Saudi Arabia: Promising outlook guided by Vision 2030

The Saudi economy has come a long way since 2015-2016; the fiscal deficit narrowed substantially, the current account is back in surplus, and non-oil growth recovered to around 3%. In line with Vision 2030, the non-oil sector is forecast to be the main driver of economic growth going forward as oil's contribution to growth diminishes and as KSA continues to lead efforts in OPEC+ oil supply management. The budgetary revenue outlook calls for spending restraint in the coming few years, but the projected fiscal deficits should be manageable, in our view, amid solid financial buffers and still-low debt levels. As a major oil exporter, the main downside risk continues to be lower-than-expected oil prices, but a steadfast implementation of Vision 2030 and higher non-oil growth rate could mitigate this risk.

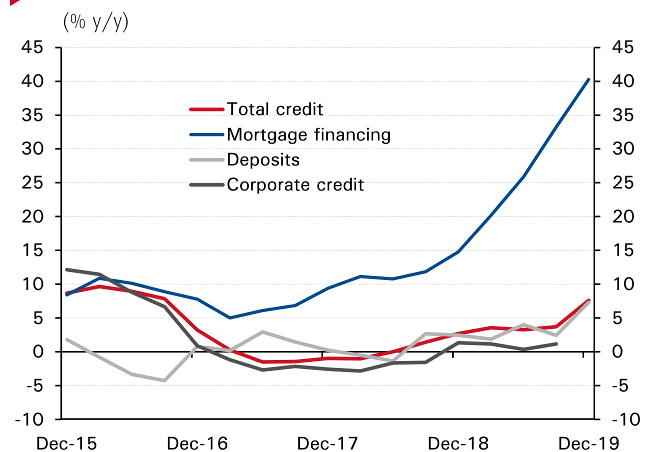
Raja Ghoussoub
Senior Economist
+965 22595365
RajaGhoussoub@nbk.com

Growth to be mainly driven by the non-oil sector

After bottoming out in 2016 at 0.2% y/y, non-oil growth started to improve gradually, reaching 3.1% in the nine months ending in September (9M2019). This improving trend is promising, but recent growth rates are relatively low in a historical context. For example, non-oil growth averaged 5.6% per annum in 2011-2015 and 8.1% in 2006-2010. The main reason for this difference has to do with lower oil prices—Brent averaged $97 per barrel in 2011-2015 compared with $57 per barrel in 2016-2018.

With higher oil prices usually comes elevated government spending, which drives to some extent private sector activity. The improvement in non-oil growth since 2017 was driven in part by higher levels of spending, including on the Private Sector Stimulus Plan (PSSP). Government spending had increased by 12% and 16% in 2017 and 2018, respectively, before inching down by 3% in 2019 to reach SAR 1.05 trillion, which is still one of the largest annual outlays on record. The government had allocated SAR 200 billion to the PSSP for the 2017-2020 period, to be directed to sectors that drive economic growth and employment of Saudis. After an estimated 2.8% in 2019, we are forecasting non-oil growth at 2.7% and 2.6% in 2020 and 2021, respectively, and we expect the private sector to grow faster than the public one.

Chart 1: Growth in credit components and deposits



Source: SAMA, NBK estimates

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In its attempt to decouple oil prices from the non-oil sector growth, the government has moved forcefully to energize the non-oil sector in line with Vision 2030. For example, boosting Saudi home ownership, which historically has been relatively low, is a main focus of the PSSP and an important target of Vision 2030. The government has been tackling that from both the supply side (providing developers with financing & land, introducing white land tax, etc.) and from the demand side through expanding the mortgage market by primarily providing subsidized credit in addition to other measures such as providing guarantees, increasing maximum loan-to-value ratios, and decreasing banks' risk weights on mortgage loans. The government's efforts have been successful as mortgage loans have soared since 4Q2018, reaching an estimated growth rate of 40% in 2019 (Chart 1), and Saudi home ownership rates have been increasing steadily.

The construction sector started recovering in 2019

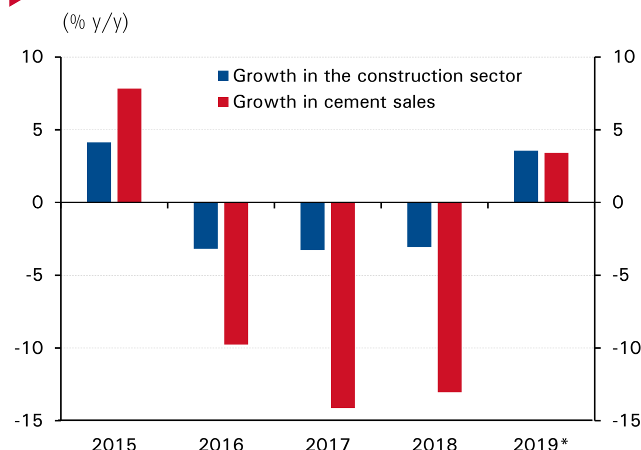
A related metric is the growth in the construction sector real GDP, which turned positive in 2019 (+3.6% in 9M2019) after three years in the red, benefiting from the various housing projects underway as well as the launch in 2019 of several mega projects in Riyadh and elsewhere in the country such as Neom, Qiddiya, and the Red Sea project, among others. The pick-up in construction activity is reflected in a solid y/y increase in cement sales since June 2019, having expanded by 16% y/y in 2H2019, and leading to positive growth in 2019 after three years of double-digit decreases (Chart 2). Going forward, we expect these trends to continue, given the government's unwavering commitment to increase home ownership rates, and to proceed with the ongoing mega projects.

Private sector investment spending has exhibited an accelerating recovery in 2019

Another positive indicator is the expansion of private sector activity, reflected inter alia by double-digit increase in new import letters of credit (LCs) since mid-2019. A more positive development is the trend in the new private sector import LCs for building materials and machinery, which is a good indicator of capital spending. Growth here turned positive (+7% in 2019), after falling by double digits in each of the four previous years—its level in 2018 was a whopping 62% below that of 2014 (Chart 3). The GDP data also show that investment spending by businesses is showing an accelerating recovery with "gross fixed capital formation" increasing y/y by 4%, 10%, and 14% in 1Q2019, 2Q2019, and 3Q2019 respectively, reversing a generally decreasing trend

Chart 2: Growth in the construction sector & in cement sales

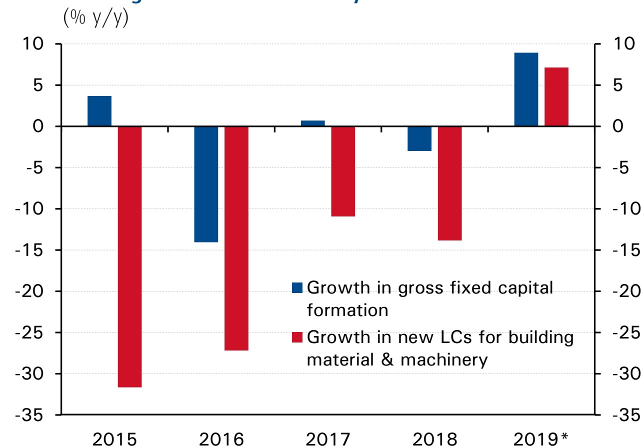
(% y/y)



Source: GASTAT, Argaam * 9M2019 for the construction sector

Chart 3: Growth in capital formation & in new LCs for building material & machinery

(% y/y)



Source: GASTAT, SAMA * 9M2019 for gross fixed capital formation

between 2016 and 2018. These indicators were confirmed by the PMI that measures private sector activity , and which has been on a generally upward trend in 2019 reaching 58.3 in November, the highest reading since August 2015, before easing to a still-solid 56.9 in December.

Consumption has rebounded, benefitting from various government initiatives

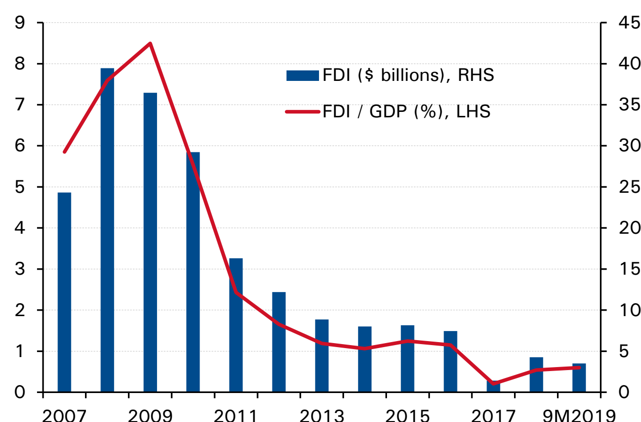
Total private consumption rebounded in 2019, rising by 4.6% y/y in real terms in 9M2019 (versus an average of 2% in 2016-2018). Consumption has been supported by various government initiatives such as subsidies through the "Citizen Account" program, extension of the cost of living allowances that were first introduced in January 2018, an ongoing Saudization drive, increased female participation in the labor market, in addition to the PSSP. Consumption, and hence overall economic growth, should eventually benefit from other reforms that are being implemented, such as allowing women to drive, relaxing visa requirements, and staunchly supporting foreign as well as internal tourism through, for example, launching several international entertainment festivals throughout the country.

Manufacturing has been weak and FDI remains muted despite recent improvement

The manufacturing sector has been weak, and corporate credit growth remained muted at around 1% y/y by the end of September 2019 although there are signs that growth has improved in the last quarter of 2019. Total credit growth has improved to 7.6% in 2019 (from 2.7% in 2018 and negative growth in 2017), supported by soaring mortgage financing, which accounted for an estimated 51% of the total increase in credit in 2019. We believe that weak corporate credit growth is most probably demand-driven, given the comfortable liquidity situation and solid capitalization levels of Saudi banks. Having said that, we would expect corporate credit growth to improve if non-oil growth were to accelerate from its current level of around 3%.

Foreign direct investment (FDI) picked up in 9M2019 (+10% y/y reaching $3.5 billion) to stand at 0.6% of GDP, which is less than half its average in the 2012-2016 period (Chart 4). Going forward, we expect stronger FDI flows in line with Vision 2030. The latter targets FDI at more than 5.5% of GDP, which is a level that could be reached in the medium term as FDI had averaged 6.5% in the 2006-2010 period.

Chart 4: Foreign Direct Investment



Source: GASTAT, SAMA

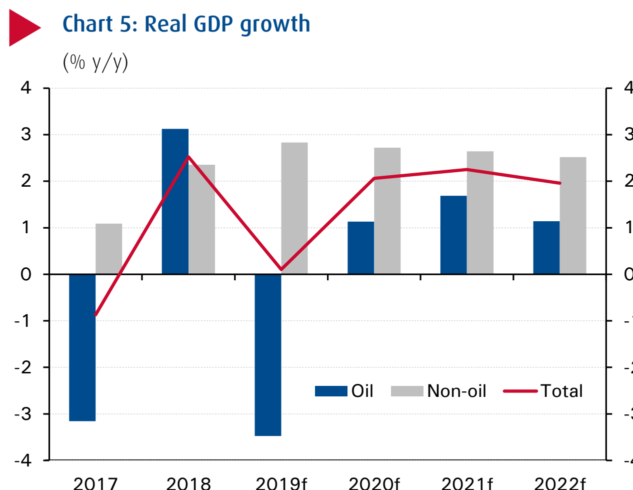
Oil production to be guided by the OPEC+ agreement, for now

Saudi Arabia has been playing a leading role within OPEC in order to balance the oil market following the surge in oil production elsewhere and the deceleration in the demand growth rate. As such, the latest OPEC+ agreement targeted a further 0.5 mb/d production cut, effective 1 January 2020. KSA's share of that cut stands at 0.167 mb/d with an additional voluntary cut of 0.4 mb/d that is conditional on full compliance by other members of OPEC+. Given its leading role, Saudi Arabia had over complied with the previous agreements and production averaged around 9.8 mb/d in 2019, 4.9% below 2018, with an average compliance rate of 266%.

In light of its dominant position in OPEC and importance in the global oil market, Saudi is likely to continue taking

the leadership role and bear most of the burden of oil cuts. Nevertheless, if circumstances change, it can easily ramp up production to its quota (of 10.1 mb/d) and up to its capacity (north of 12 mb/d) in a short time. However, statements by the Saudi authorities indicate that oil production will probably not witness a rebound, at least in the early months of 2020. Therefore, we conservatively forecast hydrocarbon GDP to expand by around 1% and 1.7% in 2020 and 2021, respectively, with oil production gradually increasing to around KSA's quota of 10.1 mb/d in 2022. These growth rates, coupled with our faster growth for non-oil GDP, should result in an average headline GDP expansion rate of around 2.1% in 2020-2022, but could well reach a stronger growth of 2.3% on average for these three years, as per the government's forecast (Chart 5).

Chart 5: Real GDP growth



Source: GASAT, NBK forecasts

As part of Vision 2030, the government was set to sell up to 5% of Aramco's shares to the private sector and use the proceeds for boosting private sector growth. Aramco's IPO yielded $29.4 billion (for around a 1.7% stake, 1.5% plus 15% of that due to the exercise of the over-allotment option), which has been transferred to the Public Investment Fund (PIF). This IPO and any additional sales in the future will deprive the budget of some oil revenues. In addition, the government has made several changes, effective 1 January 2020, to the fiscal regime under which Aramco operates, the most important of which is the reduction in the royalty rate to 15% (from 20%) on Brent prices up to $70 per barrel.

This will negatively impact oil revenues, but might be compensated by higher dividend payments from Aramco and increased private sector activity that could generate additional revenues to the budget (VAT and other taxes and fees) and less spending on wages, as more Saudis will be moving to the private sector. The transparency and flow of information related to the listing of Aramco on the Saudi Stock Exchange (Tadawul) and inclusion of the stock in the emerging market indices is a welcome development that could attract higher foreign investment. The price of Aramco's share has remained firmly above the IPO price of SAR 32, standing at SAR 34.15 as of 30 January 2020 (7% above IPO price) and reflecting a market capitalization of $1.82 trillion.

Inflation is projected to turn positive in 2020

After inflation stood at 2.5% in 2018, which was mainly driven by the 5% VAT implementation in January of that year, consumer prices were beset by deflation in 2019 (average prices decreased by 1.2% y/y) primarily on the back of falling housing rents (average rents down by 7.4% y/y). Excluding the "Housing" component, we estimate that inflation would have been around +0.7% in 2019. The increased supply of housing units and lower demand from expatriates are main factors behind the pressure on housing rents. Going forward, we expect a normalization of inflation to around 1.4% in 2020 and 2021 as the non-oil economy expands and the pressure from housing rents eases off. We think that the broadly flat government spending levels, the moderate levels of non-oil growth, and the relatively high, albeit falling, unemployment rate are factors that will restrain runaway inflation in the coming years.

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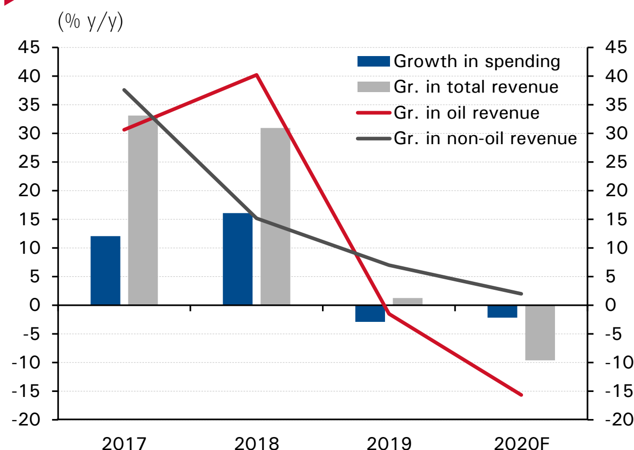
Fiscal deficits narrowed in 2017-2019

After peaking at around 16% of GDP in 2015, the fiscal deficit has been gradually narrowing, to reach an estimated 4.6% of GDP in 2019. This improvement in the fiscal deficit is in line with the government's Fiscal Balance Program (FBP), and can be attributed more to higher revenue trends as opposed to lower spending levels. Between 2016 and 2018, total revenues increased by an average of 32% annually, significantly surpassing the 14% annual expansion in spending (Chart 6). While the boost to oil revenues was driven by higher oil prices (Brent averaged $72 in 2018 versus $45 in 2016, with oil revenue increasing by 35% annually), non-oil revenues were supported by the various reform measures that the government implemented as part of Vision 2030. These reforms include the introduction of a 5% VAT, an "Expat Levy" on expatriate workers and their dependents, as well as excise taxes on soft drinks, energy drinks, and tobacco, among others.

Chart 6: Growth in government revenues and spending



Source: Ministry of Finance, NBK forecasts

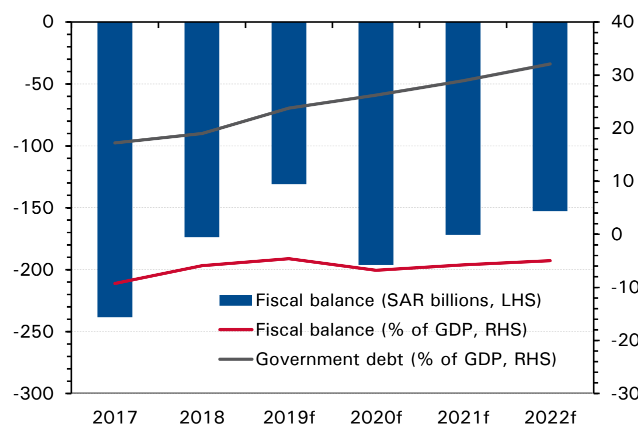
In 2019, faced with decreasing oil revenues (driven by lower production and weaker oil prices with the Brent price 11% below the 2018 average), and normalizing non-oil revenues, the government cut overall spending (by 5% compared with the budgeted level) and met its fiscal deficit target. Capital expenditures were cut by 9% in 2019 (compared with 2018) and current spending by 2%, which compensated for the lower-than-budgeted revenues. In our view, this reflected a clear commitment on the part of the authorities to keep the fiscal position under control.

The outlook for the fiscal position is manageable amid solid financial buffers and still-low debt levels

Our projections for government spending in KSA is broadly in line with the budgeted baseline. We forecast the fiscal deficit to widen to 6.8% of GDP in 2020, before resuming its downward trend to stand at 5.7% and 5% of GDP in 2021 and 2022, respectively (Chart 7).

Given the overall financial buffers that KSA enjoys ($141 billion (19% of GDP) of government deposits placed with SAMA, PIF assets of at least $300 billion (39% of GDP), $134 billion of public sector institutions deposits placed with SAMA & the commercial banks, in addition to SAMA's $500 billion official reserves) and a relatively low 24% debt/GDP ratio, we believe the projected fiscal deficits would remain manageable. Nevertheless, we expect the debt/GDP ratio to be on an increasing trend, as the fiscal deficits are expected to be financed by issuing new debt as well as by drawing down government deposits. For 2020-2022,

Chart 7: Fiscal balance and government debt



Source: Ministry of Finance, NBK forecasts

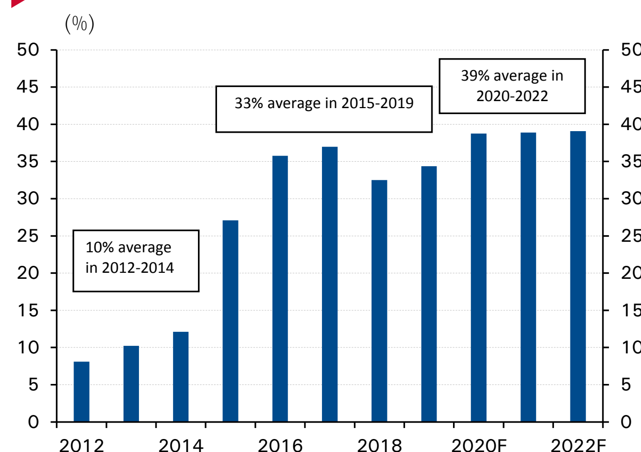
we estimate that fiscal deficits will be plugged through 55% debt issuances and 45% deposit drawdowns, and hence we forecast the debt/GDP ratio to reach around 32% by 2022, which is considered relatively low by regional as well as global standards.

With oil prices where they are, and non-oil revenues plateauing after their rapid increase in the past few years, the government lowered its revenue projections for 2020-2022 (by an average of 19% compared to its previous projections), and is aware of the need to reduce public expenditures (to be cut by an average of 15% compared to its previous projections) in order to put the fiscal balance on a sustainable and downward trend.

We are forecasting revenues to decrease by around 10% in 2020 due to a projected decline in oil revenues (using an average oil price of $60/b), before inching up marginally (around 2%) in 2021 and 2022, broadly consistent with the government's projections. The share of non-oil revenues should increase going forward, in line with the trends seen in the past few years and Vision 2030 targets, supported by the launch of the FBP and the various non-oil revenue initiatives (Chart 8).

As for spending, for 2020, the government is rightfully focusing on cutting current outlays while maintaining capital expenditures broadly flat at around 17% of total spending. The authorities intend to cut spending in 2020-2022 by an average of 3% annually, a break from past trends, reflecting the authorities' determination to contain spending. However, the PIF, one of the pillars of Vision 2030, is already taking an increasingly important role in the Saudi economy by raising its investments domestically and abroad. In 2015-2018, its assets nearly doubled to around $300 billion, and are set to grow to $400 billion by 2020 and up to a staggering $1.87 trillion in 2030. In this respect, the PIF could compensate for the impact of declining government spending on non-oil growth.

Chart 8: Non-oil revenues as a share of total revenues



Source: Ministry of Finance, NBK forecasts

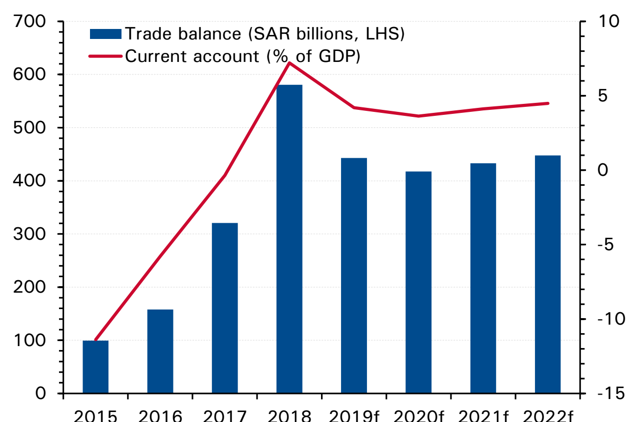
The external current account is forecast to remain in surplus

Pre-2015, the current account (CA) in KSA tended to be firmly in positive territory on the back of significant oil exports. With the slump in oil prices in 2015, the CA turned negative, but then improved steadily to register a surplus of 7% of GDP in 2018 (Chart 9) on the back of higher oil and non-oil exports and generally lower imports. After an expected weakening to around 4% of GDP in 2019 on lower oil exports, we forecast the CA to remain broadly stable through 2022 as we project higher non-oil exports in the medium term and lower drag from workers' remittances resulting from continued Saudization policies.

As for the financial accounts of the balance of payments, net FDI flows have been generally negative. As per SAMA's bulletin, outward FDI ballooned to reach $23 billion in 2018 (probably driven mainly by PIF investments), after averaging $8 billion in 2016-2017. For the first nine months of 2019, KSA invested abroad some $12 billion in outward FDI, more than three times the level of inward FDI in the same period ($3.5 billion). As for portfolio inflows, they have surged by 48% in 9M2019 reaching $29 billion, boosted by the inclusion of Tadawul in the emerging market indices of major global index providers such as MSCI and FTSE. As a result, the overall BOP was broadly in

balance as official foreign reserves remained generally flat for the second year in a row, standing at $500 billion by the end of 2019, equivalent to around 42 months of imports.

Chart 9: Trade balance and the current account



Source: GASTAT, SAMA, NBK forecasts

The outlook for KSA is promising; some risks remain

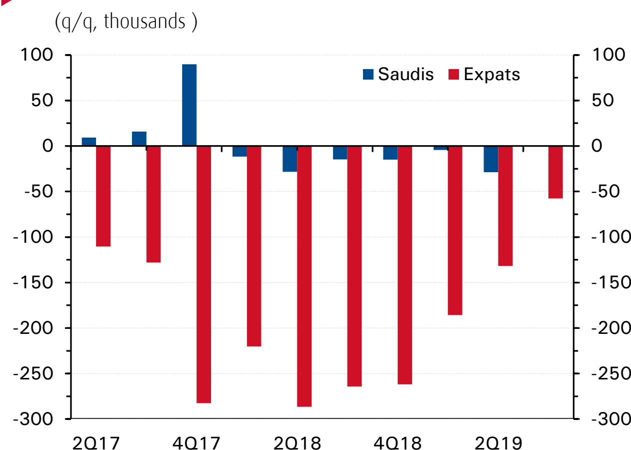
Vision 2030 provides a road map towards a country that is less dependent on oil but more on a vibrant private sector. The steadfast implementation of the strategy, which started in earnest in the past couple of years, augurs well for the future of KSA. The reform momentum could accelerate in the medium term as the country overcomes what is normally a difficult initial phase in any significant and comprehensive reform program. If the strategy continues to get implemented as per the plan, then real non-oil growth should improve, the fiscal position will likely stabilize, and the unemployment rate should decline as the private sector absorbs more of the Saudi labor force.

However, some downside risks could temporarily hinder the speed of the reform process. Given that KSA is still largely dependent on oil revenues, and as diversification of the economic base is a long-term process, a sharp drop in oil prices could complicate the implementation of Vision 2030. Another risk to the outlook is a major and sustained increase in regional geopolitical risk that hampers oil exports. This could affect government spending, and undermine consumer confidence & business investment, leading to weaker economic growth. Finally, despite a gradually decreasing unemployment rate among Saudis (down to 12% in 3Q2019 from nearly 13% in mid-2018), there is a need to create more private sector jobs for Saudi nationals and reduce the pressure on public sector wages (Chart 10).

However, with abundant financial buffers, considerable oil reserves, and improving human capital, KSA should be able to deal with temporary external shocks/other downside risks, and forge ahead with its reform efforts.

Chart 10: Job growth in the private sector

(q/q, thousands)



Source: GASTAT (based on GOSI, MCS records)

Head Office

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

International Network

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

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

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

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

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

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

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

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

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

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

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

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris, France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

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

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

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

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

Associates

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

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