Economic Update

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Saudi Arabia outlook

Economic growth improving amid record government spending

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Highlights

- **Saudi economic growth is expected to increase from 2.3% in 2018 to 2.5% by 2020, with the government supporting non-oil activity through record public spending, investment and private sector stimulus programs.**
- **Public finances are on a more sustainable footing thanks to higher oil and non-oil revenues as well as more targeted spending; the fiscal deficit has narrowed to 4.6% of GDP in 2018 but may widen in 2019 on expected lower oil revenues.**
- **Government debt to reach 23.7% of GDP by 2020 due to continued deficit financing via bond and sukuk issuances.**
- **With private credit growth still weak (1.7% y/y in Oct 2018), rising cost of funds (as well as softer oil prices) could present a downside risk to the growth outlook.**

Positive growth outlook amid record government spending

The Saudi economy has recovered after last year's contraction, and is forecast to expand by 2.3% in 2018 on the back of record high oil production since mid-2018 and increases in non-oil sector activity. However, domestic and private sector demand has been sub-optimal, having been adversely affected by lackluster credit growth and rising costs such as the VAT, expatriate levies and higher cost of funds in the context of rising interest rates, as well as by the net loss of almost a million expatriate workers since 2017. At the same time, the Saudi unemployment rate has crept up, to 12.9% in 2018. But fiscal reform has, however, proceeded broadly in line with the government's Fiscal Balance Program, accruing savings and generating greater non-oil revenues. The fiscal deficit, has consequently, narrowed to 4.6% of GDP in 2018; public debt, though, has edged up to 19.4% of GDP.

Looking ahead to 2020, in view of Saudi Arabia's participation in a further round of OPEC+ production cuts, which will cap oil GDP growth, the non-oil sector will increasingly take the lead, with annual average gains of 3.2% expected thanks to elevated government spending, private sector stimulus and ongoing Vision 2030 business reforms. But the economy is likely to have to operate in an environment of softer oil prices, which could cause the fiscal deficit to widen in 2019.

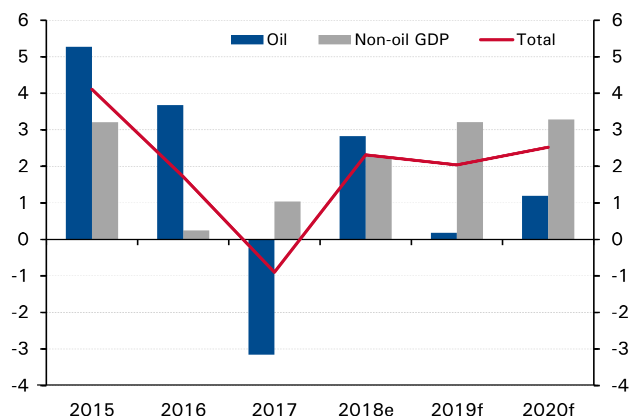
Table 1: Key economic indicators

		2017	2018e	2019f	2020f
Real GDP	% y/y	-0.9	2.3	2.0	2.5
- Oil	% y/y	-0.2	2.8	0.2	1.2
- Non-oil	% y/y	1.0	2.3	3.2	3.3
Inflation	% y/y	-0.8	2.5	2.1	2.2
Budget balance	% of GDP	-8.9	-4.6	-6.4	-4.1
Public debt	% of GDP	17.2	19.4	22.2	23.7

Source: Official sources, NBK estimates

Chart 1: Real GDP

(% y/y)



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

Oil output rebounds but non-oil activity to drive growth

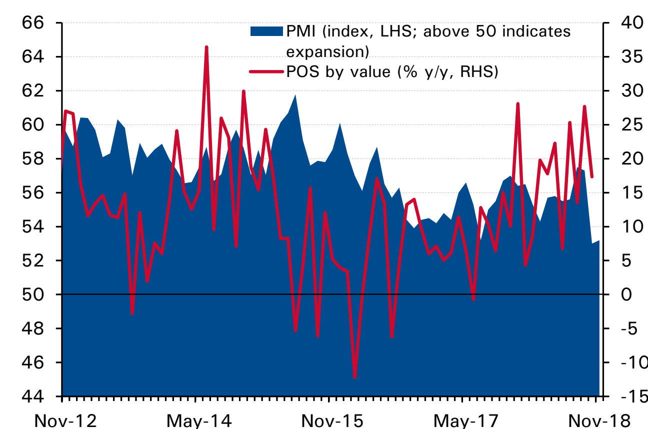
Saudi oil sector output in 2018 benefitted greatly from the OPEC+ decision in mid-2018 to boost crude production to offset falling Venezuelan and Iranian supplies, the latter due to US President Trump's decision to reinstate stringent energy sanctions on the Islamic Republic. Saudi crude production hit an all-time high of 11.09 mb/d in November, helping to realize real oil growth of around 2.8% in 2018. (Chart. 1)

However, with Saudi Arabia signing up to another round of

OPEC+ production cuts for the duration of 1H19 in order to stabilize oil prices that had dropped by more than 30% since October, crude output is not expected to increase above 10.2-10.3 mb/d. Consequently, oil GDP gains in 2019 and 2020, at 0.2% and 1.2%, respectively, will be limited, and reflect primarily increased gas production and crude flows to feed expanding refinery operations, namely the 400,000 b/d Jazan refinery, which went on line in 2018.

Nevertheless, it is on the non-oil sector that the kingdom's economic fortunes will ultimately rest.

Chart 2: Point of sale (POS) and PMI data



Source: SAMA, Markit/Emirates NBD

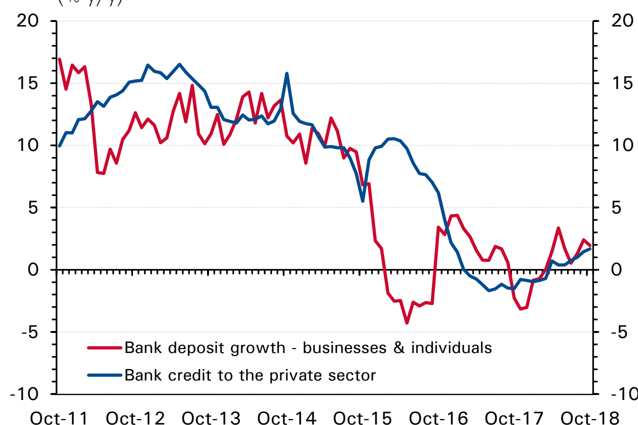
Saudi non-oil activity has been increasing amid record budget outlays of SR1 trillion-plus and a renewed government focus on the private sector—the second phase of the SR72 billion ($19bn), four-year private sector stimulus plan was launched in November—and on capital intensive projects. Billions have been pledged on housing, tourism, transportation, power and education projects.

Sectoral data released during the year confirmed the improvement in non-oil activity, with the manufacturing component of the industrial production index, up 16.4% y/y in 2Q18, and real manufacturing GDP growth increasing to 3.2% y/y. Real estate and financial services were also positive contributors, rising by 4.2% y/y. In terms of business and consumer activity, the value of point-of-sale (POS) transactions in October had increased by 17.3% y/y and the headline figure in the Saudi Purchasing Managers' Index (PMI) was up at a 2018-high of 55.2 in November. (Chart 2.)

Despite the gains, consumer activity remains below potential. The average PMI for 2018, at 53.7, is the lowest in the history of the survey—and well below 2011's avg. of 60—and private sector credit growth, though rising last October to a twenty-two month high of 1.7% y/y, is still a long way off the double digit growth rates of 2011-2015. (Chart 3.)

Still-subdued consumer confidence amid rising household costs—fuel and utilities, expatriate levies, tobacco and soft drinks and the 5% VAT—have undoubtedly played a part. Consumption was also affected by the net loss of almost a million expatriate workers since the start of 2017 in the face of rising expatriate fees and an acceleration in the government's Saudization policy.

Chart 3: Private sector credit and deposit growth



Source: SAMA

Recognizing the adverse effect on demand, the government created the citizens' and household allowance programs to mitigate some of the additional cost burdens and augmented citizen's take home with SR1000 ($266) in monthly allowances and, from 2019, bonus payments for public sector workers independent of performance. The government is also reportedly considering slowing down the scheduled rate of increase in expatriate fees to ease the cost burden on both expatriates (currently SR200 per expatriate dependent per month but due to double to SR400 by 2020) and firms (currently SR400 per month for every expat worker that exceeds a Saudi employee and due to rise to SR700-800 per month by 2020). Of course, firms also face the reality of hiring costlier Saudi workers, given their higher salary expectations.

Moreover, the Saudi unemployment rate continues to creep up. The government's Vision 2030 reform drive sought to reduce the rate to 7.0% from 11.6% in 2015. As of 2Q18, the figure had reached 12.9%—the fifth consecutive quarterly rise—as the Saudi labor force growth outpaces employment growth.

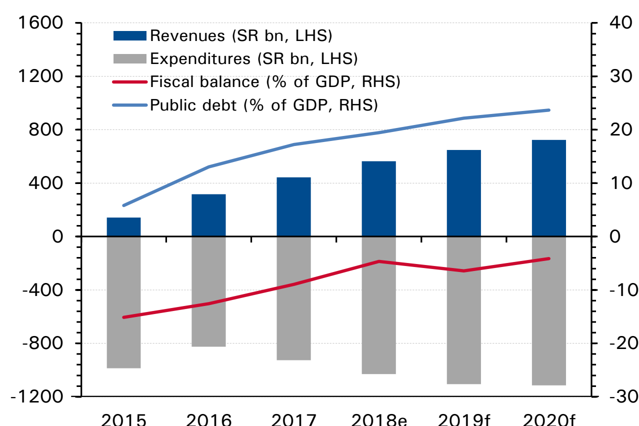
Inflation easing after the VAT-related spike in 2018

Inflation has moderated since the authorities rolled out the 5% value added tax (VAT) and instituted the second round of energy price hikes in January. Having been as high as 4.0% y/y in February, headline inflation slowed to 2.8% y/y in October 2018 on falling housing/utilities costs (25% of the CPI basket). We are not expecting inflation to increase much above 2% on average in 2019, from 2.5% in 2018, with inflationary impulses coming mainly from higher food, restaurant and transportation costs and in line with a pick-up in economic activity underpinned by the government's expansionary fiscal stance.

Fiscal deficit to narrow by 2020

The kingdom has made considerable improvement over the last few years in rationalizing public spending, creating viable non-oil revenue streams and, ultimately, bringing down the fiscal deficit from a peak of 15.1% of GDP in 2015 to an estimated 4.6% of GDP in 2018. (Chart 4.)

Chart 4: Fiscal balance and public debt



Source: Ministry of Finance, NBK estimates

The narrower fiscal deficit of 2018 was the result of revenue growth (+29% y/y to SR895bn) significantly outpacing expenditure growth (+11% y/y to SR1,029bn). Not only did the kingdom capitalize on higher oil prices (+35% y/y at an avg. of $71/bbl) and greater volumes exports, it was also able to substantially raise non-oil revenues (+12% y/y) from excise duties (tobacco etc.), expatriate levies and of course the VAT. Non-oil revenues as a share of GDP reached a high of 10%.

The authorities, recently announcing another record budget, of SR1,106bn ($295bn), for 2019 are committed to supporting the non-oil economy through austerity-mitigating social allowances and through more productive infrastructure investments. They plan to increase spending by 7.4% over actual 2018 outlays.

While the government is broadly on track to achieve its balanced budget objective by 2023, 2019 could see the deficit widen, to 6.4% of GDP, rather than narrow. This is because we expect both oil prices to be softer than in 2018 and the government to continue with its expansionary fiscal policy. We believe that the government will be obliged to pare back some of its intended expenditure outlays to keep the deficit in check.

Public debt to rise on further bond/sukuk issuances

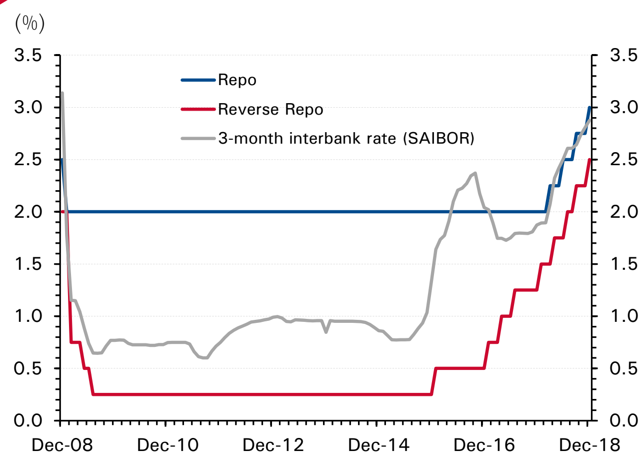
The government continues to finance the deficit through a combination of debt issuance (e.g. bonds, sukuk, loans) and reserve drawdowns. Public debt reached an estimated 19.4% of GDP (SR563bn) at the end of 2018, and is forecast to rise to 22.2% of GDP in 2019 and to 23.7% of GDP by 2020 (See Chart 4.) We put the government's financing requirement at around SR188bn ($50.3bn) in 2019, higher than the government's own forecast of SR118bn ($31.5bn), due to our lower oil price estimate. Saudi debt is still low by international standards. Meanwhile, central government deposits and reserves are estimated to have fallen to SR523bn at end-2018, a drop of SR66bn y/y (-11%), equal to half of 2018's fiscal deficit.

Deposit growth picking up pace but rising cost of funds presents a downside risk

Total bank deposit growth rose by 1.2% y/y in October, while deposits of businesses and individuals grew by 1.9% y/y. (See Chart 3.) While weak by pre-2014 standards, it is an improvement on the negative deposit growth seen in 2017.

Funding costs, however, are on the rise, which could stifle still-weak consumer/business borrowing. SAMA just raised, for the fourth time in 2018 following the US Fed's lead, its key policy rates, the repo and reverse repo, by 25 bps to 3.0% and 2.5%, respectively. Two further hikes are now expected in 2019.

Chart 5: Saudi interest rates



Source: SAMA

Interbank rates (SAIBOR) have also trended upwards in 2018, by about 100 bps to 2.91% as of 19 December 2019, as the Saudi central bank (SAMA) works to maintain a positive spread with US Libor in order to stem capital outflows. (Chart 5.)

Outlook is positive, spearheaded by public investment

Government investment is expected to continue spearheading the kingdom's development and diversification plan. While visible improvements have been made by in the fiscal, economic and regulatory spheres, the outlook is still very dependent on the trajectory of oil prices. Retaining the confidence of businesses and foreign investors is paramount. Feeding into that, however, the authorities are sure to have recognized the value of managing expectations and perceptions.

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