Macroeconomic outlook

Saudi Arabia: Non-oil growth to edge up; fiscal reforms proceed apace

Overview and outlook

- GDP will fall by 0.6% in 2017 on adherence to crude output cuts under the terms of the OPEC agreement. Non-oil growth is expected at 0.8% this year and 1.1% in 2018, on the back of rising consumer activity and government spending.
- The fiscal deficit should halve to 8.0% of GDP in 2017 on higher oil prices, new non-oil revenue measures and only modest spending increases. The goal of balancing the budget by 2020 is not unrealistic.
- The deficit will continue to be financed through debt issuance and reserve drawdowns, leading to a peak debt/GDP ratio of 24% in 2018.
- Bond sales and deposit growth have improved banking sector liquidity.
- The stock market index is up 33% over the past year on improved investor sentiment due to higher oil prices, as well as economic and regulatory reform.

More than three years into the oil price downturn and the Saudi economy continues grapple with subdued domestic demand, lower consumer confidence and the effects of the pullback in government spending. Energy and utility subsidies have been curtailed, taxes have been introduced, public sector bonuses have been frozen (though now reinstated) and government ministries have been subjected to a concerted cost-cutting and efficiency drive.

These and other measures, including privatization and localization, were undertaken as part of the authorities’ triumvirate of economic development initiatives: the National Transformation Program 2020 (NTP), the Fiscal Balance Program (FBP) and the overarching strategic Saudi Vision 2030 plan. Long overdue, they were generally welcomed by the economic community for their onus on fiscal sustainability and economic diversification. But while the kingdom’s finances are on a somewhat firmer footing, with the fiscal deficit forecast to narrow in 2017 for the first time in three years, consumer activity has been negatively affected. And this year, as Saudi Arabia institutes the 4.6% cut to its crude oil production mandated by last November’s OPEC/non-OPEC agreement, GDP is expected to contract for the first time since 2009.

Key economic indicators

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<thead>
<tr>
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<th>2015</th>
<th>2016</th>
<th>2017f</th>
<th>2018f</th>
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<tbody>
<tr>
<td>Real GDP growth</td>
<td>-4.1</td>
<td>1.7</td>
<td>-0.6</td>
<td>0.9</td>
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<tr>
<td>Oil</td>
<td>5.3</td>
<td>3.8</td>
<td>-2.3</td>
<td>0.5</td>
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<tr>
<td>Non-oil</td>
<td>3.2</td>
<td>0.2</td>
<td>0.8</td>
<td>1.1</td>
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<tr>
<td>Inflation</td>
<td>2.2</td>
<td>3.5</td>
<td>0.2</td>
<td>2.5</td>
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<tr>
<td>Fiscal balance</td>
<td>-15.0</td>
<td>-16.6</td>
<td>-8.1</td>
<td>-4.8</td>
</tr>
<tr>
<td>Public debt</td>
<td>5.8</td>
<td>13.1</td>
<td>17.8</td>
<td>24.8</td>
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Sources: Official sources and NBK estimates
Indeed, the authorities, mindful of the socio-economic impact of pursuing too frenetic a pace of reform, have recently indicated that the NTP is being reappraised. More realistic goals and timeframes are being worked out ahead of the release of version 2.0, which is slated for October.

Headline GDP to fall on crude oil output cuts, but non-oil activity showing signs of picking up

With the kingdom going above and beyond its OPEC production cut obligation, cutting close to 5% from its reference level output (9.95 mb/d in August), our forecast for growth this year sees a sizeable weakening to -0.6% from 1.7% in 2016. (Charts 1 & 2.)

Next year, we expect GDP to rebound by 0.9% as both oil and non-oil growth recover. The former will improve thanks to a slight increase in oil and gas production, while the latter will benefit from more buoyant consumer spending and a more expansive government fiscal stance. The reinstatement of public sector bonuses will certainly provide a welcome boost to domestic demand, although this may have to be tempered by the second round of energy cuts, reportedly due for implementation in October, which will once more, adversely affect disposable incomes.

Recent evidence on the non-oil economy has been mixed. In the first half of this year, overall GDP declined 0.8% y/y, with the drag coming mostly from decreased oil and gas production, while the private sector grew a disappointing 0.7% y/y. Key indicators of consumer spending, such as point of sale/ATM transactions, purchasing managers’ indices (PMIs) and private sector credit growth, have begun to tick up again, albeit slowly. (Charts 3-5.) Private sector credit growth and consumer loan growth, in particular, at -1.5% y/y in July and -0.8% y/y in June, respectively, are not at levels sufficient to facilitate the kind of private sector activity that the authorities envisage as per the Saudi Vision 2030.

Social indicators, specifically Saudi unemployment and female labor force participation, are still a cause for concern

Saudi unemployment, which the authorities hope to lower to a rate of 9% by 2020, and female participation, which they hope to raise to 28%, are moving in the opposite direction. Unemployment reached 12.7% in 1Q17, up from 12.3% in 2016, with some evidence to suggest that the cause was a fall in employment rather than an increase in the Saudi labor force. (Chart 6.) In fact, the Saudi labor force appears to have contracted between 4Q16 and 1Q17, by as much as 160,000 persons. 120,000 (80%) of these are females exiting the labor market. This brought the female participation rate down from 19.3% in 4Q16 to 17.4% in 1Q17.

But things are slowly changing. The landmark royal decree in September permitting women to drive from June 2018 for the very first time is immensely significant for both social and economic development in the kingdom. As well as the direct gains to the automotive, insurance and consumer industries, there is the much larger productivity dividend that could accrue from higher female workforce participation.

Deflation so far in 2017, but price rises expected in 2018 not least due to the introduction of VAT

With domestic demand under pressure, it is perhaps not surprising that the Saudi non-oil economy has been beset by deflation through 2017. Consumer prices were still falling 0.1% y/y in August, with housing, food and transportation, the largest three contributors to the index by weight, all in negative territory. (Chart 7.) In fact, were it not for the imposition of the so-called ‘sin tax’ on sugary drinks and tobacco in June, which pushed up prices in both the food & beverages and tobacco categories (by almost
100% y/y in the latter), deflation would have been even greater. With demand subdued, we don’t expect inflation to move beyond 0.2% on average this year. 2018 will be a different story, however, with prices projected to rise 2.5% on average after the introduction of a VAT (at a 5% rate) in January and on a general recovery in consumer spending. Continued weakness in the US dollar, which pushes up the cost of imported goods from outside the US, will also be a factor.

**Improved fiscal footing due to higher oil prices and fiscal consolidation**

The government’s fiscal position in 2017 appears to have improved. The fiscal deficit halved from SR149 billion ($40 billion) in 1H16 to SR73 billion ($19 billion) by 1H17, which is lower than the government’s pro-rata budget forecast of SR99 billion ($26 billion). Granted, this largely reflects an improvement in oil revenues, which were up 63% y/y thanks to higher oil prices (total revenues increased by 6% y/y), but also some fiscal restraint, with expenditures down by 1.9% y/y after the government reinied in project and procurements costs, froze public sector salaries and cut allowances.

The latter’s reinstatement in July will raise government expenditures going forward, as will higher outlays on both infrastructure projects, which usually pick up in the second half of the year, and interest payments due to the authorities’ burgeoning international bond and domestic sukuk program. Were the government to roll out the second round of energy subsidy cuts in October, specifically targeting gasoline and fuel oil, then it could count on some additional savings. According to the FBP, the estimated cumulative savings to the Saudi treasury could amount to SR209 billion ($55 billion) by 2020, equivalent to 8.7% of 2016 GDP.

The government will, therefore, probably just about meet its spending targets for this year, pushing up spending by 6% budget-on-budget and 8% versus realized expenditures in 2016 (if you exclude the SR105 billion in delayed payments to contractors that accrued from 2015). 2018 should see spending rise by another 4.3%, assuming that oil prices do not fall.

Non-oil revenues should receive a welcome boost this year from the imposition of several taxes, including the excise tax on sugary drinks and tobacco, the tax on expatriate workers’ dependents and the so-called ‘white’ lands tax (2.5%) on undeveloped land. The introduction of a VAT in 2018 alone could bring in SR22 billion ($5.8 billion), equivalent to 1.5% of non-oil GDP. All in all, the Saudi treasury could see additional inflows of SR150 billion ($40 billion) by 2020.

The fiscal deficit should, therefore, narrow this year to 8.1% of GDP from 16.6% of GDP in 2016. Next year will see further improvement to 4.8% of GDP. (Chart 8.) The authorities’ target of erasing the deficit entirely by 2020 is not unrealistic.

**Debt issuance key part of deficit financing, but government reserves continue to decline**

The authorities recently sold their third riyal-denominated sukuk (SR7 billion) since the summer, following the sale of the kingdom’s first international sukuk ($9 billion) in April and its first sovereign bond ($17.5 billion) in October 2016. In total, about SR120 billion ($32 billion) in debt is likely to be issued in 2017, which should cover about 58% of this year’s projected deficit. Bank holdings of government bonds have, consequently, risen, by 29% y/y to SR216 billion ($58 billion). (Chart 9.)

But government deposits at SAMA have continued to draw down (by 32% y/y in July), albeit at a slower rate of SR8.5 billion per month this year (SR80 billion cumulative) compared to SR24 billion per month last year.
(for a cumulative total of SR 293 billion). (Chart 10.) The kingdom’s foreign reserves are down to $494 billion as of July, which is the lowest they have been seen 2011. Import cover is still around a comfortable 30 months, though. (Chart 11.)

Government debt to peak at 24% of GDP in 2018, but external creditors still view Saudi sovereign debt favorably

With the government’s bond issuance program proceeding apace, gross public debt is expected to reach SR458 billion ($122 billion), or 17.8% of GDP, this year. (Chart 12.) The authorities have indicated that further sovereign international bond issuances could be in the offing this year and next, which could push total debt up to a peak of around 24% of GDP in 2018. The government has capped the maximum permissible level of debt at 30% of GDP by 2020.

Creditors, both domestic and external, however, continue to view the kingdom favorably, brushing off the one-notch ratings downgrade by Fitch earlier in the year (from AA- to A+). Both international and domestic bond and sukuk issuances have been heavily oversubscribed. Yields on Saudi government have trended lower in 2017; although there has been a slight uptick in recent weeks to around 2.7% for the 2021 bond. (Chart 13.) Even at a potential maximum of 30% of GDP, Saudi debt levels are still low by international standards; the kingdom also has sufficient financial reserves at its disposal.

Banking system liquidity improves as deposits grow

The sovereign bond issuances have injected much-needed liquidity into the banking system. Deposit growth has improved (3.3% y/y in July), especially in the context of lackluster credit growth and higher oil prices. Interbank rates have, consequently, trended lower, by about 60 bps, from their October 2016 peak of 2.39% to around 1.79%. (Chart 14.)

Outlook more bullish for Saudi equities, despite delay in bourse inclusion in key emerging market index

Higher oil prices, modernizing and liberalizing reforms by the regulatory authorities and the coveted potential MSC/FTSE EM inclusion have provided the backdrop for a general improvement in investor sentiment in recent months – though there was some disappointment when FTSE Russell ruled in September that Saudi had missed out on a classification upgrade with the decision to be reviewed next March. TASI, the main Saudi index, was up 33% y/y at the start of October at 7,224. (Chart 15.) The reinstatement of public sector allowances and solid second quarter corporate earnings have also been generally positive for equity valuations. 2018 should see some movement towards the showpiece of the Saudi Vision 2030: the part-privatization of Saudi Aramco. The listing of 5% of the energy giant could net at least $45 billion for the kingdom’s newly-designated SWF, the Public Investment Fund.