samba سامبا

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Economic Monitor

Contents

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Highlights

- **The global economy** is slowly recovering from the impact of the Coronavirus (Covid-19). Unusually for a recession, the first and biggest hit has been to services, while industrial production has fared somewhat better. All major economies, with the exception of China, are likely to see severe contractions this year.

- The recovery path is likely to be uneven, if only because of the different national policy responses. The obvious contrast is between Europe and the US. European countries generally locked down their economies early and firmly, and most of them are now showing a solid rebound in activity as restrictions are eased. The US response varied by state, and it is now becoming clear that those that eased lockdowns early (or imposed them half-heartedly) are suffering from renewed waves of infections. Populous states, such as California and Texas, are now having to re-impose restrictions.

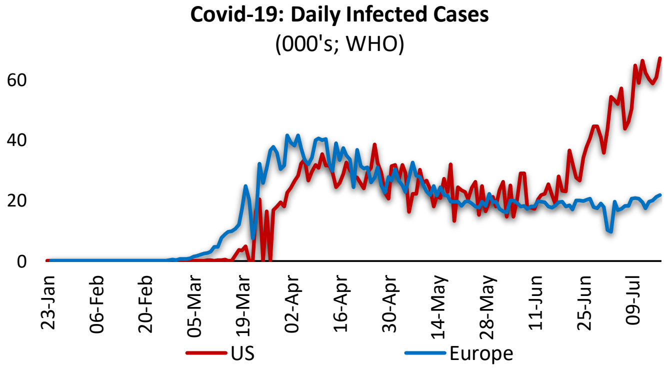
- **Oil prices** have recovered some of their earlier losses and now appear to have stabilized in a range of $40-$45/b (Brent). This reflects both the partial recovery of demand and the substantial reductions in supply by both OPEC Plus and higher-cost producers. However, the overhang of crude stocks is still extremely large and it is likely to take well over a year before it is worked down to normal levels. In the near term we expect prices to soften again as previously shut-in US crude is released to the market. Prices should begin to increase again in Q4 as demand gains traction. Yet prospects have been clouded somewhat by the second wave of US Covid infections, which are impacting states that are large gasoline consumers. Assuming that any new lockdowns are short-lived, then we expect Brent to average **$40/b** this year, rising to **$46/b** in 2021.

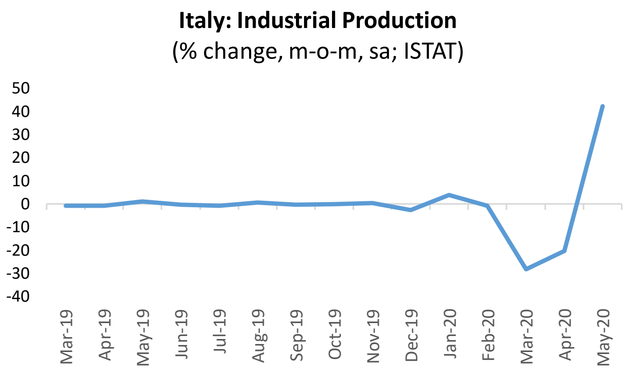
- **The Saudi economy** has had to contend with both the impact of the virus and low oil prices, which has left no scope for a fiscal response. Services have taken the biggest hits, though the impact has been partially mitigated by high levels of public sector employment, which has meant that job losses have been confined largely to expatriates.

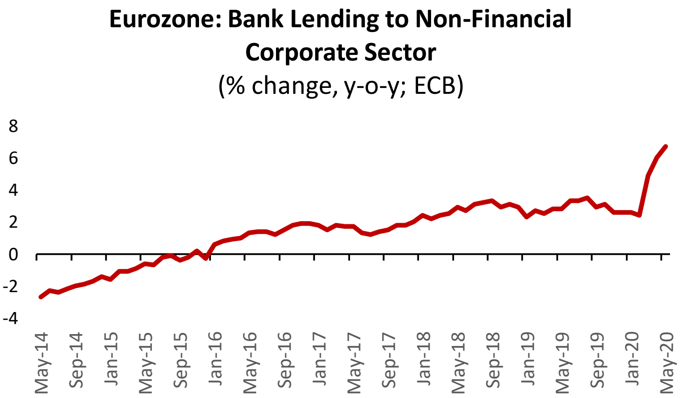
- Nevertheless, with household confidence fragile and VAT recently tripled, consumption is likely to be subdued this year. With construction also under pressure, we expect the nonoil economy to contract by around 3.5% in 2020. Overall GDP will be pulled even lower by reduced oil output and we expect a real contraction of almost 5%.

Global economy

Global economic activity is slowly recovering from the impact of the Covid-19 pandemic. However, the recovery is far from complete, and varies enormously between regions.







Global economy finds a floor following COVID-19 devastation

Having collapsed in March, global economic activity bottomed out in April, and has since begun a hesitant recovery as lockdowns have eased. Consumer spending has generally been stronger than expected, though timely data, such as restaurant bookings, point to lingering—or possibly enduring—caution. Globally, industrial activity remains subdued, though there are striking differences between regions. Overall activity is particularly weak in Latin America and India, where the virus is still rampant.

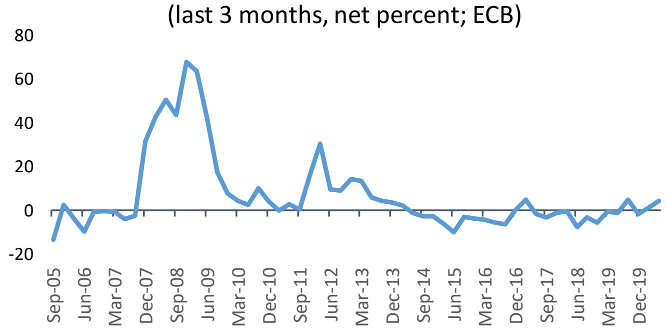
Europe hit hard, but handles pandemic better than the US

In Europe, where the lockdown was generally enforced early and forcefully, new cases of the Covid-19 virus are currently running in the hundreds in most major economies, compared with thousands as recently as May. Economic activity is inverted to this pattern, with a depressed March and April, followed by a forceful rebound in May and June. The second quarter was undoubtedly tough, but the contraction in quarter-on-quarter GDP might have been nearer to 12% than the 20% that many were anticipating. For example, Italy's industrial production rebounded by a staggering 42% month-on-month in May, putting its level of IP even higher than Germany's when benchmarked off January 2019. France also posted a robust recovery in IP, though Germany's was lower than expected. Consumers appear to be returning to the shops in Europe. Retail sales volumes rebounded by a larger-than-expected 18% in May as outlets re-opened and shoppers began to spend the surpluses that had built up during lockdown. That said, retail sales are still far below their pre-virus levels.

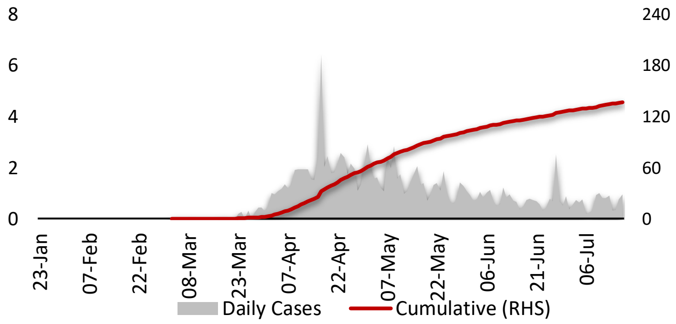
Granted, the EU has not left Covid-19 behind, and there have been localised resurgences around the Union. Germany and Austria have been forced to quarantine some areas near their shared border, while Spain has implemented local lockdowns in two regions on opposite sides of the country. Encouragingly, localised lockdowns appear to have been successful so far**,** with daily infections in Germany and Austria falling again, though the outlook for Spain is less clear.

The lockdown has certainly caused corporate hardship in Europe. Demand for loans from Eurozone businesses surged to a record high in the second quarter, according to the ECB, which cited "acute liquidity needs for inventories and working capital". Demand for short-term loans was much stronger than that for longer-term credit, or for loans to fund fixed investment. Much of

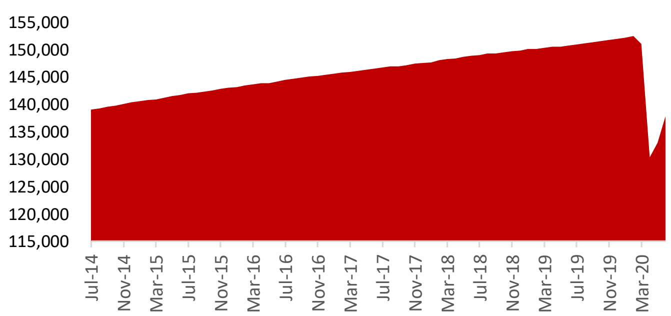
Euro Area Banks: Change in Credit Standards to Business
(last 3 months, net percent; ECB)



Covid-19 Deaths: US
(000's; WHO)



US: Nonfarm Employment
('000s, SA; Bureau of Labor Statistics)



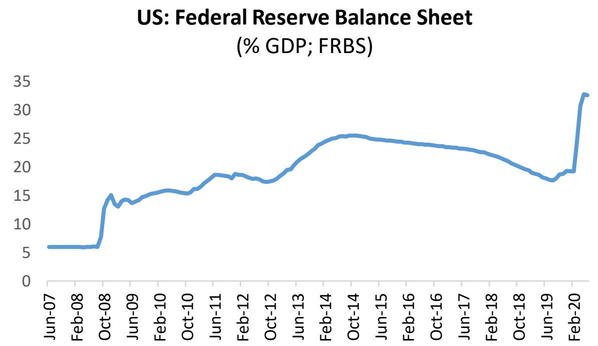
the demand was from SMEs, which have struggled with inventory demands. However, banks have tightened their lending standards only slightly, reflecting the vast efforts of public authorities to avoid a credit crunch. European governments have guaranteed large amounts of loans to hard-pressed borrowers, while central banks have flooded the banking system with ultra-cheap loans at negative rates and allowed lenders to draw down into their capital buffers. Nevertheless, banks told the ECB they expected lending standards to tighten in Q3 as state loan guarantee schemes were unwound in some countries.

This suggests that there will be bumps in the road ahead, especially as generous state support for both firms and households is withdrawn. Some jobs have been permanently lost, and this will weigh on consumer confidence and government budgets. Export markets are also likely to be weaker than pre-virus.

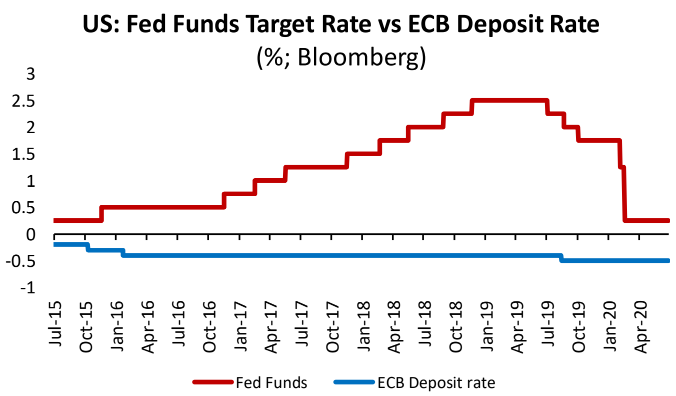
US cases surge again following early re-opening

Yet Europe's near-term outlook looks decidedly better than the US one. The US daily infection rate has risen above 60,000, surpassing the previous peak. Florida has recently seen its highest daily rate of infections, while Texas has also seen a resurgence of cases. Six states—Arizona, California, Colorado, Florida, Michigan and Texas—have re-imposed restrictions on bar and restaurant activities. But there has also been a clear upturn in the infection rate across the rest of the country too. The resurgence, and the generally haphazard approach of policy makers, is beginning to erode consumer confidence. Polls show a clear rebound in the share of Americans saying they are worried about the virus, while footfall in shopping malls began to recede again in late June.

Further restrictions will probably be needed in various states if the virus is to be brought under control. This suggests that the US recovery is likely to be slower and more fitful than May and June data would suggest. Of course, there will still be a significant bounce in GDP in H2 given the slump in H1: the annualised decline in Q2 GDP was something in the order of 30%, and a Q3 rebound of some 25% seems plausible. Similarly, after peaking at close to 15% in April, unemployment eased to 11% in June as more furloughed workers returned to their jobs. But employment remained 14.7 million below its February level and high-frequency data suggest that activity is stalling. On August 1 millions of Americans will lose $600 a week in additional Federal unemployment benefits, which is likely to weigh on consumption.



The monetary and fiscal responses to Covid have been impressive on both sides of the Atlantic.

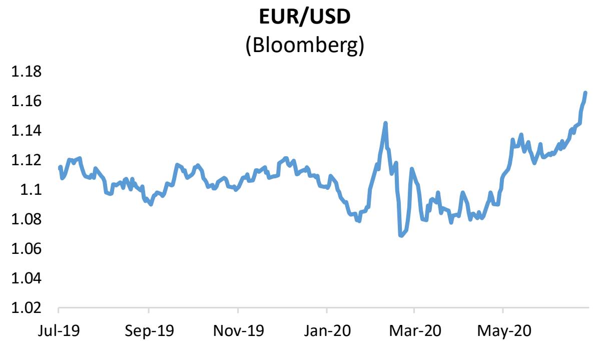


The US's somewhat haphazard health response to the Covid virus contrasts with the early and decisive fiscal and monetary response. The fiscal impulse was particularly impressive given the state of relations between Republicans and Democrats. The Coronavirus Aid, Relief and Economy Security Act (CARES) provides—at least on paper—relief amounting to $2.3trn (11% of GDP) in the form of expanded unemployment relief, a food safety net, and loans and guarantees firms from going under. In addition, the Paycheck Protection Programme provides $321bn in additional forgivable loans to small businesses.

The monetary response has also been overwhelming. The Fed was quick to cut rates and expand overnight and term repos. It also reduced the cost of swap lines with other major central banks, which was vital in calming USD markets across the globe. The Fed's programme to support the US corporate bond market has also been important and somewhat ingenious. The Fed first made it clear that it would be willing to hold non-investment grade debt in its bond programmes, alleviating many worries about the overhang of debt rated at the lowest tiers of investment grade. More recently, it announced a willingness to buy single-named paper. Together, these announcements encouraged investors to act as though the Fed had issued an implicit guarantee for corporate debt, alleviating an actual Fed need to buy amid strong private sector demand.

Unlike its health response, the Eurozone took a while to click into gear, particularly on the fiscal side. The ECB did act early (in March) to increase its asset purchase programme of public and private sector securities by €750bn, while expanding the list of eligible securities. In early June the soft inflation outlook prompted the ECB to expand this by an additional €600bn to €1.35trn, and to extend the programme until the end of 2021. The ECB also enhanced the terms of its TLTRO programme, which is designed to encourage commercial banks to lend to the private sector.

The most significant development in the EU was on the fiscal side. In mid July, the bloc's leaders reached a momentous decision to launch a €750bn Recovery Fund. This is the first time that the EU's 27 leaders have effectively agreed to establish a fiscal deficit as an instrument of crisis management. It had been assumed that Germany would be unlikely to agree to such a "fiscal transfer" mechanism. In the end, Germany pushed quite hard for the accord and it was left to smaller northern states to push back against some of the provisions (reducing the amount of grants in the agreement, for example). Even so, the core facility to channel recovery grants to damaged member states was largely preserved. The fraught negotiations exposed many of the bloc's fault-lines, but the outcome is an important step forward in securing the long-term cohesion of the EU.

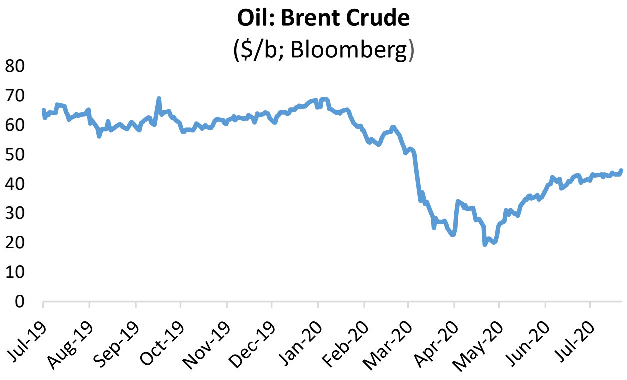


The agreement has further bolstered support for the euro, which had risen to almost $1.17 by late July from $1.10 in April. The single currency has also been supported by market perceptions that—for once—the Eurozone's economic outlook looks more promising than that of the US, as well as the compression in yield differentials following the Fed's substantial interest rate cuts.

Looking further ahead, the chances of global GDP returning to trend growth in the medium term are reasonably good, in our view. Granted, there are uncertainties around the virus, such as whether it might mutate, or whether social distancing becomes ingrained in human behaviour (which would be bad for a number of sectors). Yet the reassuring feature of the Covid recession is that there is no accompanying financial crisis. History shows that recessions that are not accompanied by financial crises tend to be shorter-lived than those that are.

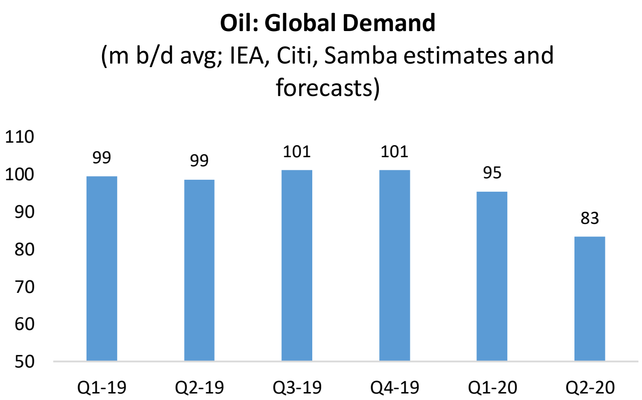
Oil markets

Oil prices stabilise as demand gains some traction



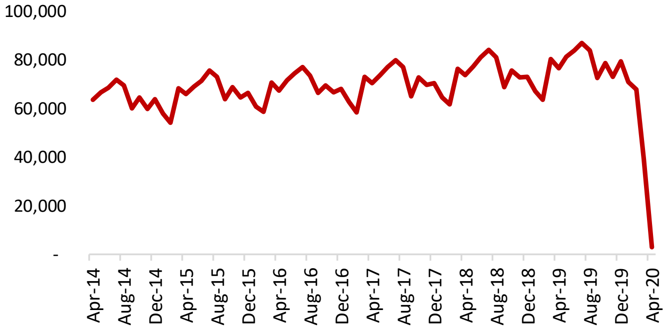
Oil prices have stabilised following intense volatility in March and April, which included a brief period of negative oil prices for some US and Canadian crudes. During July, Brent was trading in a narrow band between $40/barrel and $45/b, some $15-20/b below its pre-Covid level. Naturally, the recent stabilisation reflects both supply and demand dynamics.

Starting with demand, the emerging consensus is that the second quarter collapse might not have been as severe as feared. While full data are not yet available, the fall in Q2 demand appears to be more like 15% year-on-year, rather than the 20-30% estimates that appeared in the middle of the quarter. There are various factors at play here, such as the "V"-shaped bounce-back in China's economic activity, along with some opportunistic re-stocking of strategic reserves by the Chinese authorities. The fact that many Americans appear to be shunning public transport in favour of cars for their daily commutes may also be having an impact at the margin. But this needs to be put in perspective: as of mid-July, global oil demand was running at 2005 levels.

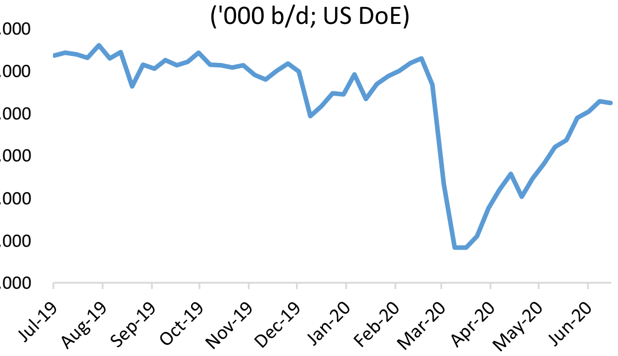


The big hits have been to gasoline demand and jet fuel, unsurprisingly given the impact of lockdowns on travel. The outlook for demand recovery is extremely hazy, with a wide spread of views among analysts. Automobile use is clearly on the rise again as lockdowns are eased, but the trajectory is unlikely to be a smooth one: the surge in Covid cases in the US incorporates three of the biggest consumers of gasoline: California, Texas and Florida. India, another large oil consumer, was continuing to see

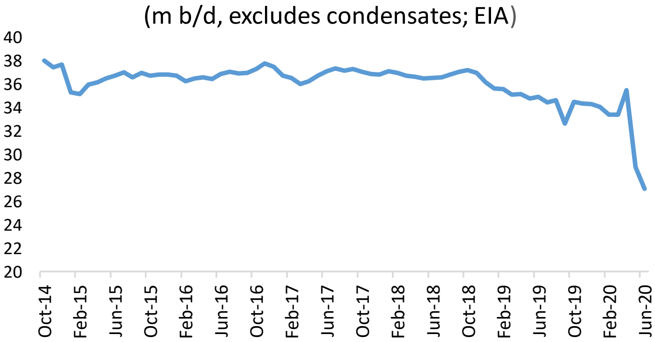
OIl: Scheduled Travel on US Airlines
(passengers; Dept. of Transport)



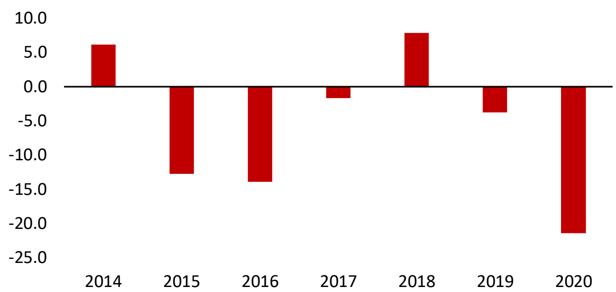
Oil: Implied US Gasoline Demand
('000 b/d; US DoE)



Oil: OPEC Total Liquids Supply
(m b/d, excludes condensates; EIA)



Oil: Iraq Fiscal Balance
(% GDP; IMF, IIF)



an acceleration of Covid cases in late July and Mumbai, the country's financial hub, has extended its lockdown by a month. These are reminders that the recovery from the impact of Covid is likely to face periodic setbacks, at least until a vaccine is discovered and distributed.

As for global air travel, the picture remains grim with a 70% year-on-year collapse in the second quarter. The International Air Transport Association (IATA) anticipates a very slow recovery, and does not expect 2019 levels to be regained until 2023 at the earliest, such is the hesitancy of potential tourists, and a re-working of business communication.

There is little consensus on demand outlook

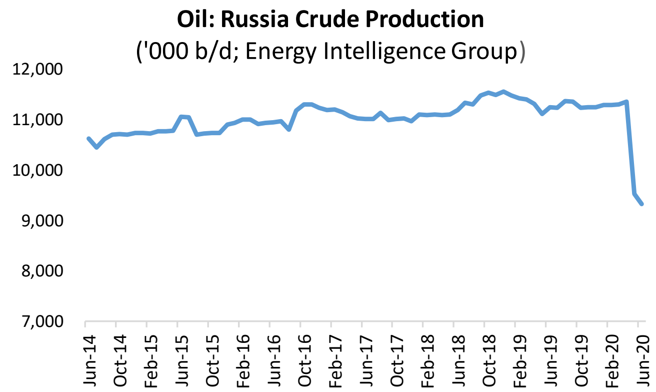
The elevated level of uncertainty around the post-Covid recovery can be seen in a wide range of views from leading analysts. On the bullish side, Citi thinks that demand will be back to pre-Covid levels by Q4 2021; Standard Chartered, by contrast, suggests that demand will still be below 2018 levels in 2021.

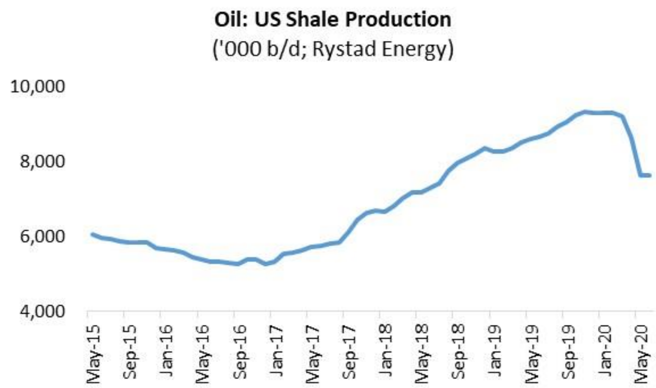
The supply outlook is somewhat easier to gauge, though it is still far from straightforward. May and June data show that the OPEC Plus cuts were largely delivered, with the GCC and, to a lesser extent, Russia, leading the way. In early June the group agreed to extend the 9.6m b/d of cuts to the end of July, rather than tapering to 7.7m as originally agreed. However, by mid-July the organisation had enough confidence in the demand outlook to agree to taper to 7.7m b/d in August.

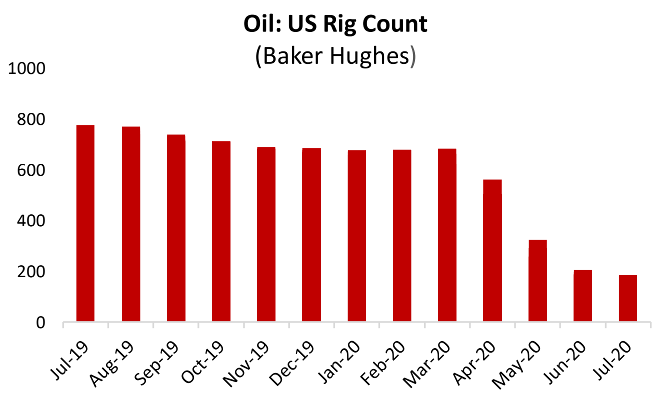
OPEC Plus delivers substantial cuts, though discipline is still patchy

That supply increase will be partly offset by members that did not fulfil their commitments to reduce output in May and June. As recompense, Iraq, Nigeria, Angola and Kazakhstan say they will collectively deliver an additional 410,000 b/d of cuts in August and 660,000 b/d in September. Iraq, which is a habitual over-producer, will account for just under half of this total. The problem for Iraq is that much of its oil output is delivered by IOCs, which may be reluctant to shut in additional output, while its budgetary strains—and broader socio-economic grievances—are acute.

That said, Iraq is under particularly strong pressure from other OPEC members, and the chances seem reasonably good that there will be significant cuts to Iraqi output in July and August. Meanwhile, Russia, which has rarely fully complied with monthly targets, is also showing renewed commitment to the OPEC Plus strategy. Exports of its flagship Urals crude are set to fall by 40% in July according to loading data cited by Bloomberg.







US output falls as unforgiving financial metrics take hold

The other key dynamic on the supply side is the fate of non-OPEC production, most notably US shale. The collapse in the benchmark WTI crude price in March and April hit shale production hard, with large amounts of oil being locked in as demand collapsed and storage rapidly filled up. By end-May US shale output was down some 1.8m b/d from its pre-Covid level, according to Rystad Energy, with 18 exploration and production companies bankrupt. Deloitte estimates that at a price of $35/b around a third of shale firms are insolvent.

A restart to US drilling is still some way off

The outlook for shale production remains dependent on the price recovery. With WTI now around $40/b one can expect more shut-in barrels to be released in the next few months. But fresh drilling—and hence sustainable production gains—will require prices at $45/b or above. The number of drilling rigs has slumped from almost 700 in March, to some 180 in mid-July. Capex plans for the sector have been almost halved to $54bn for the year.

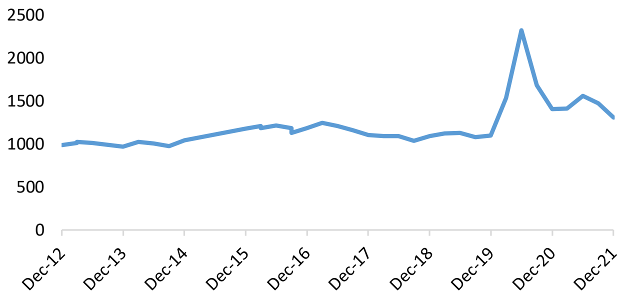
For OPEC Plus, this poses an obvious dilemma: how to push prices higher but simultaneously stop shale from reviving? The answer might be provided by Wall Street. Shale operators have devoured some $340bn of capital over the past 11 years. This may reflect some profligacy, but it is more a function of shale production. Fracked wells give an initial spurt in output but then crater by around 60% in the first year of production. This means that more and more wells need to be drilled in order to push overall output higher. If these wells are not drilled –owing to a lack of capital, for example—then production rapidly falls away.

Some analysts believe that overall US production would fall by over a third in just 12 months if no new wells were added. This is about seven times the rate for the global industry. The number of bankruptcies is emblematic of Wall Street's growing impatience with this business model, and shale firms are likely to find capital scarce for this year at least. Consolidation remains likely, but there are only a few firms with the balance sheets to contemplate this. One such is Chevron, which agreed to acquire Noble Energy and its substantial shale assets, for a knock-down price in mid-July.

US firms have yet to fully hedge 2021 production

The other complicating factor for shale firms is hedging. As it stands, shale firms have hedged only around 17% of 2021 production, according to Standard Chartered. This is largely a reflection of low futures prices, which in turn reflects the lingering

Oil Stocks
(m barrels; IEA, Citi, Samba)



We expect a halting recovery in oil prices during the rest of 2020 and into 2021. WTI should rise above $45/b next year, which will spur some recovery in US shale output. This in turn will keep prices for both WTI and Brent below $50/b in our view.

effects of contango, whereby deferred prices are weaker than prompt ones owing to storage issues.

Release of locked-in shale to put cap on price growth in near term

Pulling these various strands together, we expect the OPEC Plus cuts, shale's woes and a rebound in economic activity to nudge prices upwards during the rest of the year and into 2021. However, in the very near term, the release of locked-in shale oil will keep prices under pressure and it will be up to OPEC Plus to maintain production discipline. Assuming this is achieved, we expect the market to move into deficit in Q4, so allowing a gradual drawdown of the large inventory overhang. By the end of 2020 we expect Brent to be pushing $45/b, giving an average for the year of $40/b.

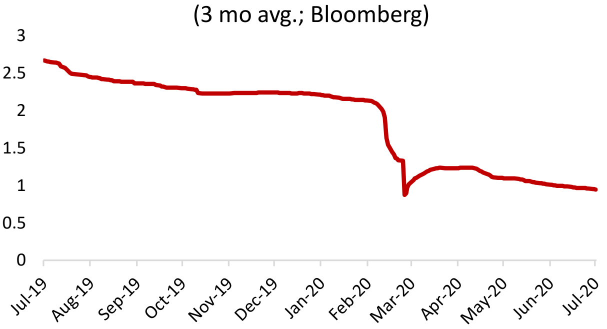
Firmer prices expected for 2021 but low by historical standards

In 2021 as global economic activity firms and stocks continue to be drawn down (even in the face of higher OPEC Plus output) so we expect WTI to push past $45/b. This will spur a revival of shale drilling, but this is likely to be hesitant and patchy, indicating that it may not be until H2-21 before shale makes a meaningful recovery in output. This additional shale production will cap price growth and we expect Brent to average $46/b in 2021.

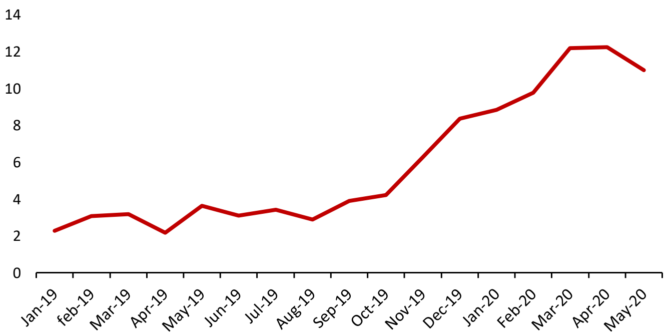
The main risk is to demand, with the potential for renewed lockdowns in the US eating into gasoline demand. Additional risk is from the production side, namely the adherence of Iraq and Nigeria to pledged cuts, particularly in a context of growing socio-economic pressures.

International bond investors appear largely unconcerned by the impact of lower oil prices on the Saudi budget and economy. The Kingdom's April sovereign bond was some eight times over-subscribed.

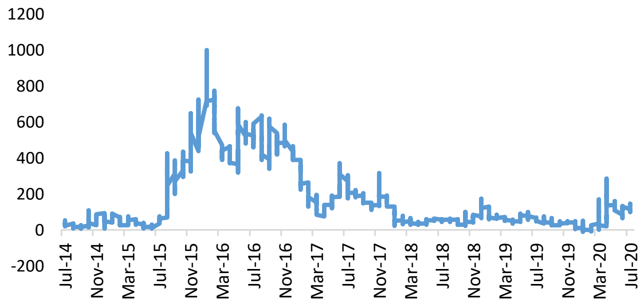
Saudi Arabia: SAIBOR
(3 mo avg.; Bloomberg)



Saudi Arabia: Bank Lending to the Private Sector
(% change, year-on-year; SAMA)



Saudi Arabia: SAR/USD 12 Month Forward
(points; Bloomberg)



Saudi Arabia

Saudi Arabia: Economic Indicators	2019	2020f	2021f	2022f	2023f	2024f
Real GDP (% change)	0.3	-4.8	5.8	2.3	3.3	4.0
Real nonoil GDP (% change)	3.1	-3.4	4.0	3.2	3.6	3.8
CP Inflation (average %)	-2.1	3.7	2.8	1.9	2.0	2.0
Fiscal balance (% GDP)	-4.5	-10.9	-4.8	-4.3	-2.1	-2.2
Current account (% GDP)	6.5	0.4	2.2	2.2	5.0	4.6
Net Foreign Assets (% GDP)	63	63	56	55	58	63
Bank deposits (% change)	7.1	4.0	4.0	4.0	5.0	6.0
Private sector credit (% change)	8.2	5.0	6.0	6.0	7.0	8.0
Sources: national authorities, IMF, Samba						

Saudi financial metrics stable despite oil price correction

Despite the sharp fall in oil prices this year, the Kingdom's macro-financial positon remain stable. Official net foreign assets have declined sharply, but this has been exaggerated by central bank transfers to the Public Investment Fund. It is true that the current account is under pressure, but it still returned a surplus in Q1 (see below). Firms and households are clearly retrenching, but confidence in the banking system is robust, with deposits growing by 10% in May, and the proportion of deposits held in foreign currency well below historical averages. The benchmark interbank rate, 3 month Saibor, has softened appreciably in the past couple of months as initial stresses in credit markets, following the imposition of Covid-related restrictions, eased somewhat. Saibor's easing also reflects interventions by the authorities to support both liquidity and businesses (notably SMEs).

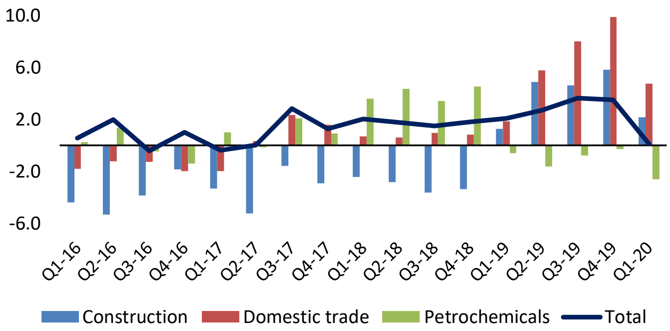
Stresses in domestic corporate sector as authorities work to keep credit flowing

Granted, there are still stresses—some of them acute—in the corporate sector. The Covid-19 restrictions have hit many customer-facing businesses especially hard, while curfews, restrictions around manpower, and sharp cuts in public investment constitute multiple blows to the contracting sector. But the authorities are working hard with banks to ensure that credit lines (especially to SMEs) remain available, and private sector credit growth remains firm at around 11%.

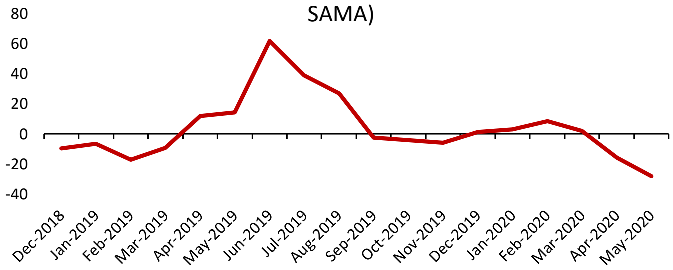
Foreign demand for Kingdom's sovereign bonds is undimmed

Foreign perceptions of the Kingdom's financial situation remain largely sanguine. There has been speculation on the SAR in the forward market, but even at its recent peak (in March, following the oil price collapse) activity was nowhere near as intense as that during 2015. There is also a clear divide between bond investors and currency speculators: the former rushed to secure a slice of the Kingdom's April $7bn sovereign placement, with the offering

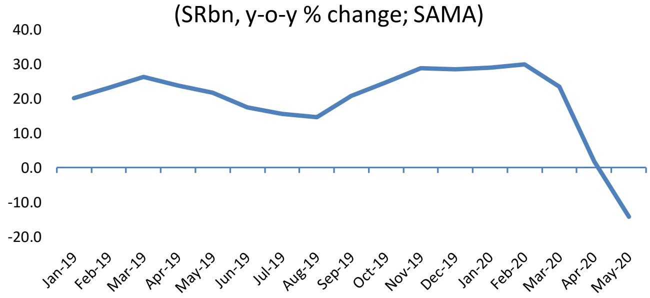
Saudi Arabia: Nonoil GDP
(y-o-y % change, constant 2010 prices; GASTAT)



Saudi Arabia: Private Sector Imports of Building Materials
(new letters of credit, value, y-o-y, 3 mo rolling avg; SAMA)



Saudi Arabia: Points of Sale Transactions
(SRbn, y-o-y % change; SAMA)



almost eight times oversubscribed. The enthusiasm for this offering, which was made in the depths of the oil price slump, confirms that investors remain positive on the Kingdom (though it also reflects more global liquidity than ever).

Nonoil economy struggles in Q1, with worse to come

Looking at the real economy, the authorities have released GDP data for the first quarter. These show that overall real GDP declined by 1%, year-on-year, following a 0.4% increase in Q4-19. Nonoil GDP, which we define as overall GDP less oil and gas output, grew by 0.1%. However, the quarter-on-quarter contraction of 4.8% was the biggest since Q2 2015.

Overall GDP was pushed down by a 2.9% contraction in crude oil output. This in turn reflected the intensification of the OPEC Plus agreements in January and February, though note that this period does not include the impact of the most recent accord, which removed 9.7m b/d from the market (the gyrations in output that accompanied this should be visible in Q2-20 GDP data).

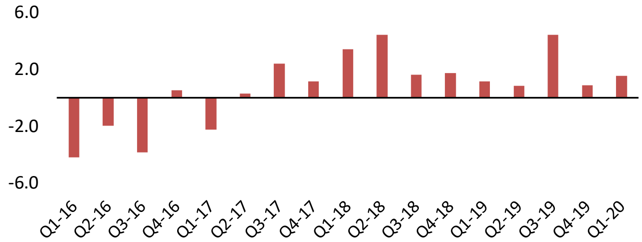
Nor does the period coincide with the Covid-19 restrictions, which only began to materialise towards the end of March. Nevertheless, the prospect of such a lockdown, coupled with the slump in oil prices during March, would certainly have begun to influence consumer and business behaviour during that month.

Construction, trade and petrochemicals all under pressure

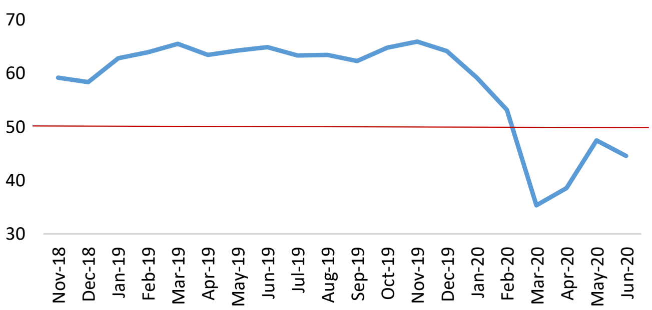
Looking at the main sectors of nonoil GDP, **petrochemicals** posted a 2.6% decline, reflecting the Q1 lockdown in China's Hubei province and elsewhere, which sapped demand. **Construction** continued its run of quarterly GDP gains, with a 2.2% increase. However, that is likely to be the last positive number for a while, given the impact of lockdown on activity and manpower (for example, 3pm curfews in the main cities). It is notable that private sector imports of building materials, which are a leading indicator of construction activity, began to tank in March, and fell even further in April and May.

Retail and wholesale trade (which includes hospitality) is perhaps most exposed to Covid and its associated restrictions. This sector too recorded another robust gain (4.8%) to add to an impressive series running back to Q2-17. However, there are early signs of distress with a 7.3% quarter-on-quarter contraction. Meanwhile, official data show points of sale values slumping from 30% annual growth in February to 14% contraction in May. Imports of appliances and clothing also slumped in April and May, while car imports were heading the same way.

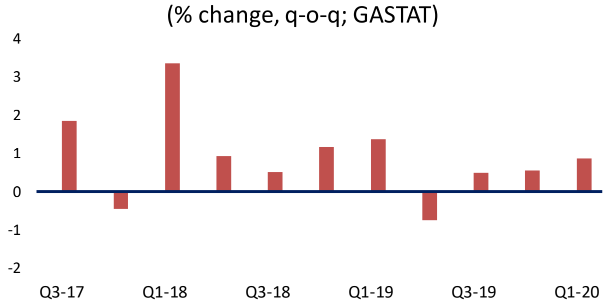
Saudi Arabia: Government Services Contribution to Nonoil GDP
(y-o-y % change, constant 2010 prices; GASTAT)



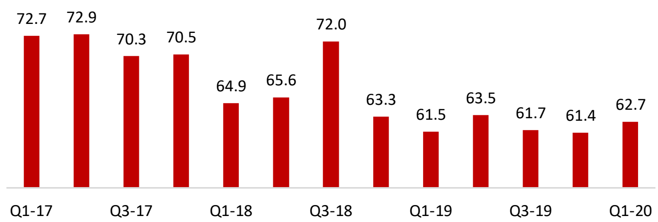
Saudi Arabia: PMI - New Orders
(50+ denotes growth; Markit)



Saudi Arabia: Public Sector Wages
(% change, q-o-q; GASTAT)



Saudi Arabia: Private Sector Wages as Proportion of Public Sector Wages
(%, avg; GASTAT)



Government services one of few areas of growth

Nonoil GDP would have contracted were it not for government services, which posted a 1.5% year-on-year increase. Government services account for a quarter of nonoil GDP. This is also visible when viewed from the expenditure side. Government consumption grew by almost 8% in the first quarter, far outstripping private consumption growth of just 0.9%. The data show that real imports fell by almost 15%, thereby staving off an even worse contraction in GDP.

PMI data suggest April was the low point

PMI data indicate that April is likely to have been the worst month for the economy, with sharp falls in all the subcomponents. But while the Output and New Orders indices showed some recovery in May and June, they were still firmly below the 50 breakeven mark. Indeed, the New Orders index fell again in June, as the cuts to government procurement and capex began to tell. Firms also reported cuts to staff levels and wages, though these overwhelmingly affected non Saudis.

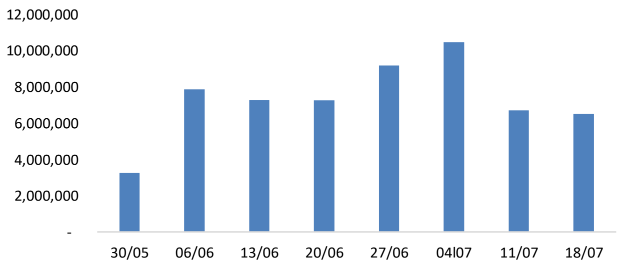
Q1 data show unemployment easing, though this is unlikely to be sustained

Earlier data, for the first quarter, show that the Saudi unemployment rate fell to 11.8% from 12% in Q4, thanks to a rise in female employment (male unemployment rose by 70 basis points). Expatriate employment also rose, by some 200,000. The PMI data suggest that expatriate employment is likely to fall back again, and it is difficult to see how the Saudi unemployment rate will continue to decline given weak private and public investment. Meanwhile, average public sector wages for Saudis edged up in Q1, by 0.9% compared with Q4-19. Such an increase would be large by most country's standards, though in the Saudi context it was subdued relative to the gains in 2018, which averaged 1.5%. Private sector wages for Saudis also showed an upturn, this time by 3%. This gain meant that private sector wages narrowed the gap slightly on public sector wages, though private sector earnings are still just 63% of those in the public sector. Indeed, in nominal terms private wages are still some way below the recent peak recorded in Q3-18; at that point, they were equivalent to 72% of public sector earnings.

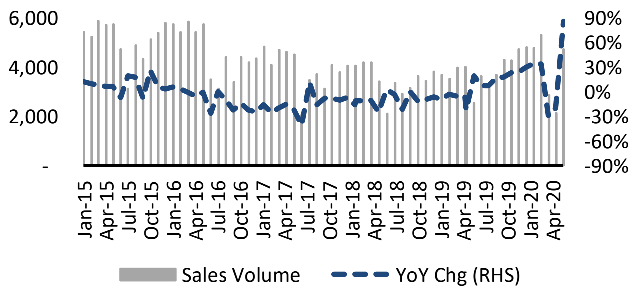
Retail sales show pre-VAT bounce

Very recent data are more positive. SAMA now publishes weekly points of sale data, and these show that there was a substantial

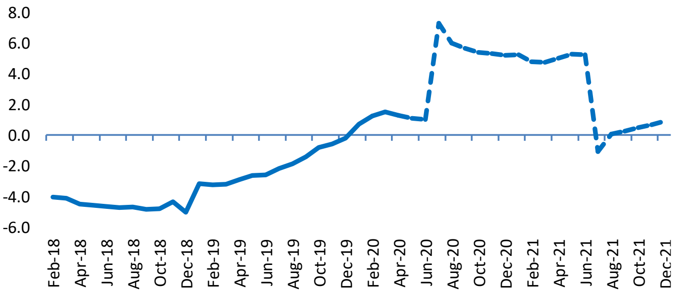
Saudi Arabia: Weekly POS Transactions
(value, SR'000s; GASTAT)



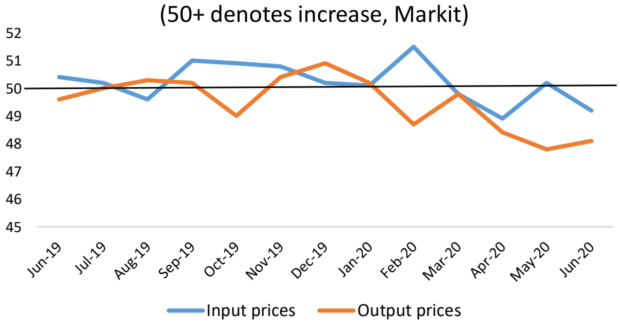
Saudi Arabia: Monthly Cement Sales
('000 tonnes; Yamama Cement Co.)



Saudi Arabia: Consumer Prices
(y-o-y % change; GASTAT, Samba)



Saudi Arabia: PMI - Input Prices vs Output Prices
(50+ denotes increase, Markit)



bounce-back in the final week of June and the first week of July as the lockdown was lifted (or substantially eased) in most cities. The average value of transactions in those two weeks was more than a third higher than the previous two. On a monthly basis, this amount of spending would be more than double that of June 2019. While much of the increase represents pent-up demand, a good deal will also reflect pre-VAT buying (see below). Either way, it is unlikely to be representative of post-lockdown shopping trends. Indeed, subsequent data showed transactions settling back at around mid-June levels.

Cement production also shows an upturn

There are also signs of a revival in cement output, which saw a sharp rise in June following two Covid-hit months. The monthly surge was 86%, which was enough to give a slight overall rise for Q2 versus Q2-19. In the absence of any meaningful private investment and with the central government investment also weak, the surge is likely to be related to PIF activities.

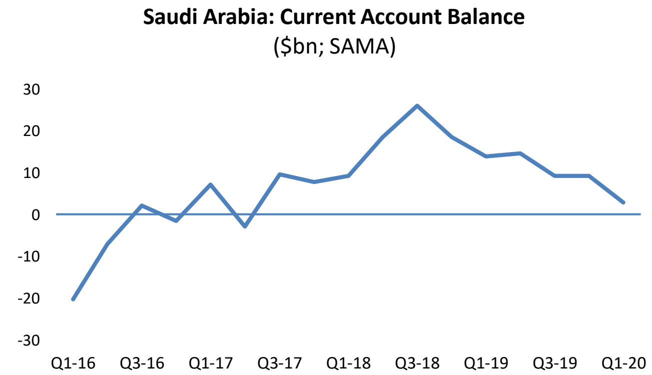
Price pressures generally subdued

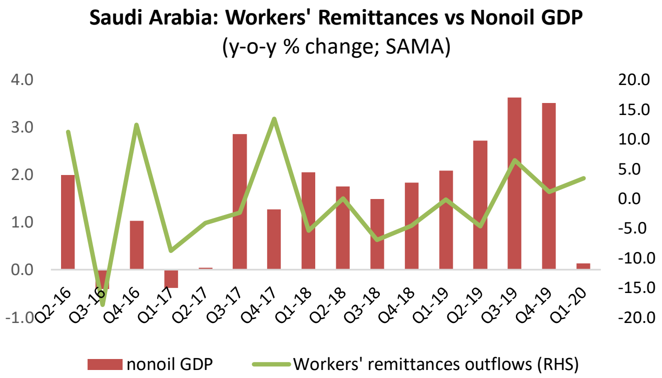
Prior to the tripling of VAT on July 1, Saudi consumer price pressures were subdued. Official data show that year-on-year inflation eased to 1.1% in May, from 1.3% in April. What pressures there were came from higher food prices, which have a heavy weighting in the index. This likely reflects some hoarding by shoppers as the lockdown intensified. Other price pressures were weak, with a notable decline in transport costs as local fuel prices were slashed in line with falling oil prices.

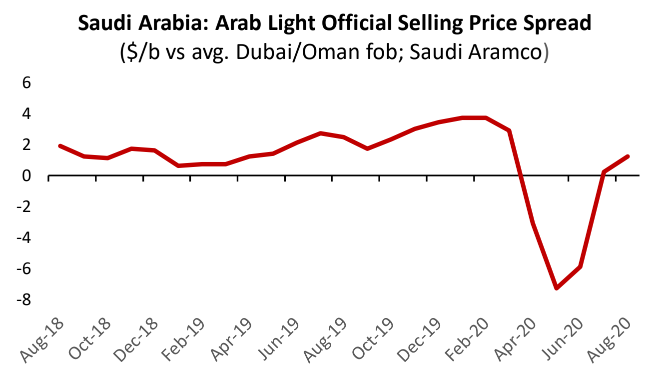
VAT will see July prices spike, but retailers likely to absorb some of this

Prices will naturally spike in July with the VAT increase, and the impact will be exacerbated by the recent increase in import duties. The main impact for consumers will be through food prices, where customs duties have increased from 0.5% to a range of 0.6%-15%, depending on the product.

Nevertheless, competition in both the wholesale and retail sectors is intensifying again, with the PMI showing that output prices are falling much faster than input prices. This suggests that wholesalers and retailers are likely to absorb a good portion of both the VAT and customs increase; we think that shoppers will see prices rise by some 6-8 percent in July. After the increase, we expect to see month-on-month deflation to resume. Based on this we think average inflation for the year will be around 3.7%, up from -2.1% in 2019.







Upward price pressures are expected to resume in 2021 as confidence and spending improve somewhat, but these are likely to remain muted, and we expect inflation to average around 2.5% next year.

Current account posts Q1 surplus, but will it stay there?

SAMA data show that the current account maintained a surplus in Q1, albeit one that was more than two thirds lower than the previous quarter. The surplus was $2.9bn, the smallest recorded since the current account moved out of the red in the second half of 2017. The primary reason for this was a $10bn contraction in the visible trade balance, with an $11bn fall in export earnings (owing to slumping oil prices in March) only fractionally offset by reduced import spending. Nonoil exports also fell, as chemicals and plastics demand continued to soften.

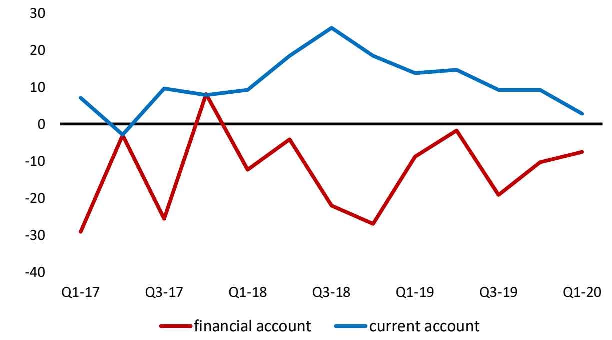
The services balance, which runs a structural deficit, was reduced quite sharply, with reductions in freight and especially business services costs. Less helpful was an uptick in outward remittances. This was not large, but the unexpected increase in expatriate employment in Q1 (see above) clearly played a role here. We still expect a full-year reduction in remittances outflows, which should become apparent in Q2 data, though it is true that these flows have been volatile in the past and do not always follow economic fundamentals.

April recorded a visible trade deficit

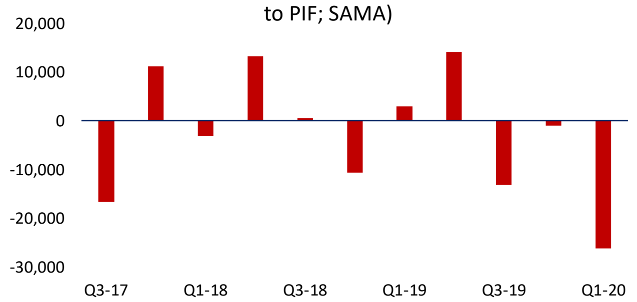
The near term outlook for the current account is not especially good, but we do expect a surplus to be maintained in Q2. Somewhat troublingly, monthly data for April show that the Kingdom actually recorded a visible trade deficit (albeit small). This reflects a slump in oil revenues as the Kingdom slashed its official selling prices (OSPs) for deliveries to Asian customers even as it boosted production in a bid to gain market share. Import spending continued to slide in April, but not by enough and the visible trade balance showed a deficit of around $250m.

OSP spreads returned to normal in July, and with the partial recovery in oil prices a visible trade surplus for the quarter as a whole seems likely. Assuming no spike in remittances outflows as expatriates leave the country and take their money with them (which should actually be recorded on the capital account) then we would expect a modest current-account surplus. For the year as a whole we continue to expect a small current account surplus, though the risks—in the form of oil revenues and volatile remittances flows—are to the downside.

Saudi Arabia: Current Account vs Financial Account
($bn, Q1-20 excludes assumed transfer to PIF; SAMA)



Saudi Arabia: Reserve Assets
($m, q-o-q change, Q1-20 includes assumed transfer to PIF; SAMA)



Some official forex reserves shifted to PIF

A transfer of funds from SAMA to the PIF, which according to the Minister of Finance, amounted to a total of $40bn in March and April, distorts the financial account. It is not entirely clear how this is accounted for in the balance of payments, though there were sharp increases in both portfolio and other investment outflows compared with Q4 (roughly $15bn), which may well represent PIF investments abroad (these were higher-than-anticipated in Q1).

These transfers, which can be designated as "one off", obscure the underlying trend in the financial account in Q1. If we assume that $20bn was transferred to the PIF in March, and we set this to one side, then the financial account would have recorded a deficit of some $7.5bn, which is somewhat below the average quarterly deficit in 2019 ($10bn). Naturally, this is partly a reflection of the smaller current-account surplus.

As for the transfers themselves, the funds will be staying under the control of the public sector and should generate higher returns to support the current account in the future.

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