Why is inflation in Saudi Arabia so low?

- **Saudi Arabia's inflation rate has been remarkably soft** relative to most of the emerging world in the post-pandemic era and we think it will slow further – and be weaker than most expect – over the coming years. Given the constraint of the dollar peg, this could help to improve **the competitiveness of Saudi's non-**oil sector, but it also risks making debt dynamics worse.

- The Kingdom's headline inflation rate has edged higher at the start of this year but, at just 2.4% y/y in May, it remains soft compared to Saudi's EM counterparts. That's been a common theme over the past four years. Food, core goods and non-housing services inflation have all weighed on the headline rate.

- A strong dollar, subsidised local fuel prices, cheaper imports from China, and structural drivers such as a flexible labour market have all played a key role in keeping inflation subdued. Inflation would have been even weaker were it not for housing. A boom in the residential real estate market has seen prices rise by a third since the pandemic, which has fed through into higher rents.

- There are some upside risks to the inflation outlook. One is that the weakness of the US dollar, to which the riyal is pegged, at the start of this year pushes up imported goods inflation over the coming months. There's also a risk that the government tightens fiscal policy by raising indirect taxes, such as VAT.

- Nonetheless, we think that inflation will remain soft over the coming years. First, energy inflation is likely to remain contained, particularly if the Aramco fuel price cap is removed and prices are adjusted to reflect lower global oil prices. Second, food inflation is likely to ease. Third, we expect that China's export prices will continue to decline amid overcapacity in its industrial sector, resulting in goods price disinflation.

- Fourth, recent housing reforms, including efforts to increase supply, are likely to have some success in curbing the run up in prices, putting downward pressure on rental inflation. And finally, notwithstanding tax hikes that lead to a one-off rise in inflation, a period of fiscal consolidation will weigh on non-oil activity. The experience from the period of austerity in 2014-16 is that this will dampen underlying price pressures.

- The upshot is that, w**hile we think that Saudi Arabia's headline inflation rate will hover around the 2.0-**2.5% y/y mark over the rest of this year, it is likely to slow as we head into 2026. Our forecast for inflation to average 0.8% in 2026 sits below the consensus.

- Given the constraint of the dollar peg, if Saudi inflation does remain weak, it could improve the Kingdom's external competitiveness and efforts to expand its non-oil economy. Services exports like tourism may benefit. But it's worth noting that non-oil goods exports, excluding those of refined products, make up a very small share of Saudi's exports.

- **What's more, because the peg forces Saudi monetary policy to follow the US,** interest rates could be too high. Real interest rates will remain positive, which could raise debt servicing costs. This could weigh on credit demand and add to concerns about the recent rise in mortgage lending and the exposure of banks to the real estate sector.

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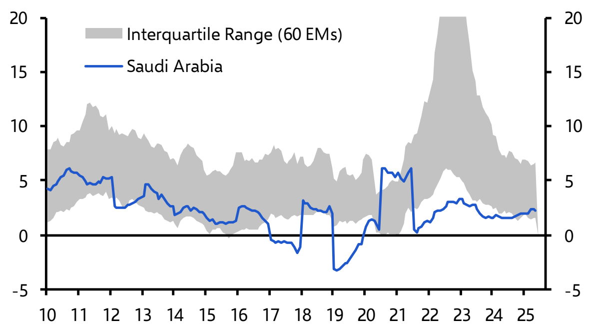
Why is inflation in Saudi Arabia so low?

Saudi Arabia avoided the inflation crisis that gripped most of the rest of the world a few years ago and inflation has eased over the past few years. In this *Focus*, we take a closer look at what have been the main drivers of inflation in the Kingdom over the past few years, what this tells us about the future path for inflation, and the macro consequences.

Inflation remains stubbornly stable and low

For the best part of a decade, headline inflation in Saudi Arabia has been running at a soft pace relative to many of its EM peers. (See Chart 1.) Admittedly, there have been two periods in which inflation jumped, from late-2018 and from early 2020, when VAT was first implemented at 5% and subsequently tripled. But, outside of those instances, Saudi's headline inflation rate has averaged just 1.1% y/y since the start of 2014.

Chart 1: Consumer Prices (% y/y)



Sources: GASTAT, CEIC, LSEG, Capital Economics

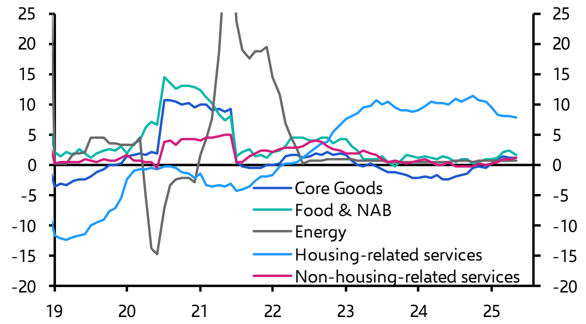
What's more, unlike many EMs where inflation surged in 2022 on the back of pandemic-related supply chain disruptions as well as spillovers from the war in Ukraine on global commodity prices, Saudi Arabia's headline rate climbed to a peak of just 3.4% y/y. It has since softened and, through much of 2024 and so far this year, has remained relatively stable around the 2% y/y mark.

A deep dive

The General Authority for Statistics does not provide further analytical breakdowns of the inflation data, such as their own measure of core inflation, so we have taken a closer look and compiled our own analytical series for food and non-alcoholic beverages, energy, core goods, housing-related services, and non-housing-related services.

As Chart 2 shows, over the past couple of years, inflation in almost all price categories has been virtually flat or even negative, except for services related to living – this includes rentals paid by tenants, maintenance and repair services, refuse collection, sewage collection and other miscellaneous services. Rentals paid by tenants is the main category as it makes up 21.0% of the overall CPI basket.

Chart 2: Saudi Arabia Consumer Prices (% y/y)

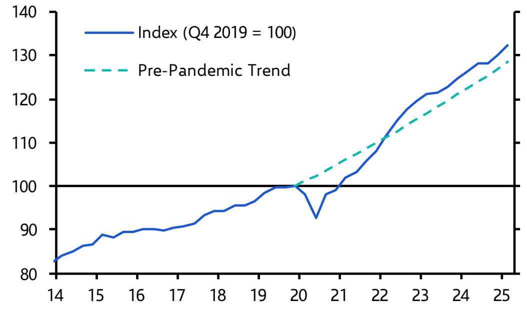


Sources: General Authority for Statistics, CEIC, Capital Economics

We have highlighted before that the recently-revised Saudi residential real estate data showed that property prices had increased by 30% since the pandemic. That is likely to have fed through into the rental market with landlords charging higher rents to tenants. With affordability constrained, demand for rental properties may have increased too.

Outside of housing though, it is somewhat surprising that price pressures in the Kingdom have been so weak. After all, Saudi Arabia's non-oil sector has grown by nearly a third since 2021 and growth has outstripped its pre-pandemic trend. (See Chart 3.)

Chart 3: Saudi Arabia Non-oil Real GDP (Index, Q4 2019 = 100)



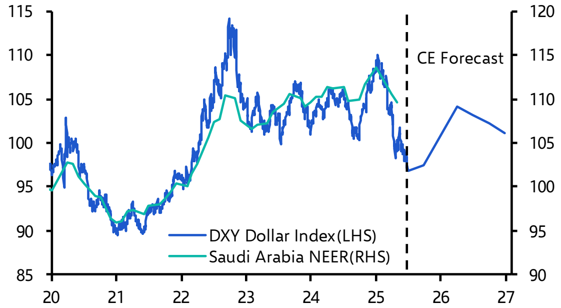
Sources: General Authority of Statistics, CEIC

Some of the stability in prices can be pinned on government policy. For one thing, the rate of Value Added Tax (VAT) has not been altered further after being tripled in early 2020. And second, the government capped local fuel prices in July 2021 which absorbed the run up in global energy prices and kept domestic energy inflation at virtually zero. (See Chart 2 again.)

At the same time, the Kingdom has benefitted from the strength of the dollar for much of the past few years. The riyal's peg to the dollar means that, since the start of 2021, Saudi Arabia's nominal trade-weighted exchange rate has appreciated by 14%, increasing its purchasing power. (See Chart 4.)

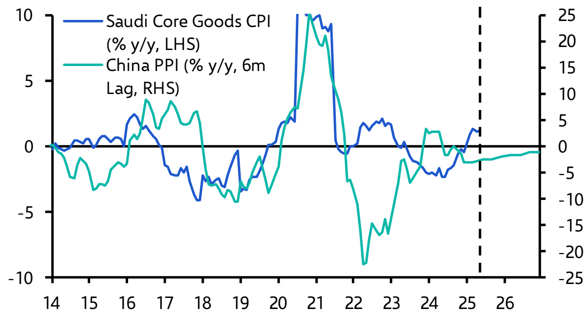
Meanwhile, import price pressures have also been dampened by disinflationary pressures emanating from China, the source of just over a fifth of Saudi Arabia's imports. After adjusting for exchange rate movements, producer prices have been negative for most of the period since 2021 which has weighed on core goods prices in Saudi Arabia. (See Chart 5.)

Chart 4: DXY Dollar Index & Saudi Arabia Nominal Effective Exchange Rate



Sources: LSEG Data & Analytics, BIS, Capital Economics

Chart 5: Saudi Arabia Core Goods Inflation & China FX-Adjusted Producer Price Inflation

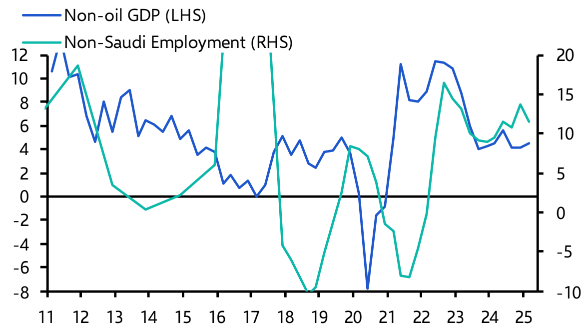


Sources: GASTAT, CEIC, Capital Economics

There are also structural factors that might help to explain why inflation in Saudi Arabia (and the other Gulf states for that matter) has stayed low. In particular, the Kingdom's labour market is highly flexible due to the ease with which it can increase and decrease its supply of labour via foreign workers.

Nearly 80% of the workforce is made up of non-Saudi's. As Chart 6 shows, growth of non-Saudi employment has broadly followed the path of non-oil GDP growth i.e. when activity accelerates, Saudi firms hire at a faster rate to absorb this demand. Because they can hire foreign workers with ease, the labour supply is very flexible and adding workers doesn't bid up wages and prices. Recently, as the economy has begun to run hot in recent years, non-Saudi employment has increased and dampened upward pressure on wages and prices in the Kingdom.

Chart 6: Saudi Arabia Non-oil GDP & Non-Saudi Employment (% y/y)



Sources: GASTAT, CEIC, Capital Economics

So where now?

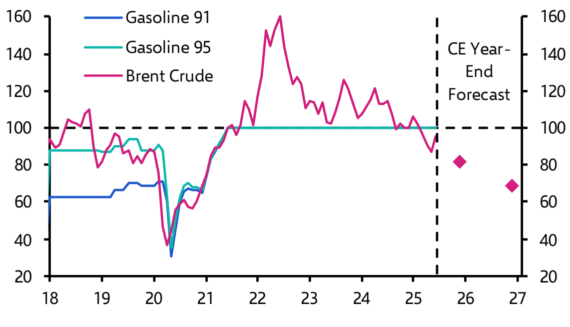
There are some upside risks to the inflation outlook. One is the recent weakness of the dollar – which the riyal is pegged to. The DXY dollar index has weakened by ~10% year-to-date and could be behind the slight uptick in Saudi Arabia's headline inflation rate in recent months and may lead to further upward pressure over the coming months. That said, we do think the dollar will pare back most of this lost ground over the next year or so.

Meanwhile, as we have argued for some time, the government needs to tighten fiscal policy against the backdrop of lower oil prices. The key risk here is that the government decides to hike the rate of VAT or broaden the number of goods subject to the tax. The state could, of course, decide to raise other taxes, or introduce new ones, that create inflationary pressures by raising costs to businesses that are passed onto consumers. But any such tax rise would lead to a one-off step change in the price level, rather than lead to a permanently higher inflation. (And, as we come to shortly, fiscal consolidation is also a disinflationary force.)

Nonetheless, notwithstanding these upside risks, there are good reasons to think that inflation in Saudi Arabia will stay subdued over the next few years.

The first is that energy inflation is likely to remain contained. If the government were to remove the Aramco fuel price cap, it would pave the way for local petrol prices to be lowered. We expect that the price of oil will fall to $60pb by the end of this year and a further 16% fall to $50pb by end-2026 (see Chart 7), if Aramco were to adjust prices accordingly that could, all else equal, knock as much as 1.3%-pts off headline inflation. Lower oil prices could feed into falling costs to domestic producers.

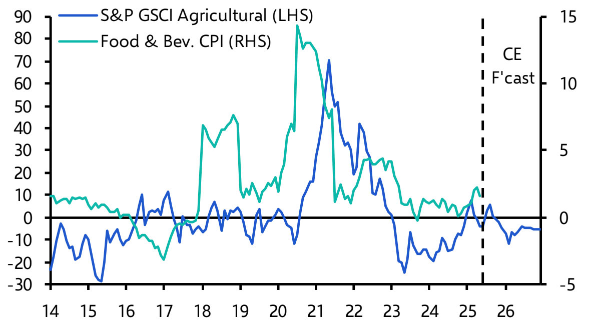
Chart 7: Saudi Aramco Local Gasoline Prices & Brent Crude Oil (Index, July 2021 = 100)



Sources: Saudi Aramco, LSEG, CEIC, Capital Economics

Second, food and beverages inflation is likely to remain weak. Global indices of food prices have fallen this year – the S&P GSCI Agricultural Index is down by 9% year-to-date. Saudi Arabia is one of the most import dependent economies for its food supply globally, leaving its domestic food inflation more vulnerable to moves in global prices. We expect the index to fall a further 5% by the end of next year, which should soften Saudi food price pressures. (See Chart 8.)

Chart 8: S&P GSCI Agricultural Spot Index & Saudi Arabia Food and Beverages Inflation (% y/y)



Sources: GASTAT, CEIC, LSEG, Capital Economics

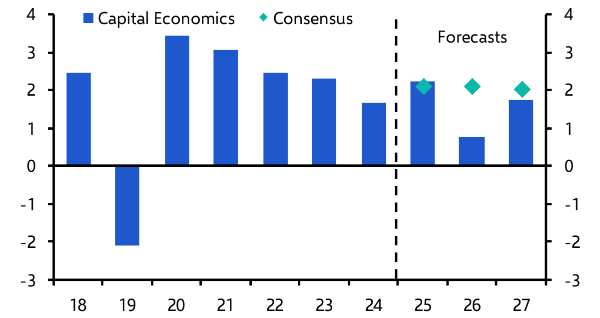
Third, we expect that China's producer prices will continue to decline over the next few years against the backdrop of overcapacity in China's industrial sector. (See Chart 6 again.) This will continue to have a disinflationary effect on goods prices in Saudi Arabia.

Fourth, housing-related inflation is likely to ease further. Since peaking in October, inflation in rentals paid by tenants has slowed to 8.1% y/y in May – the weakest pace in two-and-a-half years – and the government has recently pushed for further reforms to increase housing supply as part of longer term plans to increase home ownership rates. A faster increase in housing supply would, all else equal, help to put downward pressure on housing prices and rents; rents make up a fifth of the CPI basket.

Finally, while fiscal consolidation via tax hikes could raise inflation in the near term (as mentioned earlier), broader austerity measures will weigh on non-oil activity in the Kingdom over the next few years. This will dampen underlying price pressures. Indeed, amid the harsh fiscal consolidation in 2014-16 when oil prices slumped, inflation in Saudi Arabia fell into negative territory in 2017 and could feasibly have remained below zero for longer if it were not for the introduction of VAT in 2018.

All told, we think that against this backdrop that inflation in Saudi Arabia will hover around the current rates of 2.3-2.6% y/y until the end of Q3 before slowing into 2026. Our forecast for inflation to average 0.8% in 2026 is below consensus. (See Chart 9.)

Chart 9: Saudi Arabia Consumer Prices (% y/y, Period Average)



Sources: General Authority for Statistics, CEIC, Capital Economics

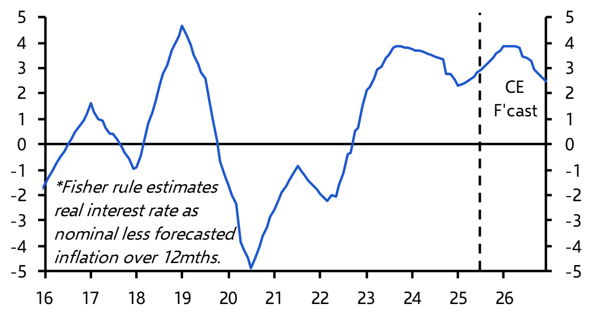
What are the macro consequences of low inflation?

If inflation in Saudi Arabia is to remain soft and even fall towards zero, there are two major implications for the Kingdom's economy.

The first is that **Saudi Arabia's real effective** exchange rate (REER) is likely to depreciate and, in turn, **provide a boost to the Kingdom's external** competitiveness and its non-oil exports. That being said, non-oil goods exports are equivalent to just 4.8% of GDP and 17% of Saudi Arabia's total exports. What's more, around half of those non-oil goods exports are refined petroleum products. So the gains may be limited. That said, the improved competitiveness may at the margin benefit the Kingdom's efforts to boost its services exports, particularly tourism, as its seeks to diversify its economy away from oil.

Second, **given the riyal's dollar peg, Saudi Arabia** has to import monetary policy from the US. At present the Saudi Central Bank's (SAMA) benchmark policy rate – the reverse repo rate – is set at 4.50%. This means that Saudi Arabia is currently running a positive real interest rate of ~2.7%. With our expectation that the US Fed will keep interest rates unchanged this year and will only cut by 50bp in 2026 – and that SAMA will follow suit – real interest rates in Saudi Arabia will remain in positive territory for longer. (See Chart 10.)

Chart 10: Saudi Arabia Real Interest Rate* (%)



Sources: GASTAT, SAMA, CEIC, Capital Economics

This would keep debt servicing costs in the Kingdom high, making it more difficult for households and businesses to meet their debt repayments, refinance, and/or take on new loans. Weaker private sector credit demand would weigh on non-oil activity. Higher debt servicing costs could raise concerns about the legacy of the recent boom in mortgage lending as well as banks' exposure to the real estate sector. As for the public sector, while the debt-to-GDP ratio is still low (29.6%), it's likely to remain on an upwards trajectory.