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Saudi Arabia: Reaping the benefits of reforms and effective policymaking

Effective policymaking and the ongoing economic/structural reforms have put the Saudi economy on the right track to continue faring well within the Vision 2030 umbrella. Amid this positive outlook, we forecast non-oil growth to average 3.4% in 2022-2024 and the fiscal deficit to fall below 1% of GDP by 2023. As for the oil market, KSA has been playing a leading role within OPEC+ to rebalance the global market, and much of the success in terms of that can be attributed to the Kingdom's effective strategy. Total GDP is expected to grow by an average of 3.7% in 2022-24 given that the oil sector should support growth going forward after being a drag since 2019.

Raja Ghoussoub
Senior Economist
+965 2259 5356
rajaghoussoub@nbk.com

Robust growth driven by the oil and the non-oil private sector

The non-oil economy has been resilient since the outbreak of Covid-19, contracting by a limited 2.3% in 2020 then recovering by a relatively strong 5.4% y/y in 1H2021 (2% higher than pre-pandemic levels of 1H2019). We believe this robust performance was an outcome of the reform momentum that started in 2016, a timely and well-targeted fiscal/monetary stimulus, and a generally successful control of the Covid-19 spread that included a relatively quick vaccination rollout (65%+ of the population fully vaccinated). The recovery was mostly driven by the private sector (+7.5% in 1H2021), while the less-pandemic-impacted government sector was up by 0.8%.

The manufacturing sector saw the highest growth rate of 11.9% in 1H2021 helped by the several initiatives taken to develop that sector, in line with the National Industrial Development and Logistics Program (NIDLP), one of the key Vision 2030 programs. The manufacturing sector is benefiting from two key pillars of the NIDLP, which are the requirement to increase local content and the target to boost non-oil exports.

In terms of GDP components, private sector consumption led the recovery with a 10.8% increase in 1H2021. This resilient growth is reflected in an 11% y/y increase in consumer spending (value of POS transactions, ATM withdrawals, and e-commerce using MADA cards) in the first ten months of 2021, following a marginal decrease (-1%) in 2020.

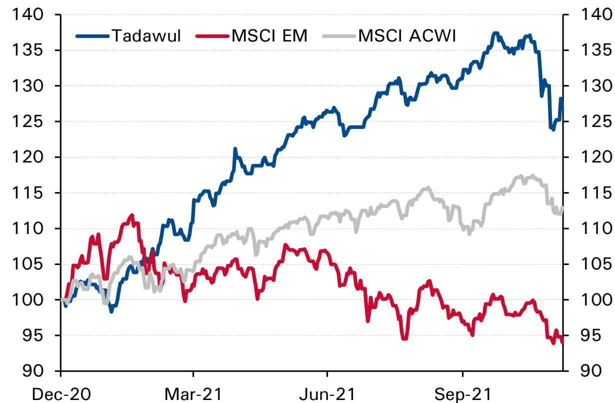
While the recovery lost some momentum in 2Q2021, with non-oil output falling by a seasonally-adjusted 0.5% q/q, official flash estimates for GDP in 3Q2021 indicate a solid non-oil private sector rebound of around 1.6% q/q (seasonally adjusted). We expect the strong momentum to continue in 4Q2021, resulting in a 4.6% non-oil expansion for the full year.

Effective policymaking and reforms to unlock non-oil growth

Effective policymaking, ongoing reforms, the launch of the National Investment Strategy (NIS), and the Public Investment Fund's (PIF) commitment to invest at least SAR 150 billion annually in 2021-2025 (versus an estimated average of SAR 77 billion in 2019-2020) in the local economy underpin a robust growth outlook. We forecast non-oil growth to average 3.4% in 2022-2024, led by the private sector.

Chart 1: Stock market performance

(Rebased to 100)



Source: Refinitiv

Reflecting this positive outlook, the Saudi Exchange (Tadawul) is up by more than 25% YTD, reaching levels unseen since more than 10 years, and outperforming the MSCI Emerging Markets Index and the MSCI All Countries World Index by a wide margin.

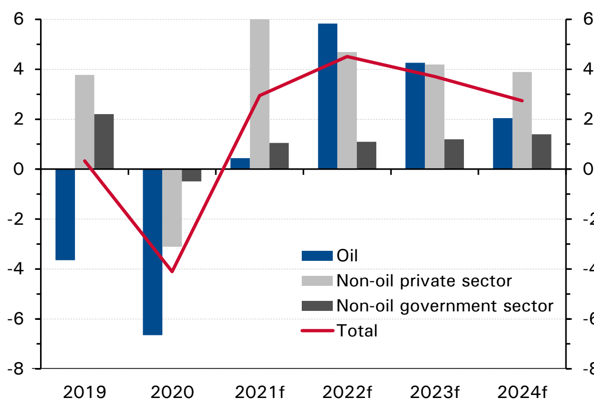
The recently-launched NIS is an ambitious strategy to propel the Saudi economy to be among the 15th largest globally by significantly increasing investment, both local and FDI, in the economy. In addition to cumulative PIF investments worth SAR 3 trillion by 2030, it targets SAR 5 trillion investments from the Shareek program (24 of the largest Saudi companies, led by Aramco and SABIC) and an additional SAR 4 trillion from other Saudi and foreign companies. By 2030, some of the NIS targets are for private-sector investment to account for 30% of GDP (up from 23% in 2020) and for FDI to represent 6% of GDP, reaching around $103 billion on an annual basis ($5.4 billion in 2020, $15.6 billion in 1H2021).

Oil GDP is forecast to expand through 2024; capacity hike should not conflict with net-zero pledge

As for the oil sector, KSA has been playing a leading role within OPEC+ to rebalance the global market, and much of the success in terms of that can be attributed to the Kingdom's effective strategy. While the oil sector has been a drag on GDP growth since 2019, it is expected to support growth going forward given higher oil production as per the OPEC+ agreement, and we forecast oil GDP to grow by an average of 4% in 2022-24 after a slight increase (+0.4%) this year. The country's pledge to attain net-zero emissions by 2060 should not conflict with higher oil production going forward given that the strategy will rely heavily on carbon capture, as mentioned by the authorities. In fact, Aramco is going ahead with the plan to increase production capacity to 13 mb/d from the current 12 mb/d.

Chart 2: Real GDP growth

(% y/y)



Source: General Authority for Statistics (GASTAT), NBK forecasts

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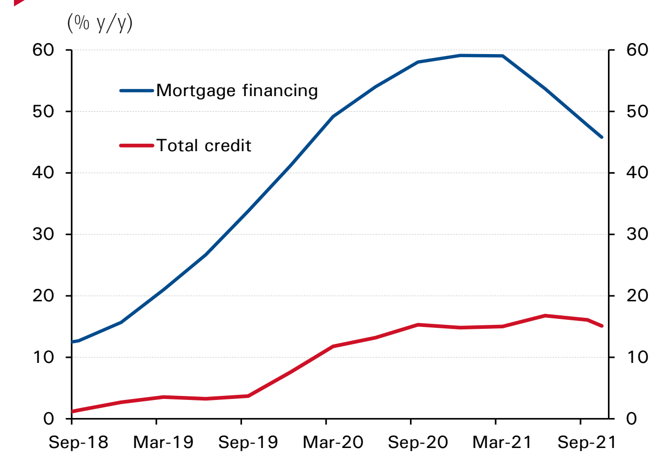
However, if oil market dynamics result in a sustained weakening in oil prices, it will not be surprising if KSA again takes the lead in terms of the willingness to cut production given its leading role within OPEC+, which will impact our oil GDP growth forecast. All in all, total GDP is expected to grow by an average of 3.7% in 2022-24, after a softer 2.9% projected expansion in 2021 that is being held back by the oil sector.

Inflation to normalize following the VAT-induced spike

Following the tripling of VAT to 15% in July 2020, inflation increased to 3.4% in 2020. While the yearly increase in consumer prices softened to 0.8% through October, this relatively low inflation level continues to be strongly impacted by falling housing rents (-2.6% y/y, 21% weight in the basket), which have been dropping for more than three years, mainly driven by lower demand given the strong push to increase home ownership rates. Nevertheless, average inflation for the full year will likely end at around 3.1% (given that the VAT hike had still impacted 1H2021 inflation levels), before normalizing to 2% in 2022-24.

Chart 3: Growth in total credit and mortgage financing

(% y/y)



Source: SAMA

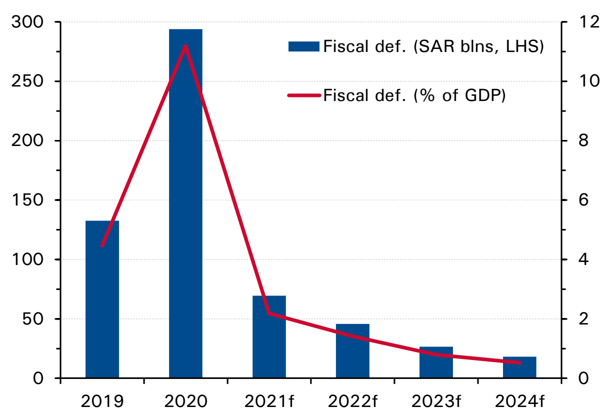
Mortgage lending growth is expected to soften but remain high

Credit growth remained solid at 15.1% y/y through October, in line with the 14.8% recorded in 2020, as higher growth in personal non-mortgage credit compensated the slower growth in mortgage lending. Growth in mortgage lending is expected to remain strong, though it will likely soften further from the 46% y/y through October (peaked at around 60% in early 2021), given a much-higher base and the fact that Saudi home ownership had already exceeded its prior targets, and is on track to reach the targeted 70% rate even before 2030 as originally envisioned.

Fiscal position on a sustainable footing

Following the pandemic-induced deterioration in 2020 when the fiscal deficit widened to 11.2% of GDP, the narrowing of the deficit was sharp in 9M2021 on soaring non-oil revenues, higher oil prices, and spending restraint. Revenues increased by 29% y/y in 9M2021 as oil revenues were up 25% on higher oil prices, while non-oil revenues expanded 33% driven by higher tax receipts. The hiking of the VAT to 15% last year resulted in a solid increase in VAT receipts for the government, which we estimate at around 8% to 8.5% of non-oil GDP in 2021.

Chart 4: Fiscal deficit



Source: Ministry of Finance, GASTAT, NBK forecasts

In contrast, expenditures dropped by 3% in 9M2021 as current spending was broadly flat, while capital spending was cut by 29%. The fiscal deficit dropped to less than 0.5% of GDP in 9M2021. However, given seasonal spending patterns (spending highest in Q4)

and the fact that 4Q2020 likely included some material non-oil revenue one-offs that may be difficult to sustain in the same magnitude this year, we forecast the deficit to stand at around 2.2% for the full year.

Looking ahead, given the increase in oil production and the government's unwavering commitment to continue expanding non-oil revenues and rationalizing spending in line with Vision 2030, we forecast a steady and gradual improvement in the deficit to less than 1% of GDP by 2023.

The expansion in non-oil revenues in the past few years has been impressive, consistently recording double-digit annual growth despite an increasing base. This resulted in non-oil revenues accounting for 47% of total revenues in 2020 (and 43% in 9M2021) up from 27% in 2015. While this non-oil revenue stream across the years included some material one-offs, one challenge going forward is to replace these one-offs with more sustainable non-oil revenue flows.

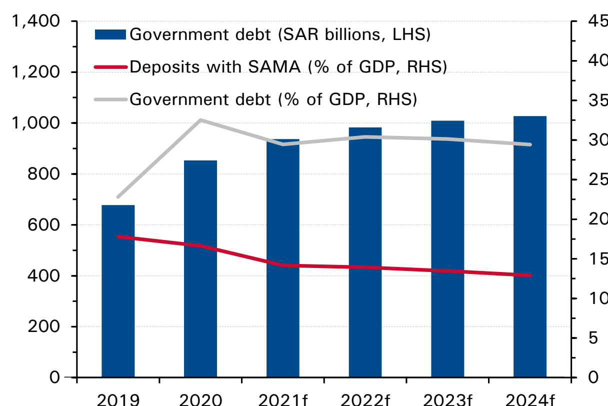
In terms of expenditures, a key matter is that capital spending will be increasingly driven by the PIF, other governmental funds, and the private sector. In fact, on-budget capital spending is already playing a less important role compared with history falling to a budgeted SAR 101 billion in 2021 from SAR 208 billion in 2017. Another probably even more important matter is that on-budget government spending (current and capital) is not expected to increase much through 2030, in a striking difference with the past when government spending trended upwards through the years. The authorities mentioned that government spending should be around SAR 10 trillion between 2021 and 2030, implying an average of SAR 1,000 billion per year, which is broadly in-line with the government's SAR 1,015 billion estimate for 2021 and SAR 955 billion budget for 2022. The government's target here is that the efficiency of this broadly-stable annual government spending level should increase driven by reforms, privatizations, digitization, etc.

Although a deficit of less than 1% of GDP by 2023 (as per our base case forecast) already reflects a favorable outlook for the fiscal position, an even rosier outcome (such as recording budget surpluses during the forecast horizon) could materialize if higher-than-expected oil prices are recorded; our forecast reflects average Brent prices of $63 in 2022 and $60 in 2023-24. In addition, opening up additional sustainable non-oil revenue streams and/or keeping government spending strictly in line with budgeted levels may result in flipping the fiscal account into surplus in as early as 2023, as envisioned by the government.

Debt/GDP is forecast to remain broadly stable at around 30%-31%

Beyond 2021, we expect fiscal deficits to be financed fully through debt issuances without tapping government deposits at SAMA. Despite that, and given the relatively limited projected deficits and robust growth in GDP, we see the debt/GDP ratio staying below 31% through 2024, significantly lower than the 50% self-imposed cap.

Chart 5: Government debt and deposits with SAMA



Source: GASTAT, Ministry of Finance, SAMA, NBK forecasts

Non-oil exports exceeded pre-pandemic levels, hitting an all-time high

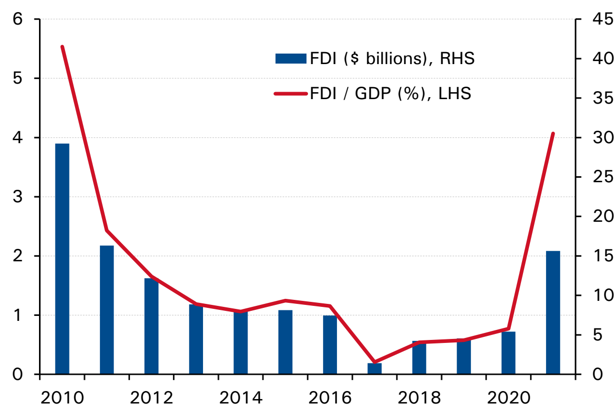
The current account slightly dipped in to the red in 2020 (-3.1% of GDP) driven by a 40% plummet in oil exports on the back of lower oil prices and production. However, we forecast the current account to return to surplus of around 5% of GDP in 2021 on higher oil prices and a strong rebound in non-oil exports. The latter exceeded pre-pandemic

levels (in 9M2021, 15% above the same period in 2019), hitting an all-time monthly high in September. Boosting non-oil exports is one of the main pillars of Vision 2030, which targets non-oil exports to account for as much as 50% of non-oil GDP by 2030 (12% in 1H2021). While that target seems very ambitious, the many initiatives taken to support non-oil exports should see the ratio of non-oil exports/GDP trend higher going forward, which will be favorable for economic diversification, job creation, and the balance of payments. The latter has been showing improving trends as can be seen in SAMA's reserve assets, which have been broadly flat YTD through October (after dropping 9% in 2020) to stand at $451 billion (53% of 2021F GDP). The nearly $14 billion in new Special Drawing Rights that were allocated to KSA by the IMF in August supported that level of reserves. Nevertheless, even with excluding that, reserve assets would have decreased by a limited 3.5% YTD through October.

FDI jumped sharply in 2Q2021 boosted by Aramco's oil pipeline sale

As mentioned before, boosting FDI is a main pillar of the NIS and has been assigned very high targets by 2030 (6% of GDP). After hitting a low in 2017, FDI steadily improved reaching $5.4 billion in 2020 (less than 1% of GDP) though remains well below the peak years of 2008-2010 when annual FDI recorded $30 to $40 billion. Flows continued to improve this year, soaring to $13.8bn in 2Q2021 (7.1% of GDP), nearly matching the combined flows for the last three years. This surge has been mainly driven by Aramco's $12.4 billion deal to sell a 49% stake in its oil pipelines to a global investment consortium. However, even with excluding that deal, FDI would have increased by 60% y/y as per the Minister of Investment, indicating robust broad-based FDI trends.

Chart 6: Foreign Direct Investment



Source: GASTAT, SAMA

Significant benefit to be derived from privatizations and the tourism/entertainment sector

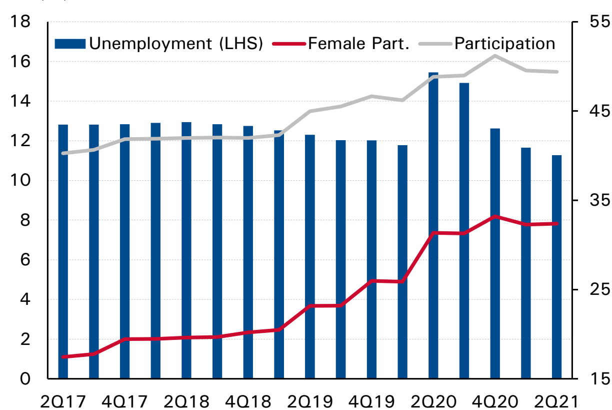
Other than the key transaction of selling 1.5% of Aramco's shares, privatization of state-owned entities (a key pillar of Vision 2030) has been relatively limited but should pick up going forward following the passage of the private sector participation law in March 2021, and which became effective in July. The government has identified 160 projects (privatizations and public-private partnerships) across 16 sectors, targeting to raise $55 billion by 2025. Success on that front will not only give a boost to the public finances but should also improve the quality of the services offered, increase productivity, decrease costs for the government, and attract FDI. On another note, significant potential to unlock non-oil growth can be achieved through developing tourism (including domestic tourism), or more generally, the entertainment industry, which are objectives that fall under Vision 2030's Quality of Life Program. Tourism accounts for a relatively small share of the economy (estimated by the authorities at around 4% in 2021), and therefore has significant potential to grow if it were a focus area for the government, which it is; in fact, the government has put a 10% target for the share of tourism in the economy by 2030. Given the very low base currently, expanding the entertainment/tourism sector not only would mean a higher number of inbound foreign tourists, but it would also result in Saudis/residents spending more money domestically (rather than spending it abroad), which will have a multiplier effect on economic output.

Labor participation rate among Saudi females nearly doubled in four years....

With the onset of the pandemic and the imposition of lockdowns, the unemployment rate among Saudis had jumped from a then-recent low of 11.8% in 1Q2020 to 15.4% in 2Q2020. Given the recovery that is underway and staunch Saudization initiatives, the unemployment rate already undershot pre-pandemic levels, standing at 11.3% in 2Q2021. Moreover, this lower unemployment rate is concurrent with a higher participation rate of 49.4% in 2Q2021 versus 48.8% one year before. In fact, the participation rate among Saudis has been steadily increasing, as it was 9 percentage points lower four years ago (40.3% in 2Q2017). This improvement was mainly driven by a near doubling of the participation rate of Saudi females, which increased from 17.4% in 2Q2017 to 32.4% in 2Q2021 on the back of the many reforms and initiatives taken to facilitate and encourage female employment in line with Vision 2030. Higher female participation/employment, while undoubtedly a step in the right direction from a societal point of view, will expand the country's potential output and be a key enabler of moving the economy closer to the targets envisioned as per Vision 2030.

Chart 7: Unemployment & labor participation among Saudis

(%)



Source: GASTAT

...but creating enough private sector jobs to hit Vision 2030 targets remains a challenge

While good improvement has happened in terms of lowering the unemployment rate and increasing female participation in the labor force, creating enough private-sector jobs to absorb the new supply of labor and continue lowering the unemployment rate (Vision 2030 targets an unemployment rate of 7% among Saudis by 2030) remains one of the key challenges facing policymakers in KSA.

Higher-than-forecast oil prices is a key upside risk to our forecast

As mentioned before, higher-than-forecast oil prices is a key upside risk to our forecast. In addition, a further easing of geopolitical risks (such as the conflict in Yemen and relations with Iran) will be an incremental positive development for the overall outlook. On the other hand, slower-than-projected momentum in terms of non-oil growth, which could materialize, for example, from lower-than-projected investment within the umbrella of the NIS and/or weaker-than-expected productivity gains is a main downside risk. In addition, weaker-than-forecast oil production given KSA's leading role within OPEC+ is another major downside risk to our forecast.

Finally, and as mentioned before, effective policymaking and the reform momentum are the key drivers for the country's favorable outlook. Some of the key recent reforms and policy initiatives included a wide array of areas such as investment strategy, public procurement, transport/logistics, FinTech, personal data protection, education, legal/judicial, labor, privatization, competition, and many other societal matters. Successful reforms will increase overall productivity, improve spending efficiency, attract FDI and, in the process, unlock significant private sector growth potential. Although not our base-case expectation, a slowdown or stalling of the reform momentum is a downside risk to the outlook.

T: (965) 2259 5500, econ@nbk.com, © 2021 NBK

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

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