SAUDI ARABIA

Cheap oil continues to test the economic resilience of the Kingdom of Saudi Arabia (KSA). In the first half of 2016, the authorities switched gears from an ad hoc approach to a medium- and long-term strategy to counter the growing challenges posed by the new reality of oil markets. With unfolding fiscal consolidation efforts, tradeoffs between fiscal sustainability and public spending driven growth will manifest themselves in favor of the former.

Recent developments

Low oil prices continue to threaten growth and fiscal sustainability in the Kingdom of Saudi Arabia (KSA). Despite a recent recovery, at US$45 per barrel as of July 2016, prices remain 60 percent below their peak in June 2014. With hydrocarbons accounting for about 80 percent of fiscal revenues and more than 40 percent of GDP (Figure 1), the KSA remains vulnerable to subdued prices.

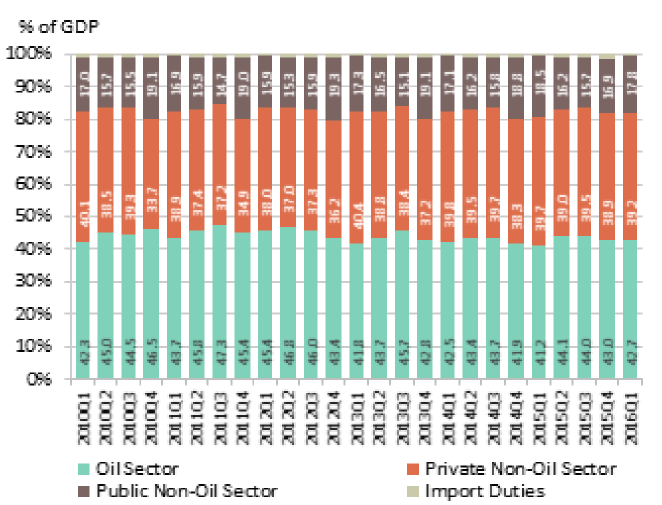
The Government of the Kingdom of Saudi Arabia (GoKSA) initially responded to the oil price slump with a counter-cyclical reflex: oil output was increased from 9.7 million barrels per day (bpd) in 2014 to 10.1 million bpd in 2015, and fiscal expenditure cuts were contained at 2.5 percentage points of GDP. However, despite keeping growth at 3.4 percent in 2015, with sharply decreasing revenues, this approach triggered a twin-deficit: a fiscal deficit estimated at 15.2 percent of GDP and a current account deficit estimated at 8.3 percent of GDP. Deficits were largely financed by using SAMA's reserves, which dropped from USD 727 billion in 2014 to USD 612 billion (106 percent of GDP) by the end of 2015.

Concerned with the potentially protracted nature of these deficits, the authorities moved to consolidate the medium-term fiscal outlook. Initial measures included a 2.5 percent tax on undeveloped land, US$23 airport fee for foreigners, and increases in fuel, gas and water prices. In addition, a 5 percent Value Added Tax (VAT) and additional taxes on tobacco and soft drinks, have been announced, but implementation may take time. The major shift in policies, however, came with the announcement of Vision 2030 and the National Transformation Plan (NTP) in the second quarter of 2016.

The Vision aims to revamp the scope of public investments, raise the private sector's share in the economy, and rationalize government expenditures. Key reforms include an ambitious subsidy reform program; increased transparency and government efficiency; partnerships with private investors to localize renewable energy and industrial equipment sectors. An IPO of about 5 percent of ARAMCO – KSA's oil company with an estimated value at US$2 trillion, is also planned. The NTP aims to fulfill the Vision 2030 objectives by: (i) identifying strategic objectives and targets for participating agencies; (ii) translating the objectives to initiatives with implementation plans and feasibility studies; and (iii) promoting joint action for a number of national priorities. The actionable implications of this framework involve a number of strategic objectives assigned to individual entities. Progress in each of these objectives will be monitored by a set of indicators and associated targets until 2020.

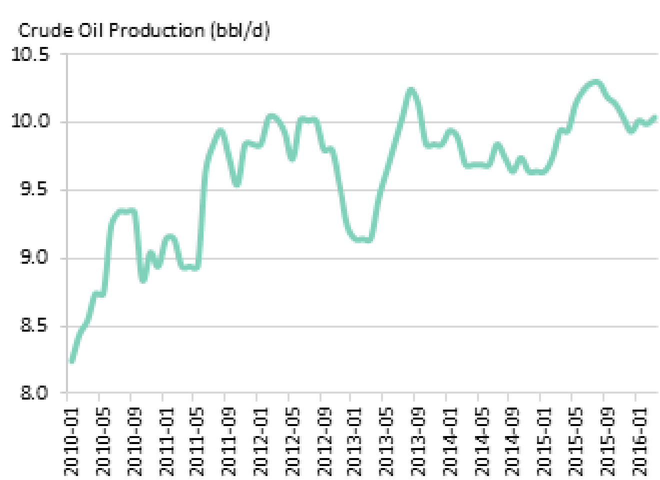
Monetary policy remains constrained by the peg to the US dollar. While the peg provides stability and predictability, it has also led to about 40 percent real appreciation in KSA's effective exchange rate against major trading partners since July 2008.

FIGURE 1 Saudi Arabia / Institutional composition of the GDP (Constant Prices)



Sources: KSA General Authority for Statistics.

FIGURE 2 Saudi Arabia / Crude oil production in the KSA



Sources: US Energy Information Administration.

Although the NTP should have significant implication for welfare of Kingdom's citizens, the plan does not include a direct focus on these issues. Further improvements in welfare measurement and analysis capacity would contribute to better design of policies to mitigate the impact of the ongoing fiscal consolidation on the well-being of the national population.

Outlook

With fiscal consolidation progressing, amid weakening investor and consumer sentiment, both government and private consumption are expected to slow in 2016. Based on Q1 performance (Figure 2), oil production is unlikely to fully offset these losses. Overall, growth is projected to slow to 1.0 percent in 2016 and to accelerate gradually to 1.6 percent and 2.5 percent in 2017 and 2018, respectively.

On the external side, the current account is projected to remain in the red, at 9.5 percent of GDP in 2016. Going forward, export prices should recover gradually in 2017 and 2018. With slower recovery in imports, the current account should revert to small surpluses from 2018 onwards.

The fiscal outlook is stable in the short term with large reserves held by SAMA. However, with US$43 average oil price in 2016 (the latest World Bank projections) current fiscal measures are insufficient, and the fiscal deficit is projected to remain at 13.6 percent of GDP. Efforts to raise non -oil revenues will likely yield some (albeit modest) savings and expenditure cuts will occur gradually, focusing primarily on the capital budget. These measures are projected to gradually reduce the overall fiscal deficit-to-GDP ratio.

Inflation should be restrained by fiscal contraction on the demand side, but be supported by hikes in utility prices. Social indicators may deteriorate along with fiscal consolidation and lower incomes, but data to assess the risks and vulnerabilities are not available.

Risks and challenges

With significant dependency on hydrocarbons, the Kingdom's economic outlook is remarkably sensitive to oil price movements. Although fiscal deficits are not likely to pose serious sustainability challenges in the short term, they will lead to erosion of accumulated reserves and increases in the public debt (the authorities are likely to rely on both methods to avoid any sharp movements in either indicator) over the medium term.

The National Transformation Plan provides an important vehicle for maintaining fiscal sustainability and promoting diversification. However, in the absence of an overarching medium-term macroeconomic and fiscal framework, the reforms may remain partial and uncoordinated across various implementing agencies.

TABLE 1 **Saudi Arabia** / Macro outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	2.7	3.6	3.4	1.0	1.6	2.5
Private Consumption	3.2	6.1	4.0	1.8	2.5	3.5
Government Consumption	11.1	12.0	3.9	-1.1	1.8	1.8
Gross Fixed Capital Investment	5.6	7.5	4.5	0.7	2.6	4.5
Exports, Goods and Services	0.2	1.7	3.0	2.1	0.9	1.8
Imports, Goods and Services	3.7	11.3	5.2	1.5	2.5	3.8
Real GDP growth, at constant factor prices	2.7	3.5	3.4	1.0	1.6	2.5
Agriculture	1.9	1.8	1.1	-0.2	-0.1	0.2
Industry	0.2	2.7	3.8	0.4	0.8	1.4
Services	6.5	4.7	2.9	1.9	2.9	4.0
Inflation (Consumer Price Index)	3.5	2.7	2.2	4.3	4.1	4.2
Current Account Balance (% of GDP)	18.3	9.7	-8.3	-9.5	-3.4	0.6
Fiscal Balance (% of GDP)	5.8	-3.6	-15.2	-13.6	-9.5	-6.6
Primary Balance (% of GDP)	6.0	-3.5	-14.8	-13.2	-8.1	-6.5

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.