 percent (Jadwa Investment forecast: 3.2 percent). Non-oil private sector slowed to 3.5 percent year-on-year (Jadwa Investment forecast: 3.8 percent), with the highest growth in the transport, construction, and wholesale and retail sectors. Lower oil export revenues meant a first current account deficit since 1998, at 6.3 percent of GDP or minus $41.3 billion.

A National Transformation Program (NTP) will likely be announced in January…

...which should have a positive impact on non-oil revenue.

- Looking ahead, a National Transformation Program (NTP) will likely be announced by the government in January, providing a roadmap for major social and economic initiatives to be undertaken in the next five years. We have already seen some elements of these major initiatives announced today along the budget such as domestic energy price reform which should have a positive impact on non-oil revenue while, at the same, curbing growth in energy consumption.

We estimate Saudi export price of $40.3 pb and 10.2 million barrels per day (mbpd) are consistent with the revenue projections contained in the budget.

We estimate a price of $40.3 pb for Saudi export crude (around $42.8 pb for Brent) and production of 10.2 million barrels per day (mbpd) are consistent with the revenue projections contained in the budget. We expect both revenues and expenditures in 2016 to be above the budgeted level, but the differential will be smaller as the government becomes more prudent in its spending procedure. We forecast a budget deficit of SR313 billion (12.6 percent of GDP) based on oil price of $47 pb for Brent in 2016.

Figure 2: Budgeted expenditure

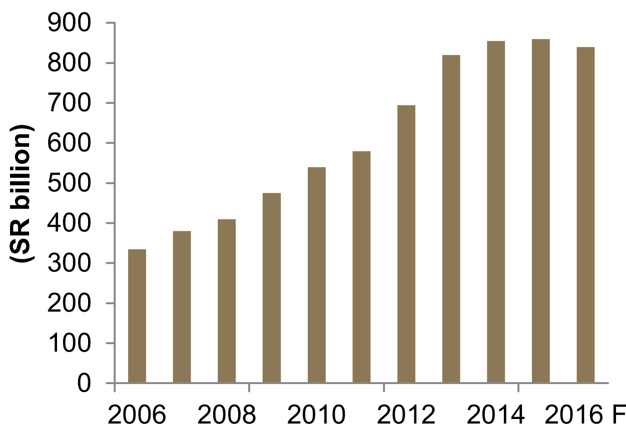
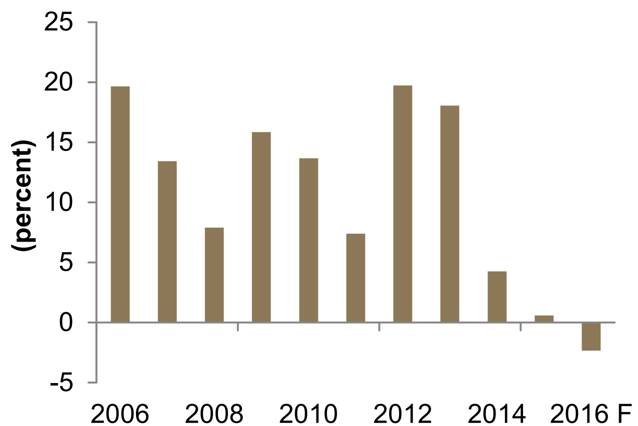


Figure 3: Growth in budgeted expenditure
(year-on-year change)



The 2016 budget

The 2016 budget outlines a small reduction in the level of spending compared to 2015, down by SR20 billion to SR840 billion.

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

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

We anticipate the NTP to focus on speeding up the diversification process.

As highlighted in our 2015 budget report last year, we expect the government to demonstrate an increasing tendency to monitor capital spending. Initiatives for tighter control over capital spending include the order by the Council of Ministers, back in April, requiring the king's approval for any project in excess of SR100 million. We also anticipate the NTP to be announced in January. One objective of this plan is likely to focus on speeding up the diversification process, including government income and the role of the private sector. We also expect this plan to be carried out through a number of ambitious targets and key performance indicators which increase the efficiency of public sector spending.

The budget sees contraction in revenues by 28.1 percent and negative growth of 2.3 percent in expenditure.

That being said, the Kingdom has budgeted for a second consecutive fiscal deficit, amounting to SR326 billion in 2016, compared with SR145 in 2015. With uncertainty still clouding the outlook for global oil market, the budget foresees a further contraction in revenues by 28.1 percent and negative growth of 2.3 percent in expenditure compared to last year's budget.

According to the latest data available, at the end of November net foreign assets at SAMA stood at $628 billion (SR 2,356 billion).

These assets give the Kingdom an advantage in alleviating the impact of lower oil prices...

At least in the short term we think that financing this deficit is straightforward, as it can be done by drawing down the stock of foreign assets built up in recent years and the financial capacity to issue debt. According to the latest data available, at the end of November net foreign assets at SAMA stood at $628 billion (SR 2,356 billion). The huge stock of assets that the government can call on gives the Kingdom an advantage over most other countries in alleviating the impact of lower oil prices. Also, the series of sovereign bond issuance (around SR20 billion per month since June) provides the government with more room to continue financing strategic

Figure 4: Budgeted versus actual spending-

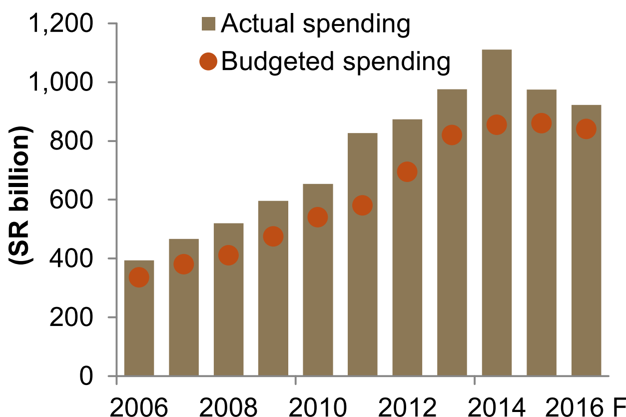
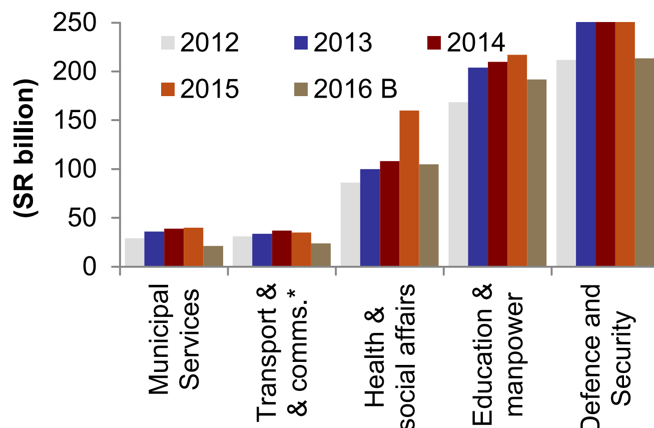


Figure 5: Spending by sector



Note*: 2015 data excludes communications

...although the budget states that government will utilize a financing plan that observes the best financing options available.

projects, such as key infrastructure developments including transport, housing, power and water, and to support the private sector where necessary. We think the government will increasingly rely on bonds to finance its future spending, which will result in less FX reserves drawdowns. That said, the budget announcement explicitly states that the government will utilize a financing plan that observes the best financing options available. This includes both domestic and foreign borrowing in order to avoid crowding out credit to the private sector.

Expenditure

Total expenditure is budgeted at SR840 billion in 2016 (Figure 2). This is lower than the amount budgeted for 2015 .

Total expenditure is budgeted at SR840 billion in 2016 (Figure 2). This is lower than the amount budgeted for 2015 (Figure 3). While there was a small decline in budgeted spending, this spending is very high and reflects the government's willingness to support the economy despite the fall in revenues. We believe that this sends an important message to the private sector that the fall in oil prices will not prevent the government from fulfilling its investment plans. High fiscal spending remains psychologically important for the private sector, in our view.

When compared to actual spending, the budgeted amount shows a declining trend from actual levels in both 2014 and 2015, which totaled SR1,111 billion, and SR975 billion respectively.

When compared to actual spending, the budgeted amount shows a declining trend from actual levels in both 2014 and 2015, which totaled SR1,111 billion, and SR975 billion 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).The last time that budgeted spending exceeded actual spending compared to the previous year was in 2000. Budgeted spending as a share of non-oil GDP is in line with historical levels, at an average of 50 percent in the last ten years. Furthermore, we think that the government will target total spending to be fixed at a certain proportion of non-oil GDP. This approach will likely be highlighted in the 2020 NTP, thereby improving the confidence related to budget announcements as well as reducing the chance for unnecessary spending.

We estimate a rise in budgeted current spending by SR618 billion or by 5.6 percent...

The 2016 budget announcement did not show a breakdown by type of expenditure. We estimate a rise in budgeted current spending (the more rigid part of expenditure), while we expect a reduction in budgeted investment spending. Budgeted current spending has likely been raised to SR618 billion or by 5.6 percent compared to the level budgeted for last year, this is half the 10 percent average annual growth in budgeted current spending over the last ten years, and consistent with slowing growth in current spending over the last two years. We think that budget commitments, spending packages, and very high public sector employment had accelerated current spending during the previous years. Wages and salaries are the largest component of this and are certain to continue being a major contributor to growth. However, the budget statement included a list of measures to be implemented which will reduce the growth in this type of spending, specially since spending on wages and salaries accounted for 50 percent of actual spending in 2015. Operations and maintenance costs are also likely to be a growing source of current spending in future years as major projects become operational.

...but we expect a reduction in budgeted investment spending by 19.3 percent to SR222 billion in 2016.

At the same time, we believe that the government has budgeted a cut to investment spending by 19.3 percent to SR222 billion in 2016. Budgeted capital spending has already been cut by 3.4 percent for 2015, and we expect the government to have budgeted for an even

larger cut in this type of spending in 2016. That said, we expect the 2016 budgeted investment spending is 21.3 percent higher than its level five years ago.

Military and security services has been allocated 25 percent of the budget…

...education is allocated the second biggest share, at 23 percent of total spending.

While budgeted expenditure in 2016 spans all sectors, the priorities are consistent with recent years (Figure 5). Military and security services has been allocated 25 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 13 percent.

Spending plans for key public sector areas outlined in the budget include:

2016 Budget Allocation

(SR billion)

Budget Allocation	2016	2015	Growth (% y/y)	Difference (SR)
Expenditures	840	975	-13.8	-135
Education and Training	192	217	-11.7	-25.3
Health and Social Development	105	160	-34.5	-55.1
Municipality Services	21	40	-46.9	-18.7
Military and Security Services	213	-	-	-
Infrastructure and Transportation	24	-	-	-
Economic Resources	78	-	-	-
Public Administration	24	-	-	-
Budget Support Provision	183	-	-	-

Military and Security Services budget totaled SR213 billion…

Education and Training was allocated SR192 billion in 2016…

...and Social Development dropped by a sizable 34 percent year-on-year to SR105 billion….

...Municipality Services SR19 billion…

...Economic Resources SR78 billion...

Public Administration SR24 billion…

Box 1: Budget Allocation 2016

The 2016 budget made a break with the reporting format of last few years and introduced four new line items. The most significant was **Military and Security Services** item, which had not previously been disclosed, and represented a total budget allocation of 25 percent at SR213 billion. **Education and Training**, the second largest budget item, was allocated SR192 billion in 2016, representing a decline of 12 percent year-on-year from SR217 billion in 2015. **Health and Social Development** dropped by a sizable 34 percent year-on-year to SR105 billion. Whilst **Education and Training and Health and Social Development** budgets are down year-on-year, as the budget report highlights, there are a number of projects which are being funded from previous budget's surpluses, indicating that both these sectors will continue to benefit from investment. **Municipality Services**, which made up 3 percent of the total allocation, declined by 46 percent or SR19 billion. **Economic Resources** is a new line and will be disclosed in the budget statement, representing 9 percent or SR78 billion of budgeted expenditure in 2016. Notably it includes an allocation for the King Abdullah City for Atomic and Renewable Energy (KA-CARE) reaffirming that the government is keen on developing a plan on renewable energy, which fits in with the proposal to conserve natural resources outlined in the budget report. **Public Administration** is another new item representing SR24 billion. A **Budget Support Provision** line item has also been added representing a back-up fund in case of shortages in revenue due to

...and Budget Support Provision at SR183 billion.

volatility of oil prices to the tune of SR183 billion or 22 percent of the total budget. This is welcome addition to the allocation and represents a clear sign that the government is pursuing a more serious risk management approach to government finances. That being said, it is conceivable that this provision remains untouched during 2016 due to better-than-expected government revenue.

Economic, Fiscal and Structural Reform

This year's Saudi budget spelled out clear objectives to consolidate expenditure over the next three to five years…

This year's Saudi budget spelled out clear objectives to consolidate expenditure over the next three to five years. We anticipate more detail will be disclosed in the NTP, but three key points stand out from the budget report which the government has outlined it will tackle. Firstly, better management of expenditure, secondly, improving revenue sources and debt capacity, thirdly, limiting growth in bloated expenditure whilst channeling resources to key sectors to ensure economic growth.

i) better management of expenditure…

...through public finance unit in the Ministry of Finance and National Project Management Agency.

Better management of expenditure:
The implementation of a public finance unit in the Ministry of Finance and the setting up of the National Project Management Agency are two initiatives which are designed to ensure that expenditure is kept in check. Two further reforms, the improvement of budgetary policies and procedures and reviewing existing government projects, will aim to reassess existing practices and projects to ensure they bring greater value to government's development objectives.

ii) improving revenue sources and debt capacity…

...by implementation of a GCC wide value added tax…

Improving revenue sources and debt capacity:
The implementation of a GCC wide value added tax is a major development that will add to government revenues. It will also be supplemented by additional fees on goods deemed as undesirable, such as tobacco and soft drinks. The budget report also cites privatizing a range of sectors and economic activities, whilst an improvement in the management of the state's assets will also generate more revenue.

..and a debt management unit within the Ministry of Finance

Since mid-2015 the government has been issuing bonds mainly to the domestic banking sector. This is expected to continue during 2016, but with the help of a debt management unit within the Ministry of Finance, the government will be able to improve its financing strategy so allow continued borrowing from both domestic and international sources.

iii) limiting expenditure and channeling resources...

..with price rises expected in energy, water, and electricity prices over the next five years…

Limiting expenditure and channeling resources:
Two majors sources of expenditure are earmarked for limited growth. One of these relates to government support to energy and utilities. A royal decree announced that petrol prices would go up by 50 percent, up from 16 cents (0.6 riyals) to 0.24 cents (0.90 riyals) for a liter of high grade gasoline. However, the budget report states that more price rises should be expected as energy, water, and electricity prices will be increased gradually over the next five years. This is a welcome move since, according to Jadwa's estimates, the government spent $61 billion on energy subsidies in 2015 with almost $9.5 billion of that on gasoline alone (Box 2).

...and growth in recurring expenditures such as wages and salaries being minimal.

The other area will be related to recurring expenditures, especially wages, salaries, allowances which amounted to SR450 billion in 2015. This would imply that the public sector is likely to see slower growth in salaries or slower growth in headcount, or perhaps both. In

Investment will also be central to ensuring that the welfare of citizens is not compromised.

Jadwa estimates that energy subsidies cost the Saudi government around $61 billion dollars in 2015.

The largest item cost was in the provision of diesel, costing $23 billion in 2015.

1.6 million barrels of oil and refined products are consumed to meet domestic electricity demand…

...which increase rise as peak demand rises by 25 percent between 2015-2020.

light of this, to ensure that the private sector can create a larger share of jobs, the government plans to improve the investment environment related to the private sector, which will include overcoming legislative, regulatory and bureaucratic obstacles.

Investment will also be central to ensuring that the welfare of citizens is not compromised with the budget specifically citing education, health, security, social and municipal services, water and sanitation, electricity, roads, electronic transactions, scientific research as a benefactor regardless of the more disciplined expenditure approach going forward.

Box 2: Cost of energy subsidies

When looking at the price of various energy products globally and then comparing those to the prices paid by end users in Saudi Arabia, Jadwa estimates that energy subsidies cost the Saudi government around $61 billion dollars in 2015 (9.3 percent of GDP). Although the opportunity cost of subsidies to government decreased by 39 percent year-on-year, as international crude and crude-related product prices dropped, the total still represents a significant loss. The largest item cost was in the provision of diesel, costing $23 billion (3.5 percent of GDP) to the government in 2015, since it makes up a significant portion of total Saudi energy demand. Diesel consumption totaled an expected 800 thousand barrels per day (tbpd) in 2015 (28 percent of total domestic consumption), through its varied use in electricity generation, desalination and transportation. At 16 US cent per liter (rising to 24 cent per liter in 2016) at the pump, the provision of gasoline also represented another major cost to the Saudi government, at around $9.5 billion in 2015 (1.4 percent of GDP), when compared to prevailing international gasoline prices. Electricity generation represent a significant cost to the Kingdom with around 1.6 million barrels of oil and refined products per day are consumed to meet domestic demand. Domestic users pay as low as 3 US cent per for each kilowatt hour of electricity, a significant discount of 60 percent when compared to international prices. We estimate that the opportunity cost for the government keeping prices at such low levels was equal $23 billion in 2015. The Electricity Co-Generation Regulatory Authority (ECRA) forecasts peak electricity demand rising by 25 percent between 2015-2020, so generation costs will rise too.

Figure 6: Saudi oil production 2004-2016F

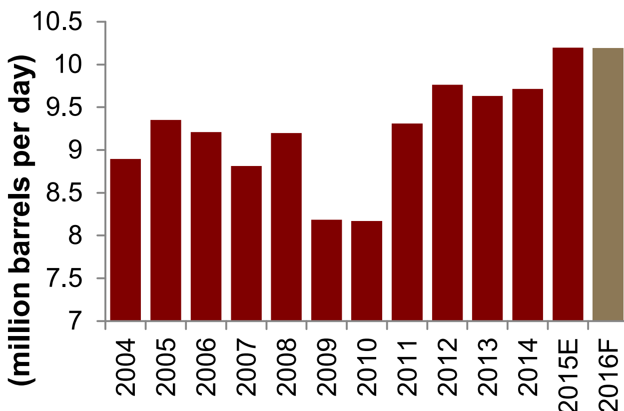
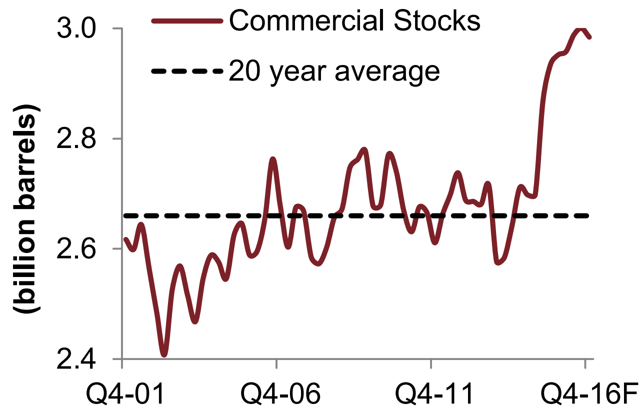


Figure 7: OECD Commercial crude stock



Revenue

Total revenue is budgeted at SR514 billion and we . We anticipate that around 73 percent of total revenue will come from oil.

We calculate that oil production of 10.2 mbpd at a price for Saudi export crude of $40.3 pb is consistent with the oil revenue projection in the current budget.

Total revenue is budgeted at SR514 billion. We anticipate that around 73 percent of total revenue will come from oil; an official revenue breakdown was not published. As is the norm, the oil price and production projections used to derive the revenue figure were not disclosed. We calculate that oil production of 10.2 mbpd at a price for Saudi export crude of $40.3 pb (equivalent to around $42.8 pb for Brent) is consistent with the oil revenue projection in the current budget. The government has consistently based its previous budgets on conservative oil price assumptions. Over the last five years, the actual oil price has averaged more than 50 percent higher than the one used for the budget. In 2015, however, the oil price assumption used for the budget was $64.8 pb, higher than the $49.6 pb year-to-date average price for Saudi crude. Nevertheless, with Brent crude currently trading at $37 pb (see box 3), we think that the oil price assumption was again reduced significantly compared to the 2015 budget price of $64.8pb, meaning the government is once again being cautious in its assumptions for 2016 oil prices.

With these assumptions in the background, the announced revenues are projected to decline by 28.1 percent compared with the previous year's budget.

With these assumptions in the background, the announced revenues are projected to decline by 28.1 percent compared with the previous year's budget. Even though we anticipate that prices will be lower than in 2015, we think that revenues will be comfortably above the government's assumption. Revenues generally provide the base from which expenditure is calculated; conservative budgetary assumptions on oil prices and spending have contributed to high levels of overspending in recent years. In 2016, however, we think that the government will be more prudent in its spending, which will likely mean lower levels of overspending compared to the budget.

The prospect of further increases to interest rates in the US is likely to improve the return on government foreign assets which account for around 96 percent of GDP.

Projections for non-oil revenues were not published. Fees and charges for government services and customs tariffs are the main sources of non-oil revenues. We anticipate receipts from both of these sources to increase gradually in line with more careful monitoring of income receipts as well as the higher demand on government services. The prospect of further increases to interest rates in the US is likely to improve the return on government foreign assets which account for around 96 percent of GDP, though we do not anticipate a significant push here as the interest rate adjustment is likely to be gradual.

Figure 8: Global oil balances

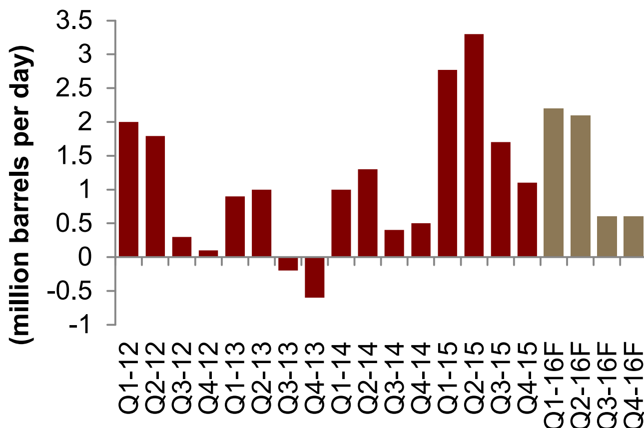
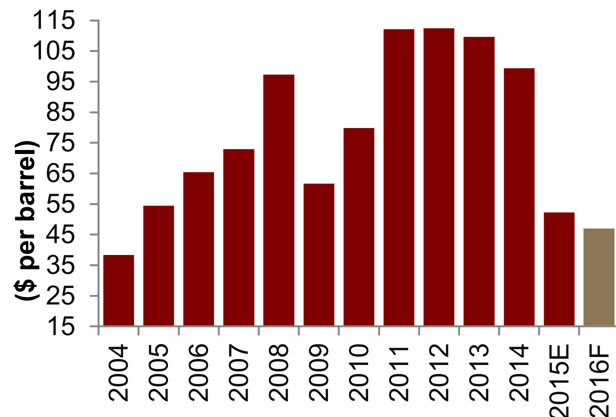


Figure 9: Average oil prices 2004-2016F



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

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

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

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

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

Box 3: Jadwa's oil market outlook for 2016

The current period of low prices is set to remain throughout 2016, pulled down primarily as a result of persistently high oil supply. All-out competition between members of OPEC will be the main reason for continued oversupplied markets. In OPEC's recent meeting the notional idea of production quotas was dropped, paving the way for even more intense competition in an already heavily-oversupplied market. Even as non-OPEC supply begins to slow during 2016 the additional supply coming on-line from Iran will mean global oil markets will be looking at demand to lift prices out of the doldrums. With global economic activity not picking up significantly in the year ahead, this will translate to moderate yearly growth in oil demand. OPEC data shows that non-OPEC supply will decrease by 0.2 million barrels per day (mbpd), year-on-year, in 2016. Amongst the largest non-OPEC players, both the US and Russia will see year-on-year declines in production. For Russia, the combination of international sanctions preventing Russian oil companies' access to international finance and government proposals for higher crude taxes to boost state revenue will mean crude production, which reached record post-soviet levels in 2015, is expected to slow slightly in 2016. According to latest Energy Information Agency (EIA) data, total US oil production will decline by 6 percent or 600 thousand barrels per day (tbpd), year-on-year, in 2016.

We forecast OPEC supplies rising by around 600 tbpd year-on-year to average of 32.1 mbpd in 2016. Most of the OPEC rises are expected to come from increased Iranian supply when nuclear-related sanctions are lifted at some point in Q1 2016. Although Iraq saw an estimated 11 percent increase in production year-on-year in 2015, this has been attributed to investment in the upstream sector since 2009. Further substantial increases in Iraqi production will be more difficult due to the country's deteriorating fiscal situation as a result of lower oil prices, higher military spending, and costs associated with civil conflict.

Saudi Arabian crude production is expected to average 10.2 mbpd in 2015, slightly above our forecasted 10.1 mbpd (Figure 6). We do not see Saudi Arabian policy cutting production in order to support upward movement in prices. So far Saudi policy of gaining market share has worked with lower prices undercutting both OPEC and non-OPEC competitors in key markets and we expect Saudi production

Figure 10: Budgetary performance

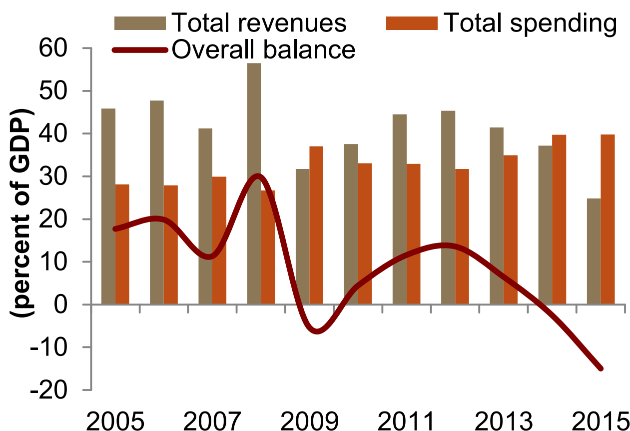
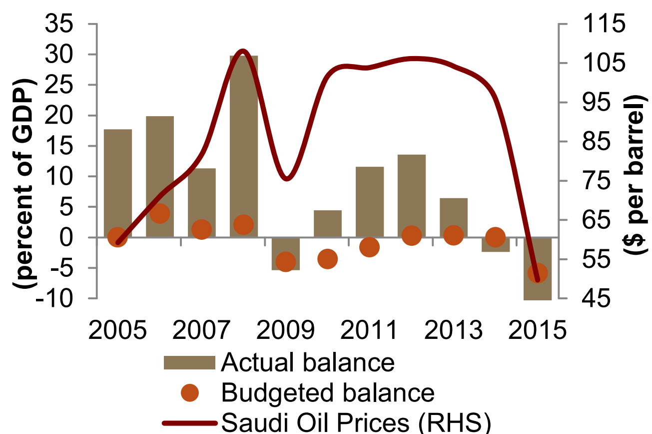


Figure 11: Budgeted versus actual balance and oil prices



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

According to OPEC data global demand will rise by 1.25 mbpd in 2016, year-on-year, in line with the average of the last four years.

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

...as a result, our revised Brent forecast is $47 pb, down from $61 pb previously, for 2016.

to be unchanged, year-on-year, at 10.2 mbpd in 2016 .

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

Moderate oil demand and a glut in oil supply will result in a continued build in OECD commercial crude stocks during most of 2016 (Figure 7). In fact, even with a currently high level of geopolitical tension there is no risk premium attached to oil prices since commercial stocks are more than capable of handling any adverse supply shocks in the short term. Even as global oil markets tighten toward the second half of 2016 (Figure 8) commercial crude stocks will have peaked in excess of their 15 year average. As a result we see limited upside to Brent prices during the year with our revised forecast at $47 pb, down from $61 pb previously, for 2016 (Figure 9).

The National Transformation Plan 2020

The NTP will introduce more detailed initiatives that could help boost non-oil revenue and improve public sector efficiency beyond 2016...

...and will likely include privatization, energy subsidy reform procedures.

While the budget contained some measures that will likely be implemented over the next couple of years, we think the NTP will introduce more detailed initiatives that could help boost non-oil revenue and improve public sector efficiency beyond 2016. The NTP will likely follow the budget and include initiatives on diversifying government revenue, improving public sector labor productivity, as well as introducing specific numerical targets to cap fiscal spending and debt accumulation in the next five years. Also, the NTP will likely include privatization, energy subsidy reform procedures (see Box 2), the imposition of a value-added tax, and revenue maximization of religious tourism, all of which would also contribute to significantly raising non-oil revenue for the government in the short-to-medium term.

Within the NTP we think the government will introduce an initiative to improve public sector workers' efficiency and productivity…

...subsidy reform would therefore enable the government to maximize its oil revenue…

Within the anticipated NTP, we think that the government will introduce an initiative to improve public sector workers' efficiency and productivity. The government has recently launched the King Salman program to develop human resources in the public sector. We think this comprehensive performance-based initiative will concentrate on raising the productivity and efficiency of public sector workers. If implemented effectively, the initiative should lead to potentially higher non-oil revenues per Riyal spent on wages, and reduce worker redundancy costs. This should ultimately contribute to an improvement in the government's non-oil fiscal balance.
Implicit energy subsidies have a high opportunity cost for the government as feedstock can be sold at much higher prices in the world market. Subsidy reform would therefore enable the government to maximize its oil revenue as well as encourage more efficient energy consumption by the private sector. Further, according to some sources citing officials, subsidies have had little benefit for lower and middle income households, with the majority benefit going to higher income groups. Additionally, and according to economic theory, subsidy reform always contributes to a net welfare gain to society, with financial gains to the government exceeding the

...and we also anticipate privatization initiatives in public sectors including healthcare, education, desalination, and grain silos/ flour mills.

We forecast a budget deficit of SR313.4 billion in 2016, equivalent to 12.6 percent of estimated GDP.

We forecast total oil revenues contributing SR609 billion to the budget and non-oil revenues contributing SR168 billion…

...actual spending will be above the budgeted level at SR922.4 billion.

The fiscal breakeven oil price (the price needed to balance our forecast level of government spending) is $88.4 pb.

This is based on our production assumption of 10.2 mbpd and an oil export/revenue transfer ratio of 85 percent.

loss to consumers. Looking ahead, we think that any reform would be gradual over the next five years, as outlined in the budget report.

We also anticipate privatization initiatives in public sectors including healthcare, education, desalination, and grain silos/ flour mills. We think privatization proceeds will be significant in the longer-term for the government to mitigate future deficits. We also believe the sectors to be privatized are labor intensive, which will mean a likely reduction in the wage bill and current expenditure for the government going forward.

Jadwa Investment's 2016 budget forecast

We forecast a budget deficit of SR313.4 billion in 2016, equivalent to 12.6 percent of estimated GDP. On the revenue front, we expect oil prices to be higher than that used in the budget (see Box 3) and therefore oil revenues will exceed the budgeted total. We forecast total oil revenues contributing SR609 billion to the budget and non-oil revenues contributing SR168 billion.

Actual spending will be above the budgeted level. Over the last ten years actual government spending has averaged 24 percent higher than the budgeted amount. However, in 2015, the overspending ratio came out lower at 13.4 percent. We expect another decline in the overspending ratio in 2016 to 9.8 percent. We think such a trend will be further enforced given the expected pressure on oil revenues and the more prudent expenditure control, together with the lower level of budgeted spending for 2016. We forecast total expenditure of SR922.4 billion.

The oil price level necessary for revenues to balance our forecast level of government spending, known as the fiscal breakeven oil price, is $88.4 pb for Saudi export crude (equivalent to around $90.9 pb for Brent). This is based on our production assumption of 10.2 mbpd and an oil export/revenue transfer ratio of 85 percent. We also assume a 1 percent growth in domestic oil consumption to 2.9 mbpd in 2016. We think that forthcoming increases in domestic gas production should take some of the burden from oil as the fuel for domestic energy consumption next year. The main growth in gas output will come from the Hasbah and Arabiyah fields in the east of Saudi Arabia and from Shaybah field in the Empty Quarter. Both Hasbah and Arabiyah are expected to produce non-associated gas

Figure 12: Government debt

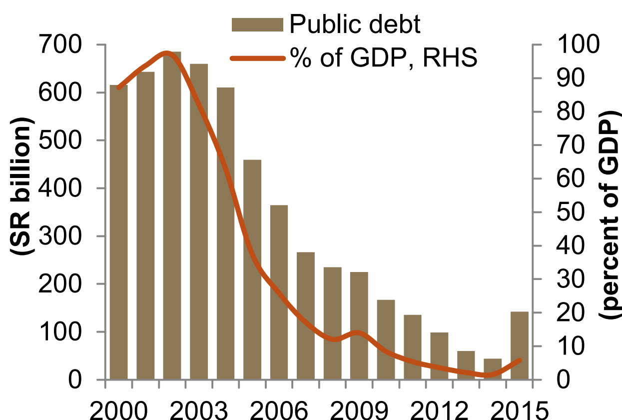
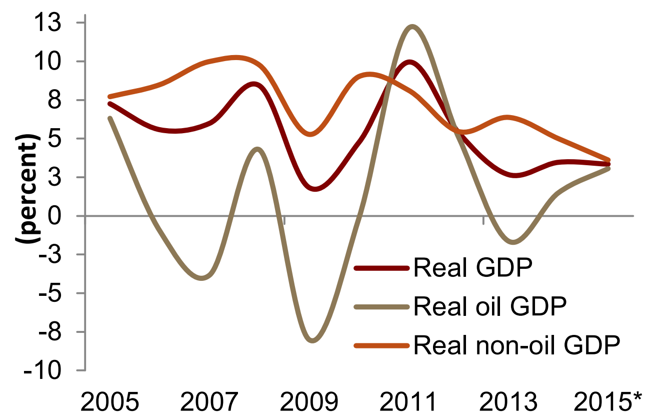


Figure 13: Real GDP growth
(year-on-year change)



Note: * From the official budget statement.

which will be processed by the Wasit processing plant. These projects were supposed to come on-line in 2015 but faced technical delays and should be operational in early 2016.

Budgetary performance in 2015

For the first time, actual government oil revenues have come out lower than budgeted in 2015.

The recent announcement by the Ministry of Finance also reveals that the preliminary 2015 fiscal outturns were significantly different than the 2015 budget's projections, and at line with our projections. For the first time, actual oil revenues have come out lower than budgeted; the result of falling oil prices ($52.2 pb for Brent in 2015, down from $99.4 pb in 2014). Total spending was again in excess of the budgeted projection, leading to a deficit of SR367 billion, the largest deficit on record, equivalent of 15 percent of GDP (Jadwa Investment: SR403 billion, 16.4 percent of GDP).

Total spending was again in excess of the budgeted projection, leading to a deficit of SR367 billion.

Revenue totaled SR608 billion, it was 15 percent lower than the budgeted level, and 41.5 percent lower than its 2014 level.

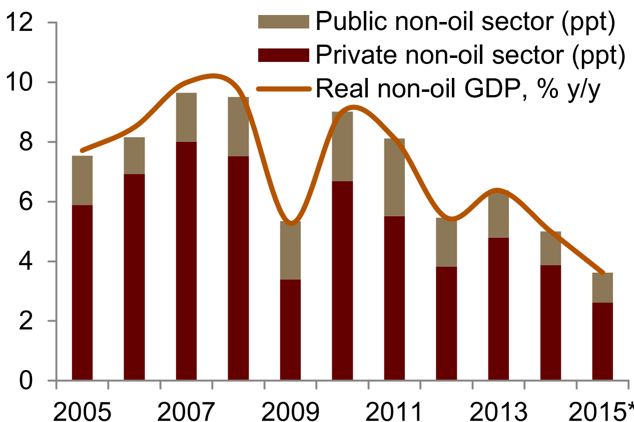
Revenue totaled SR608 billion (Jadwa Investment: SR679. billion). It was 15 percent lower than the budgeted level, and 41.5 percent lower than its 2014 level. We estimated that the 2015 budget was based on a price for Saudi oil of $64.8 pb and production of 9.6 mbpd. Actual price of Saudi oil averaged $49 pb in 2015, 48 percent lower than its level in 2014, and 11.2 percent lower than that used in the budget. The actual level of oil production was above our forecasts. Non-oil revenues were SR163.5 billion, up by 28.9 percent on the 2014 total, the fastest year-on-year growth on record. This is a direct result of the government's efforts during the year in improving the collection of fees and taxes. For example, taxes on petroleum products have increased by 7 percent, year-on-year despite the large drop in oil export revenues. Another source of growth came from foreign investment returns by SAMA and the Public Investment Fund (PIF), which rose from a total of SR21.9 billion in 2014 to reach SR 37 billion in 2015.

2015 Budget data
(SR billion)

	Budget	Actual	Difference
Revenues	715	608	-107
Expenditures	860	975	115
Balance	-145	-367	-222

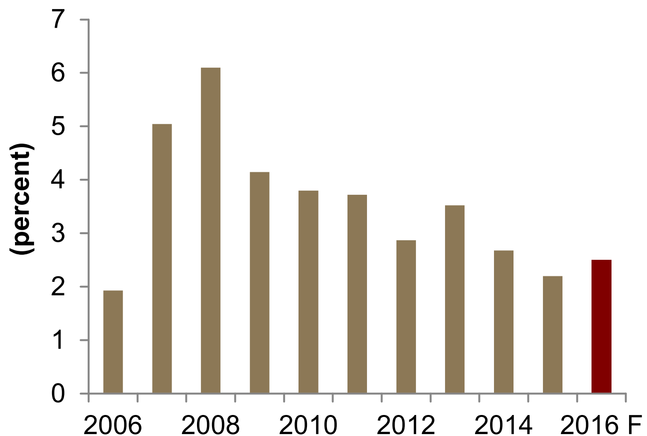
Expenditure amounted to SR975 billion (Jadwa Investment: SR1,082

Figure 14: Non-oil GDP Growth



Note: * From the official budget statement.

Figure 15: Inflation
(year-on-year)



2015 saw the first year-on-year decline in actual spending since 2002.

Spending over budget totaled SR115 billion, mainly owing to the January royal decrees.

billion), 13.4 percent above the budgeted level but 12.2 percent lower than in 2014. This was the first year-on-year decline in actual spending since 2002. In nominal terms, the decline was SR136 billion, while the overspending stood at SR115 billion. The official announcement attributes the current overspending to additional spending from the royal decrees announced in January, which totaled SR115 billion . We have highlighted the impact of this extra spending in previous publications as a downside risk factor to our earlier deficit forecast. While a breakdown of spending into capital and current expenditure was not disclosed, we maintain our view that public sector pay rises and greater employment in government accounted for a large share of current spending. This highlights the increased rigidity in the Kingdom's budget, though this includes one off spending associated with the royal decrees. Further, the government noted that its efforts to rationalize current spending will continue. It is important to note 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.

We estimate that capital spending accounted for 31 percent of total spending in 2015.

We believe that despite the budget being in deficit, capital spending remained an important element of expenditure. While the government reduced its investment spending towards the end of 2015, we think it will continue to engage in this type of spending in the short-to-medium term, as it still remains affordable to do so. The government will, as a result, be able to continue spending on key social and infrastructure projects, and at a level high enough to support growth in the private sector. That being said, we estimate that capital spending accounted for 31 percent of total spending in 2015, still high compared to an average of 28 percent between 2004 and 2014. This type of spending is critical to sustain robust growth in the non-oil sector and help to lessen the dependence on the oil sector as the main source of income. Diversification of sources of fiscal income rather than fiscal deficits should be the focus of policymakers in the Kingdom.

The public debt increased by a net of SR97.7 billion to SR142 billion by the end of 2015 (5.8 percent of GDP).

As a result of the budget being in deficit, the government has started a series of monthly sovereign bond issuance, all of which is domestic, to cover part of the shortfall. The public debt increased by a net of SR97.7 billion to SR142 billion by the end of 2015, equivalent to just 5.8 percent of GDP (Figure 12). We think that autonomous government institutions were the main subscribers to

Figure 16: Current account

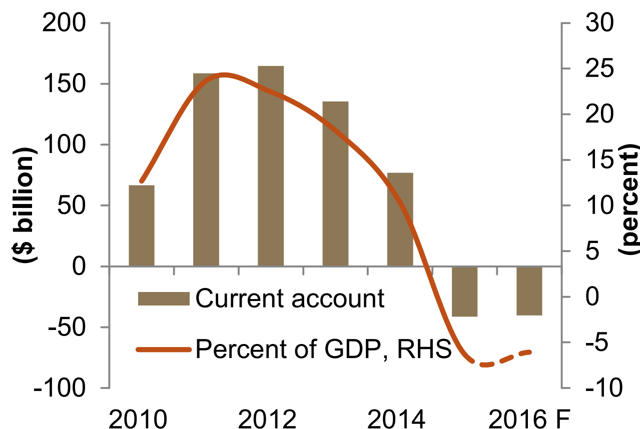
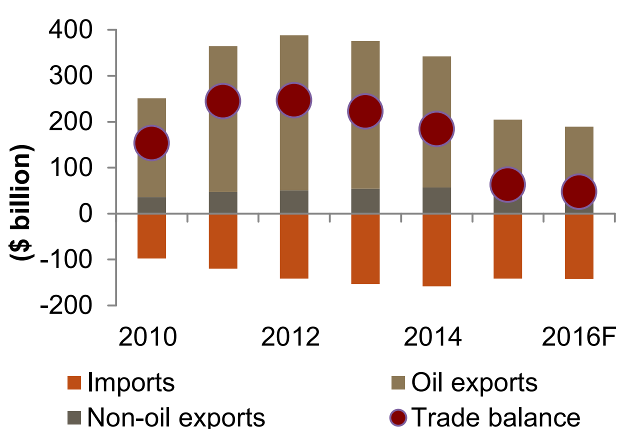


Figure 17: Imports and exports



Commercial bank holdings of government bonds have only risen by SR27 billion, year-to-November.

these debt issuances. Commercial bank holdings of government bonds, the closest proxy to their holdings of government debt, have only risen by SR27 billion over the eleven months of the year to SR80 billion. 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). As mentioned earlier, we think the government will continue with issuing more bonds to banks and other autonomous government agencies to finance its spending. Looking ahead, there is a downside risk that liquidity could shrink from further government bond issuance, which could result in a crowding out effect on credit to the private sector. While this is not our baseline scenario, if such an event does happen, we expect the government to allow other financial and non-financial institutions (i.e. insurance companies, investment firms, and family offices) to participate in purchasing public debt.

Economic performance in 2015

Data showed that overall economic growth fell to 3.4 percent year-on-year…

Non-oil economic growth was at 3.6 percent year-on-year…

…with the private sector expanding by 3.7 percent.

The Ministry of Finance budget announcement included preliminary macroeconomic data, which provides some insight into the government's view on economic performance this year and prospects for next year. Data showed that overall economic growth fell to 3.4 percent year-on-year, slowing from 3.5 percent year-on-year in 2014. We had forecasted 3.2 percent GDP growth in 2015. According to the budget statement, the oil sector grew by 3 percent year-on-year in 2015, Jadwa had forecasted 3.4 percent. Stripping out the oil and gas sector, non-oil economic growth was at 3.6 percent year-on-year with the private sector expanding by 3.7 percent, compared to Jadwa's forecast of 3.8 percent. Lower oil revenues contributed to the first current account deficit since 1998. Inflation continued to decline.

The oil sector grew by 3 percent year-on-year as the Kingdom increased production.

Real GDP growth fell to 3.4 percent year-on-year, a trend which we had anticipated (Figure 13). We anticipated lower economic growth compared to last year because of weaker non-oil sector performance, while oil sector growth accelerated. The oil sector grew by 3 percent year-on-year as the Kingdom increased production. The latter grew by 5 percent year-on-year to an average of 10.2 mbpd compared with 9.7 mbpd in 2014. Both higher crude exports, from 7.1 mbpd in 2014 to an expected 7.4 mbpd in 2015, and increased refinery output led to oil sector growth. As oil sector growth accelerated, the pace of growth in the non-oil economy did not fare as well, but nevertheless grew by 3.6 percent (Figure 14). Within the non-oil economy, growth of government services slowed to 3.3 percent.

Transport, construction, and wholesale & retail were the fastest growing sectors in 2015.

The **non-oil private sector** grew by 3.7 percent. We had anticipated a slowing performance in 2015 as negative sentiment associated with lower oil prices and reduced government spending impacted business and consumer confidence and banks' discomfort in the lending environment. The data release showed that the transport sector would be the fastest growing sectors in 2015 at 6.1 percent . Construction sector growth was robust at 5.6 percent year-on-year. Non-oil manufacturing grew by 3.2 percent year-on-year, supported mainly by improved overall capacity, up 2.5 percent year-on-year, but specifically due to a rise in higher value adding specialty chemicals capacity, up 35 percent year-on-year. The wholesale and retail sector also recorded modest growth at 3.8 percent, reflecting

weaker sentiment related to lower oil prices. Growth in the finance sector was also in line with expectations, at 2.6 percent.

Inflation was put at an average of 2.2 percent.

Inflation was put at an average of 2.2 percent, compared to 2.7 percent in 2014. This is in line with inflation data produced on a monthly basis by CDSI and is the lowest since 2006, when inflation reached 1.9 percent. Inflation has remained subdued relative to previous years, but a recent acceleration to rental inflation and the newly announced revision to domestic energy prices all point to a likely upward trend next year (Figure 15).

The current account recorded its first deficit since 1998 at $41.3 billion (6.2 percent of GDP).

Oil export revenues fell to $157 billion, down from $285 billion in 2014.

Non-oil exports also fell by 18.8 percent year-on-year, compared to 6 percent growth in 2014

Imports were also down by 10.5 percent year-on-year.

The **current account** recorded its first deficit since 1998 at $41.3 billion (6.2 percent of GDP), down from a surplus of $76.9 billion in 2014 (Figure 16). Although a detailed breakdown of the current account is not published, it is clear that the reversal in the current account balance is mostly due to the drop in oil revenues (oil revenues account for around 83 percent of total current account receipts). The fall in Saudi oil export price from $95.8 pb in 2014 to $49 in 2015 pushed the oil export revenues to $157 billion, down from $285 billion in 2014. Non-oil exports also fell by 18.8 percent year-on-year, compared to 6 percent growth in 2014 (Figure 17). The fall in non-oil exports was mostly due to a decline in plastic and rubber, and chemical product exports. We see that the decline in oil prices has increased pressure on Saudi petrochemicals due to lower oil prices having reduced the competitive advantage of Saudi petrochemical companies relative to their international competitors. Petrochemicals and plastics account for more than 60 percent of the Kingdom's non-oil exports. Imports were also down by 10.5 percent year-on-year, more than the monthly trade data. Latest available data for the first ten months of 2015 showed that imports were 5 percent down from the same period in 2014. Data on the other components of the current account were not published.

The economic outlook for 2016

We expect that the economy will continue to decelerate in 2016.

We expect that the economy will continue to decelerate in 2016, dragged down by slower growth in both the oil and non-oil sectors. Annual growth in the oil sector will remain positive in 2016 as gas production should support growth in the sector. The non-oil private sector will continue to grow albeit at a slower pace, as reduced government spending should continue to have a negative impact on business activity. However, we think that government will maintain a level of spending high enough to continue supporting positive growth in the non-oil private sector. While we expect the NTP announcement in early 2016 to include major initiatives and reforms to stimulate private sector activity, we believe that the impact of these initiatives will only start be felt towards the end of the year. These initiatives are expected to include investment and non-oil export promotion, as well as regulatory, administrative, and financial reform.

Economic growth in Saudi Arabia is forecast to slow to 1.9 percent in 2016.

Economic growth in Saudi Arabia is forecast to slow to 1.9 percent in 2016, owing to a slower growth in both the oil and non-oil sectors. Based on the available data, we expect oil sector growth to reach 0.9 percent despite a marginal decline in oil production. We think that forthcoming increases in domestic gas production will support the growth in the sector during 2016. Within the non-oil sector, we expect the government's real GDP to expand 2.5 percent year-on-

The non-oil private sector is expected to expand by 2.8 percent, slowing down from 3.7 percent in 2015.

year due to our expectation of continued spending to meet demand on government services, while the non-oil private sector is expected to expand by 2.8 percent, slowing down from 3.7 percent in 2015. We believe that the private sector will continue to feel the sentimental impact of lower oil prices, while lower government spending will limit any potential for an acceleration in growth for some businesses. From a sectorial point of view, we expect transportation and utilities, the main beneficiaries of government spending on key social infrastructure, as well as the service based wholesale and retail sector, to be the fastest growing sectors of the economy in 2016.

2015 results and 2016 Jadwa forecasts

	2015 Actual	2016 Jadwa Forecast
Real GDP (% change)	3.4	1.9
Nominal GDP (% change)	-12.5	1.6
Inflation (2007 =100, %)	2.2	2.5
Current account deficit (SR billion)	-155	-150

Inflation is expected to record an acceleration in 2016, but remain relatively low compared to previous years.

Investment income will rise, benefiting from the higher interest rate environment…

...this will cause the current account to record a larger deficit at 6.3 percent of GDP.

Inflation is expected to record an acceleration in 2016, but remain relatively low compared to previous years. We think that reform to energy prices will be a major driver for inflation in the short-term. In addition, the housing segment has been the largest contributor towards headline inflation throughout 2015. more home-seekers will continue to rent property in 2016 in anticipation that affordable housing may be available soon for purchase. This should push up demand for rental units and put further pressure on the rentals for housing segment. We also maintain our view that there will be some local inflationary pressure as a result of the high level of consumer spending. Pressure on domestic foodstuffs will likely remain subdued as international food prices continue their deflationary trend. Despite the heightened speculative trading against the Saudi Riyal in the forward market, we do not foresee any changes to the Riyal's peg to the Dollar. The stronger outlook for the US Dollar and the prospect of higher interest rates may also put further downward pressure on prices of imports. Oil exports are forecast to fall slightly, while imports will remain unchanged from their 2015 level. Investment income will rise, benefiting from the higher interest rate environment. This will cause the current account to record a smaller deficit at 6.3 percent of GDP.

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