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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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A Deeper Look Into The Consumer Basket

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Executive Summary

- As the November's meeting approaches, statements from the OPEC producers negotiations still continue to cause market price gyrations. It is not surprising as the rhetoric thus far from OPEC members has focused mostly on conditional statements, rather than on a determined goal.

- Last month, the BoJ has shifted its effort from expanding its quantitative easing program to targeting the yield curve, in particular the JGB 10-year yield.

- Investor-driven gains will remain sensitive to US economic data and, Fed rate hike expectations, and the probability that the ECB might taper its bond-buying program in December.

- Investors speculated that the 10-year Saudi sovereign bond would be sold at a 50 bps premium to Qatar's treasuries plus 150 bps, instead; the premium was only 30 bps at 3.25%.

- Tadawul, diverged from its international counterparts registering a double-digit decline by the end of September, with 13 out of the 15 subsectors in the negative territory.

- By the end of August, the loan-to-deposit ratio (L/D) stood at 90.8%, the highest since February 2006.

- The long established industrial complex in the Kingdom predates that of any GCC counterpart, a period that spans from the early 1970s where expertise and rapport was built.

View of the Month

The About 60% of the utility subsidies went to benefit businesses and encouraged overspending of such valuable resources. The slab tariff system introduced in January this year will lead to more responsible consumption and lessen the financial burden on the government.

Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	45.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.5
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,422.5	2,274.0
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	646.9	607.2
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.5%	1.5%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	4.0%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-53.5	-45.9
Current Account Balance/GDP	23.6%	22.4%	18.2%	9.8%	-8.3%	-7.6%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	544.5
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	596.9	602.8
Actual Expenditure, SAR billion	826.7	873.3	976.0	1109.9	969.6	892.1
Expenditure Overrun, %	42.5%	26.6%	19.0%	29.8%	12.7%	6.2%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-65.5	-372.8	-289.3
Budget Balance/GDP	11.6%	13.6%	6.5%	-2.3%	-15.4%	-12.7%
Break-Even Oil Price	75.3	73.9	82.6	100.1	82.1	68.1
Financial Sector						
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	2.6%	-1.4%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	6.6%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.9%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	160.0

Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
Note: Saudi Economic Review Data, October 2016 Update (Historical and Projections)

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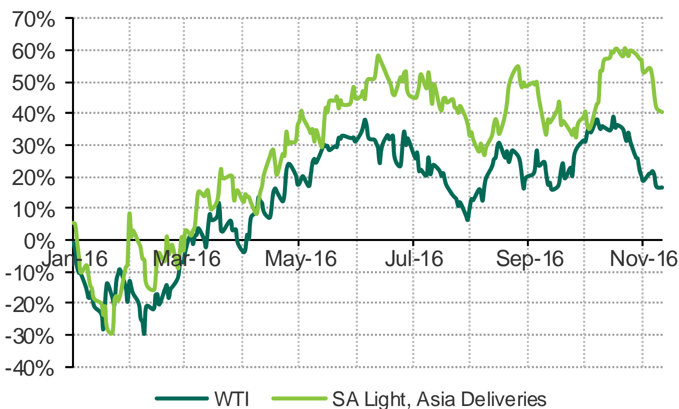
Oil Market

Crude Retreats As OPEC Meeting Looms

Brent crude oil prices reached their highest levels in October in more than a year before falling to lower USD40's a barrel in November. Monthly average spot prices for Brent and WTI increased by USD3.0 and USD5.0 a barrel, respectively, from September to October. While the outlook for global demand of petroleum products remains relatively strong because of generally positive economic data, the potential for additional oil supplies could push prices lower. Recent production gains from producers outside OPEC including Russia, UK, and Brazil, along the resiliency of US shale oil producers are already exerting downward pressure on oil prices. Increased production in Nigeria, Libya, Iran, and Iraq are set to enter the market and could complicate attempts of OPEC's members to reach a deal on production quotas at the 30th November's meeting. OPEC would have done better at balancing oil markets if it had let the market rebalances on its own in September, rather than raising the expectation of a supply cut and then failing to deliver on in the November's meeting. As the November's meeting approaches, statements from the OPEC producers negotiations still continue to cause market price gyrations. It is not surprising as the rhetoric thus far from OPEC members has focused mostly on conditional statements, rather than on a determined goal.

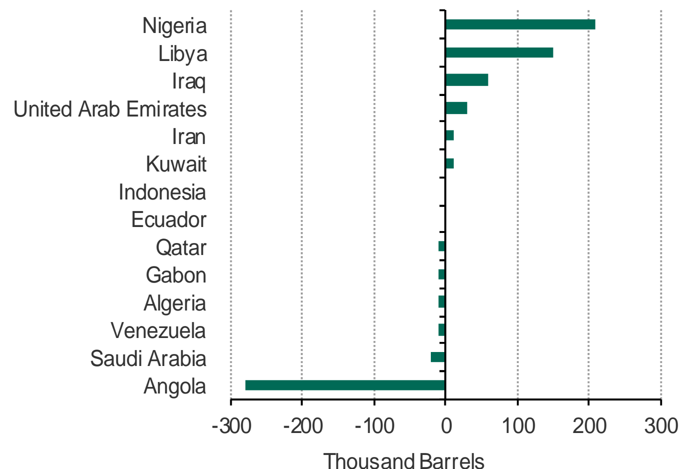
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the supply side, higher oil price has been supportive to US shale oil producers, as oil rig counts began to increase. While the low price environment since 2014 has encouraged OPEC members to come together and announce that they would target a lower group production, the individual country details still remain very challenging to agree upon. OPEC is planning for a production target of 32.5-33.0mb/d, a production cut of 0.25m to 0.5mb/d from its output estimates of around 33.2mb/d in August. The statement was seen as an attempt to push the matter further and impede market participants from positioning short during the coming season. As the winter demand picks up in November and the prospect of market balancing is in closer attention, OPEC hopes that prices may have recovered sufficiently enough that producing at current level is still appropriate. However, current market conditions suggest an oversupply, largely driven by Libya and Nigeria returning to the market. If a deal is not reached on November 30th, the potential that OPEC exports could gain further is a risk for the oil market. As Saudi domestic oil demand falls with the end of the summer season, just keeping current production would imply higher oil exports. Moreover, if Iran does not adhere to the 4.0mb/d cap, and assuming that Nigeria and Libya will continue to produce at recent levels, the potential for rebalancing in the oil market will be further delayed. However, given the political developments in Nigeria and Libya, a steady return of output is unlikely. Nigeria's Trans Forcados pipeline was attacked again last week, with Movement for the Emancipation of the Niger Delta claiming responsibility. In Libya, National Oil Company announced that it would need at USD2.50 billion in order to raise production to 0.8mb/d next year from its current level of 0.59mb/d.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, global crude oil consumption is expected to grow by 1.3mb/d in 2016 and by 1.5mb/d in 2017, according to EIA. China is expected to contribute the most to that growth, as its GDP growth reached 6.7% in Q3'16, and recent indicators for the manufacturing and services sectors indicate that China will achieve its target of 6.5%-7.0% GDP growth for the whole year. Recent strong economic data in major emerging market economies, such as India and Brazil, imply strong oil demand growth. In recent months, the value of the US dollar has appreciated, and typically, a strengthening of USD signifies weaker expectations for oil demand. However, the USD appreciation appears to be heavily weighted toward developed economy currencies, mainly the British pound and the Euro, and is not occurring against emerging market currencies. Given that oil demand tends to be highly price sensitive in emerging markets than in developed economies, the appreciation of USD against the pound and the euro is unlikely to strongly affect the global oil demand.

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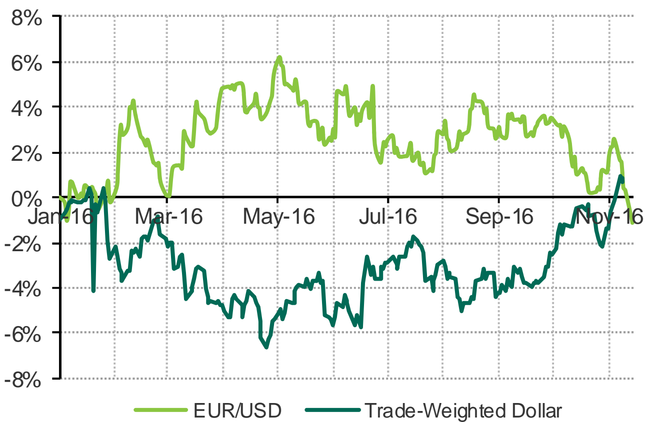
Foreign Exchange

Monetary Accommodation to Remain

Monetary policy decisions and statements by major central banks will remain the driving forces behind movements in the foreign currency market, especially those made by the Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ). As such, monetary divergence that had materialized with the Fed starting its normalization cycle by tapering in 2013 and hiking in December 2015 has created heightened volatility over the past two years, propelling the trade weighted dollar that appreciated by 25%. Adopting unconventional monetary tools in the aftermath of the global financial crisis might have saved major economies, but it is becoming increasingly clear that such policies have their limitations. Negative interest rates, the latest of such tools, adopted by the ECB and most recently by BoJ might be supportive in encouraging banks' to lend, people to spend and debt burdens on borrowers to be reduced, yet it might be a testimony of policy failure to handle unsustainable debt levels, with governments being deficit financed by central banks.

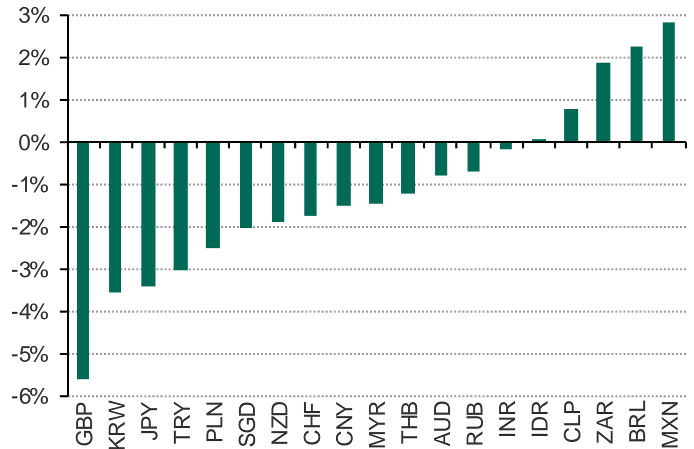
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

In 2016YTD, the USD has regained most of its losses, which was 6.6% in early May, to end the month of October at a decline of just 0.84%, on a trade-weighted basis. And it is poised to strengthen further on the back of a resilient labor market, as the unemployment rate in September remained around 5% and 156 thousand jobs were created, which is double the pace to keep up with growth in population. Furthermore, US factory production has improved in the second half of this year, growing in three of the past four months and, thus, more likely to support in the acceleration of economic growth. All the aforementioned have aided GDP growth in the third quarter that rose by 2.91%, above the second quarter's 1.49% annual rate. We do believe that this steady US economic growth increases the likelihood of a Fed rate hike in December.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

Last month, the BoJ has shifted its effort from expanding its quantitative easing program to targeting the yield curve, in particular the JGB 10-year yield. In contrast to the previous strategy that was centered around expanding the monetary base in order to achieve the price stability target of 2%, the new strategy adopted a zero target for 10-year bond yields. Some analysts viewed this as a signal that the central bank is abandoning its previous commitment of injecting liquidity via the purchase of government bonds, currently standing at JPY80 trillion per year, and a defeat to reflating the economy. Evidently, if the yield falls below zero, the central bank will have to reduce its bond buying in order to bring it back up, which will be regarded as tapering by market participants. This big transformation, however, was seen by others as inevitable given that that these debt purchases were reaching a limit, with the BoJ holding bonds worth a record USD3.86 trillion, around 40% of the Japanese government bonds market. The yen is expected to strengthen following this policy adjustment, with the debasing effect being reduced. In our opinion, the Japanese economic situation had underscored the difficulty of jumpstarting an economy using just monetary policy, with fiscal policy taking a backseat.

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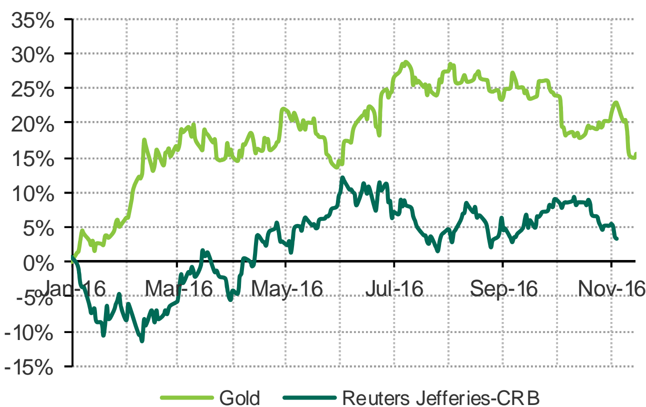
Commodities

Commodities on the Rise As Fed Stalls Hike

Commodities continued to rise in the third quarter following July's dip, on the back of low Fed-hike expectations. The Fed's hawkish tone dissipated after the Jackson hole summit mid-August, making the second rate hike less eminent. The US dollar has been negatively trending throughout the year as expectations of a prolonged low interest rate environment are becoming more prevalent among investors. However, the trade-weighted USD inched up by the end of October to 98.4, reaching the highest level since January on the back of solid consumer spending and a robust job market. After peaking at 8.3% YTD, the Reuters/Jefferies CRB index inflected mid-October, falling back to 5.8% YTD wiping all gains in the month. OPEC's Algiers meeting improved outlook on oil as an agreement to limit crude production on to 32.5-33.0 billion barrels effectively boosted the oil market. In addition, improving industrial metals outlook underpinned by supply constraints and China's policy efforts to boost the commodity-intensive infrastructure and construction sectors have been a key driver for demand. On the other hand, the end of El-Nino weather anomaly and subsiding drought concerns are posing downside risks for soft commodities.

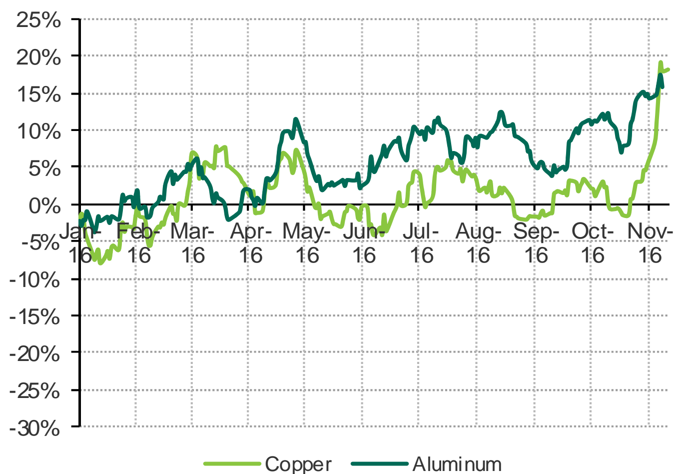
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

China is the world's largest producer and consumer of base metals. It's large industrial base makes it accountable for over 50% of global metal consumption in 2015. However, as the country is shifting its growth model from a manufacturing / export-led economy to a consumption / retail-led one, we expect to see slower demand for industrial metals as a result. Environmental concerns will also act as a drag on the heavy mining activities in China, decelerating supply. Copper prices ended October up by 3.1% YTD at USD4,853/ton, a more modest gain compared to its industrial peers. Ample supply of copper limited the upturn potential for copper prices, especially after Indonesia relaxed the ban on its exports. Aluminum prices ended October surging 15% YTD on falling LME inventories and strong demand. The closure of high cost smelters exacerbated the effect of global supply shortage. Despite the rebound in base metal prices, we expect surplus and capacity overhang to balance the upturn, limiting the upside potential to a single-digit in 2017.

Chart 6: Base Metals



Source: Thomson Reuters

Gold prices received another boost from risk averse investors who kept the yellow metal afloat in the months leading to October. Low interest rate policies and tepid US economic data encouraged safe-haven buying which pushed gold to surge by 20.3% YTD by the end of October to USD1,277.5/oz. Investor-driven gains will remain sensitive to US economic data and, Fed rate hike expectations, and the probability that the ECB might taper its bond-buying program in December. Physical demand is expected to recover and remain robust in India and China especially after India rolled back on a decision to impose a 1% tax on gold imports. Soft commodities are registering gains on a YTD basis albeit moderating from June levels. The Goldman Sachs agricultural index recorded a 6.6% upturn from the beginning of the year through the end of October to 301.9 points. Lower drought concerns and increasing Fed hike expectations are putting downward pressures on some main food grains such as wheat and corn. Wheat futures for December deliveries are down 18.9% YTD at 411.5 cents/bushel while corn future for the same month slid 7.4% to 354.7 cents/bushel.

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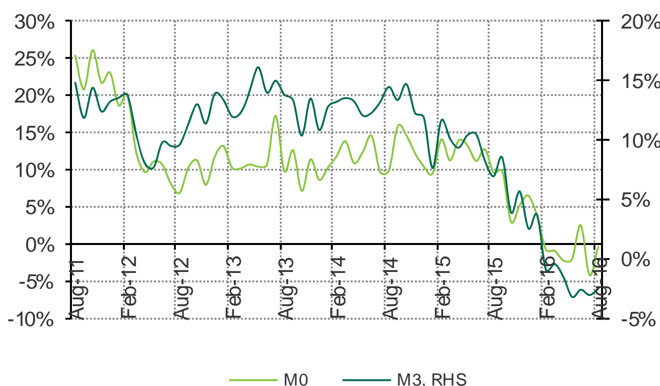
Money & Inflation

Money Growth Falls Into Negative Territory

The Kingdom's first foreign bond sale in October set an emerging market record of USD17.5 billion which reflects strong creditworthiness and investor confidence despite the oil plight. Investors put up orders of USD67 billion in search for yield, enabling the kingdom to increase the amount borrowed, eclipsing Argentina's USD16.5 billion and Qatar's USD9 billion bond sales earlier this year. The global bond issuance came as an answer to the tightening liquidity problems faced in the domestic market as dwindling oil revenues stretched local funding sources. The Kingdom's entry into international bond markets will also pave the way for the inclusion of its stock market in the MSCI by the end of 2018 and the world's largest IPO from the Kingdom's most valuable company, Aramco. The swift and decisive manner in which the government conducted its much needed reforms assured investors of its ability to steer the Saudi economy away from the current slowdown. Low debt levels, which by the end of 2015 posted 5.9% of GDP, indicate a large untapped debt capacity. Investors speculated that the 10-year Saudi sovereign bond would be sold at a 50 bps premium to Qatar's treasuries plus 150 bps, instead; the premium was only 30 bps at 3.25%. Negative yields in many major central banks and the stalling Fed rate hike have pushed investors to fervently seek higher yield in the EM.

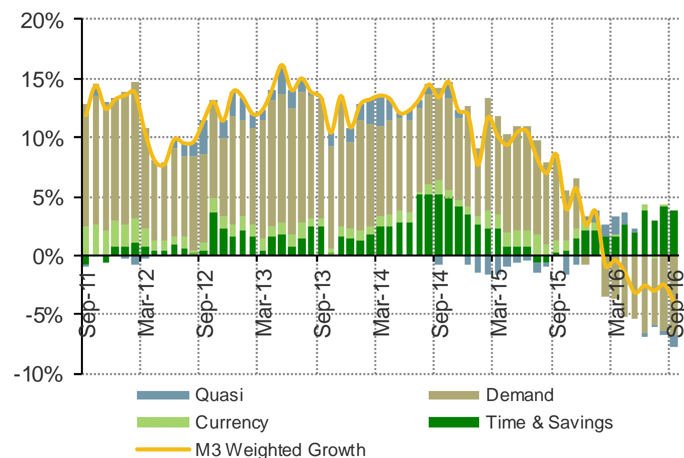
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

SAMA's monthly bulletin for the month of August reveals that broad money supply remains downward trending given the tighter liquidity conditions. By annualized comparison, M3, the broadest measure of money, slid by 2.5% to SAR1.75 trillion. The monetary base edged lower by 0.3% to SAR305.3 billion affected by a 4.8% decline in deposits with SAMA. On the other hand, currency outside banks inched up 0.9% while cash in vault rose by 7.7%. Total deposits with SAMA fell to SAR98.6 billion of which 96.4% are bank deposits. M2 money supply declined by 2.3% Y/Y to SAR1.6 trillion despite demand deposits falling by 10.7% Y/Y as a 19.6% surge in time and savings deposits dampened the impact. Demand deposits stand at SAR946.8 billion, accounting for over half the liquidity in the financial system whereas time and savings stand at SAR455.2 billion which is 26% of broad money. Quasi monetary deposits slid by 3.8% Y/Y to SAR176.6 billion on the back of declining foreign currency deposits by 2.7% Y/Y to SAR148.7 billion and outstanding remittances plummeting by 31.4% Y/Y to SAR12.7 billion.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

The cost of living index rose by 3.3% Y/Y in the month of August affected by upside pressure from housing and utilities, health, transport, and education. The housing and utilities sub-index surged by 7% Y/Y as water supply prices recorded an upturn of 186.4% Y/Y. The health sub-index rose by 6.6% Y/Y on the back of a 13.6% Y/Y upturn in hospital services. Moreover, the transport sub-index was up 8.5% in August pressured by a 60.8% Y/Y surge in fuels. The educated sub-index increased by 5.4% Y/Y pressured by primary and secondary education upturning by 8.6% and 7.8%, respectively.

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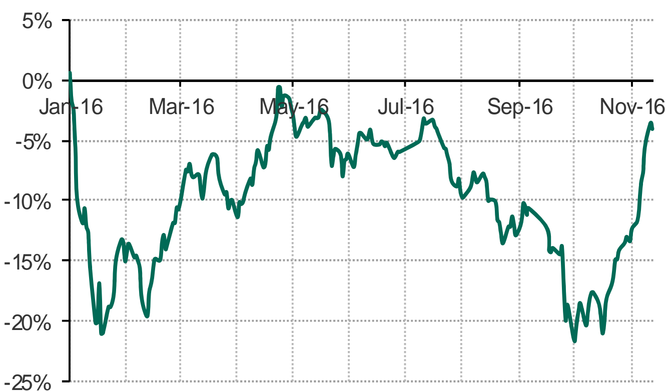
Capital Markets
Touching a Trough in September

Global equity markets have maintained their positive stance by the end of September, a clear inflection from the rout witnessed at the beginning of the year till mid-March. It seems investors' obsession with the timing of the next Fed rate increase had relatively abated, trumped by the growing understanding that the hiking cycle will be a shallower one. The benchmark indices for the world, G7 and emerging markets had registered gains of around 16%, 3% and 4%, respectively according to the MSCI World indices. The Saudi stock market, Tadawul, diverged from its international counterparts registering a double-digit decline by the end of September, with 13 out of the 15 subsectors in the negative territory. During September, the market touched a low of 5,440.70 by the end of the month, impacted by the Royal decree to freeze salaries and slash allowances as well as the uncertainties emanating from the US Congress approval of the JASTA bill and the expectations of lower corporate profitability in the third quarter. Hence, the sell-off was broad based, resulting in a 7.5% loss for the general index. Even though TASI had regained a lot of its losses by mid November, subdued oil prices as well as the government budget announcement for 2017 might contain this rally going forward.

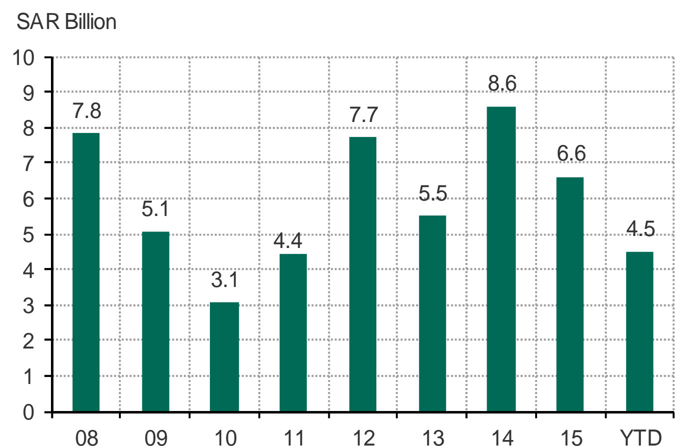
Chart 9: Tadawul All-Share Index



Source: Tadawul

Regarding the sectoral performance, the heavyweight sectors remained in the red, namely cement, banks, and petrochemicals, edging lower by the end of last month by 6.34%, 2.8%, and 5.95%, respectively. The weakest sector was media and publishing, recording a decline of 21.95% for the month, followed by the hotel and tourism sector, which fell by 19.6%. Investor appetite, represented by the average daily trading volumes, declined during September to SAR2.8 bn from SAR2.9 bn a month earlier and is far below the YTD average of SAR4.7 bn, underscoring the fear factor amidst the flurry of government announcements concerning fiscal consolidation and tightening. The majority of trading continues to be attributed to Saudi individuals, representing around 80%. In September, individuals and QFIs were net sellers while government funds, mutual funds and institutional investors were net buyers. Interestingly, even though direct investment by QFIs was permitted since June of last year, the capital inflows to Saudi equities have been limited, standing at a meager SAR1.1 bn, with QFIs being net sellers in September by SAR99 mn.

Chart 10: Average Daily Traded Value



Source: Tadawul

The primary market witnessed just a single activity since the beginning of the second half, with two out of the three IPOs floated this year losing more than 50% of their share prices. And with the latest one, Lazurde, reporting a 98% plunge in the third quarter's net profit immediately after floatation. Ostensibly, IPOs for this year and next will be delayed, with companies factoring in the current dynamics in the secondary market and the broader moderate business cycle. We do believe that the rapidity of the declines by the end of September, which have preceded global markets, have created compelling value propositions and as such the correction that ensued in November was expected.

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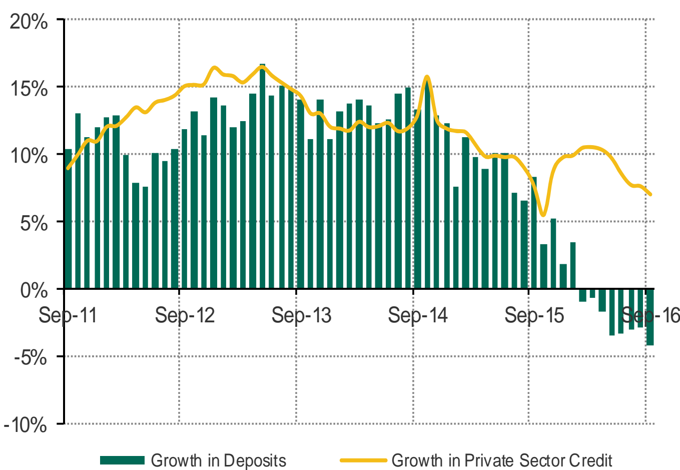
Loans Market

SAMA Further Eases Liquidity Constraints

The credit situation in Saudi banks is still on the rise despite the strain on liquidity in the financial system. In the month of August, total bank credit posted an annualized 7.9%, maintaining growth momentum despite the deceleration. In 2015, total credit growth averaged 9% Y/Y, contrasting with 9.2% Y/Y in the months leading to August since the beginning of 2016. Strong liquidity buffers mandated by SAMA helped the banking system remain resilient and withstand the oil shock. However, the growing pressure on the Saudi economy and the banking system led the government to cut public sector salaries by up to 20% and reduce allowances that reach up to 30% of annual income. About two thirds of Saudis are employed in the public sector, so we expect to see a sizeable impact in 2017, narrowing the expected fiscal deficit of SAR327 billion this year. After the Saudi government unleashed its latest fiscal consolidation measure which targeted government employee benefits, SAMA instructed local banks to reschedule consumer loans without adding extra fees or changing the interest charges.

Chart 11: Private Sector Financing

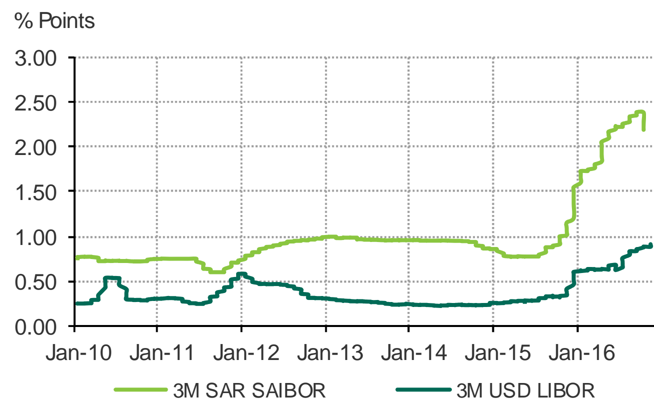


Sources: SAMA and NCB Estimates

By the end of September, consumer loans extended by banks excluding credit card loans and real estate loans totaled SAR343.9 billion, surging by 7.8% Y/Y. We expect to see a dampened spending by consumer as a result of the negative income effect next year which in turn would negatively impact consumer demand for credit. The rescheduling of consumer loans aims to enable consumers to service their loans post the recent salary reductions. Total bank loans to both the public and private sector excluding securities stood at SAR1.43 trillion of which 96.7% is lent to private sector enterprises.

The focus has shifted towards the Kingdom's first benchmark bond issuance totaling USD17.5 billion, easily trumping Qatar's USD9 billion bond sale. The liquidity that is expected to be injected into the Saudi economy will help alleviate the liquidity squeeze on Saudi banks, allowing them to maintain growth projections over the short term. Strong macro prudential policies at SAMA, in addition to low global inflation and negative interest rates in major central banks fueled the huge demand for Saudi Arabian bonds. Such investor confidence reflects how well the Saudi Arabian government communicated its vision and adamancy to balance the budget by year 2020. Despite the volatile and weak performance in the oil market, robust profitability and adequate capitalization will provide a sufficient buffer against event risks and deteriorating asset quality. By the end of August, the loan-to-deposit ratio (L/D) stood at 90.8%, the highest since February 2006.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

Despite breaching the 90% L/D threshold since June, the conservative prudential framework of SAMA left the ratio unchanged. Instead, SAMA injected the banking system with over SAR20 billion as short term deposits and availed repo transactions with the maturity of 7, 28, and 90 days in addition to the one day maturity. Moreover, SAMA lowered the ceiling of its bills issuance to SAR3 billion/week from SAR9 billion/week previously, effective on the 30th of October. Saudi banks' holdings of SAMA bills amount to SAR38.5 billion which is below last year's holdings by 79.3%. On the other hand, bank holdings of government bonds stood at SAR169.7 billion, surging over last year by 161.1%. The 3-month average Saudi interbank offered rate (SAIBOR) rose rapidly after the third quarter of 2015, standing at 2.38% by the end of October. The spread between SAIBOR and its London counterpart, LIBOR, stood at 154.7 bps, yet the recent announcements are contributing towards reducing the spread and alleviating domestic pressures in the banking system.

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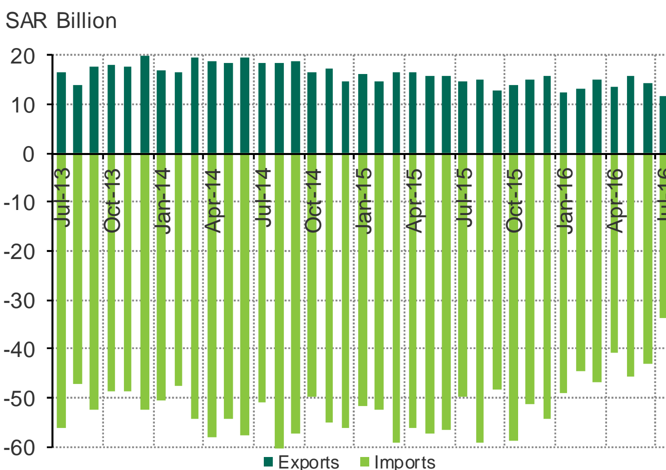
External Trade

Faltering Demand of Emerging Economies

The swift and decisive policy change undertaken by the Saudi government in order to rebalance its fiscal standing reflects the dynamic and efficient nature in which it counters the effects of dwindling oil revenues. The non-oil export market receives official support from the Saudi Exports Development Authority which was established in 2013 with a single mandate to boost non-oil exports. The Kingdom's economic diversification plan currently extends the oil production chain to become a global leader in exporting petrochemicals and plastics. In addition, the Kingdom aims to increase its utilization of the abundant mineral deposits as a main export for industrial uses. By weight, plastics and chemical products represent 37.6% and 28.2%, respectively, whereas exports of base metals make up around 8.4% of non-oil exports. The Kingdom's non-oil export market possesses several key features that makes it fairly competitive whether on a regional or a global scale. The long established industrial complex in the Kingdom predates that of any GCC counterpart, a period that spans from the early 1970s where expertise and rapport was built.

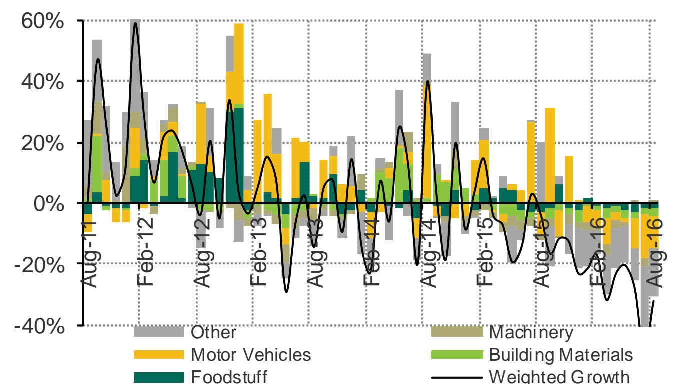
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB

However, in addition to lower oil prices, global industrial demand has cooled down as China's decision to adjust its economic growth model to focus on consumption rather than export. Consequently, the Kingdom's non-oil export figures were in decline for most of 2016. In the month of July, exports of plastic stood at SAR4.4 billion sliding by 10.0% Y/Y. Chemical products reached SAR3.3 billion, plummeting by 39.8% Y/Y, and exports of base metals slid 15.3% Y/Y to SAR0.9 billion. By export destination, the UAE was the largest recipient accounting for 11% of the monthly total at SAR1.3 billion, followed by China at SAR1.2 billion, accounting for 10% of the total. India's share stood at SAR0.7 billion, making up 7% of the monthly total. By annual comparison, non-oil exports to the UAE plummeted 40.1%, while exports to China declined by 51.2%, and exports to India fell by 1.7%. Total non-oil exports during July totaled SAR11.8 billion, sliding by 27.2% Y/Y.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

On the import side, imports of machinery and equipment which account for about 24.7% of imports by value reached SAR8.2 billion sliding by 40.5% Y/Y. Imports of vehicles and transport equipment which account for 15.4% of the total stood at SAR5.2 billion, plummeting by 38.8% Y/Y. The two main categories of imports display a significant reduction over last year's figures which is in line with the Kingdom's fiscal consolidation efforts. By countries of origin, China tops the list accounting for about 16.4% of imports at SAR5.5 billion followed by the USA which accounts for 12.3% of the total at SAR4.1 billion. Germany was the third largest origin of import, making 6.1% of total imports at SAR 2 billion. By annual comparison, imports from China slid 27.9%, while imports from the US declined by 34.1%, and finally imports from Germany declined by 44.7%. Total imports during the month amounted to 33.5 billion, down by 32.7% on an annual basis. The ratio of non-oil exports to imports stand at 35.3% in July 2016 compared to 32.6% in July 2015 which indicates that the import bill is declining at a faster rate than non-oil exports.

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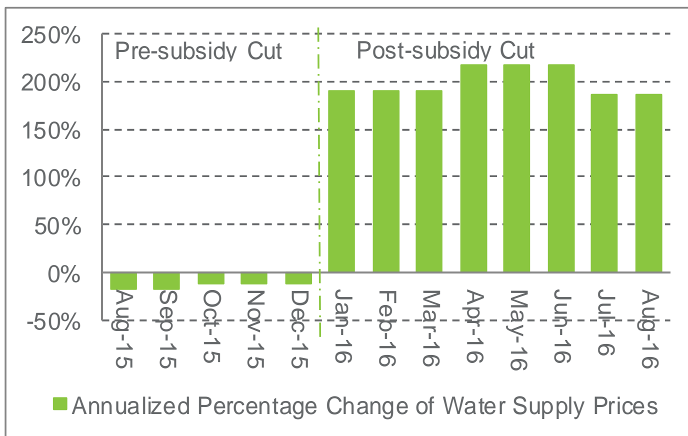
Special Focus:
A Deeper Look Into The Consumer Basket

Despite prolonged easy monetary policy by the core economies' central banks, global inflation remains at a seven-year low. According to the Organization for Economic Co-operation and Development (OECD), the annual rate of inflation for the group of countries that produce about 85% of the world's output, also known as the G20, inched down to 2.1% Y/Y in August. Persistently low inflation is pressuring respective central banks at the EU, UK, Japan and the EM to continue monetary easing measures while preventing the US Federal Reserve from normalizing its monetary policy. Numerous surprise key interest rate cuts took place in 2016 in order to stimulate growth while currency carry trade allowed commodity currencies to depreciate. In addition, recurrent expectations of a Federal rate hike in the US is pressuring commodities, notably energy, metals and food grains. In regards to energy prices, the oil supply glut exacerbated the slide which started in the second half of 2014. As a vital factor in production, cheap energy prices trickled down to almost every category in the consumer basket.

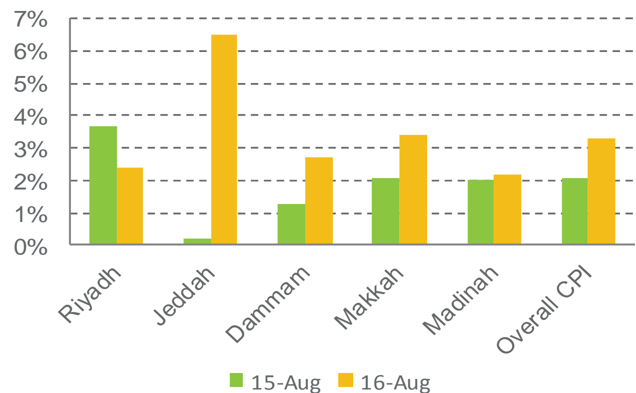
Chart 15: Water Supply Prices



Source: The General Authority of Statistics, NCB

The inflationary situation in the Kingdom is decoupling from the global trend following a series of fiscal consolidation measures. After averaging 2.7% in 2014 and 2.2% in the following year, inflation almost doubled during the first eight months of 2016, averaging around 4%. As the budget deficit soared, the government reduced the blanket subsidy which was estimated to burden the government with over SAR400 billion a year. About 60% of the utility subsidies went to benefit businesses and encouraged overspending of such valuable resources. The slab tariff system introduced in January this year will lead to more responsible consumption and lessen the financial burden on the government. During the first eight months of 2016, the housing and utility category surged by an average of 7.7% Y/Y due to the hike in water and electricity bills. The surge of water supply bills averaged around 200% Y/Y whereas electricity bills upturned by 14.3%. The reduction of retail gasoline subsidies also hiked the prices by an average of 60.8% Y/Y. The trickle-down effect can be noticed in various sectors in the economy as expenditure groups such as transport services experienced an average increase in prices by 11.2% Y/Y, while hospital services surged by 13.6% Y/Y.

Chart 16: General CPI by City



Sources: The General Authority of Statistics, NCB

By Region, the surge in energy and utility prices in 2016 varied considerably. The general cost of living index recorded the highest average increase in Baha at 7.6% Y/Y, followed by Jeddah at 6.3% Y/Y. The lowest average annualized inflation during this year was seen in Hail at 2.6%, followed by Madinah at 2.8%. The response from the government subsidy reduction has also been uneven among cities. In Riyadh, for instance, the prices of water supply and related services quadrupled, surging by 349.2% Y/Y in the months leading to August. Jeddah city recorded an average increase of 116.2% Y/Y in water bills, whereas in Dammam the impact was considerably less, marking an average increase of 54.3% Y/Y. In an opposite trend, the prices of housing rentals have cooled off relative to last year as the residential property market reform stuttered investors and lenders. Inflation in housing rentals averaged 3.5%in the months leading to August compared to 4.1% over the same period last year. In the main municipalities, Jeddah recorded the highest annualized surge of 18.5%, whereas Riyadh and Dammam inched up by 1.5% and 1.3%, respectively.

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