Economic Update

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Saudi Arabia outlook

Growth recovers led by oil sector rebound

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Highlights

- **Economic growth is expected to accelerate to 2.2% y/y this year as oil output increases and domestic demand recovers.**
- **Non-oil growth, expected at 1.9% y/y in 2018, is underpinned by the government's expansionary budget, private sector stimulus programs and general easing in fiscal austerity measures.**
- **Inflation to trend lower to 1.8% by 2019 as the effects of January's VAT and energy price hikes wear off.**
- **The fiscal deficit is projected to narrow from 9% of GDP last year to 4.6% of GDP by 2019; government debt is expected to reach 24.5% of GDP in 2019.**
- **Saudi equities boosted by MSCI and FTSE Russell EM inclusion; higher oil prices helping to lift sentiment.**

Growth recovering on oil and non-oil sector output gains

The Saudi economy looks poised to rebound this year from 2017's contraction, with oil production expected to increase following OPEC's decision to boost output from July and non-oil activity likely to benefit from elevated government spending after the authorities unveiled their most expansionary budget to date. The improved outlook occurs against a backdrop of continuing structural reforms under the ambitious Vision 2030 umbrella but at a pace that is less likely to impinge on consumer demand and private sector activity. Growth prospects will, however, be contingent on higher oil prices.

The reforms have been broadly two-pronged, aimed at both fiscal sustainability—through a combination of lower fuel/utility subsidies and higher taxes e.g. on tobacco, expatriate residents and consumption (VAT)—and economic diversification. This the authorities intend to pursue through private sector stimulus packages, privatization of state assets and regulatory measures designed to attract more foreign investment and technology know-how to Saudi Arabia. We expect real GDP growth to accelerate from last year's decline of -0.9 y/y to reach 2.2% y/y in 2018 and 1.9% y/y in 2019. (Chart 1.)

Table 1: Key economic indicators

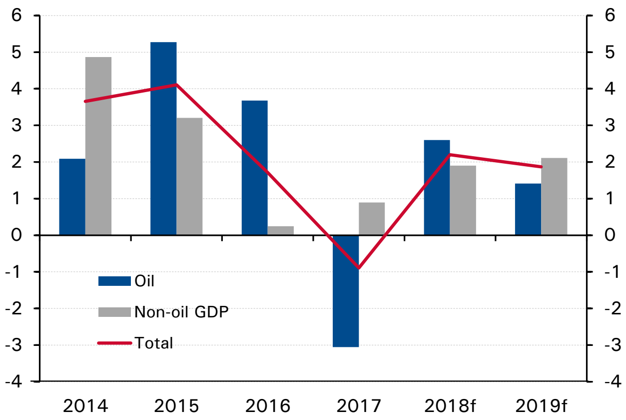
		2016	2017	2018f	2019f
Real GDP	% y/y	1.7	-0.9	2.2	1.9
- Oil	% y/y	3.7	-3.1	2.6	1.4
- Non-oil	% y/y	0.2	0.9	1.9	2.1
Inflation	% y/y	2.1	-0.8	2.9	1.8
Budget balance	% of GDP	-12.6	-9.0	-6.1	-4.6
Public debt	% of GDP	13.0	17.3	20.9	24.6

Source: Official sources, NBK estimates

Just-released quarterly GDP data for 1Q18 supports the view of an economy slowly rebounding from recession. Real output expanded by 1.2% y/y, ending a run of four consecutive quarters of negative growth.

Chart 1: Real GDP

(% y/y)



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

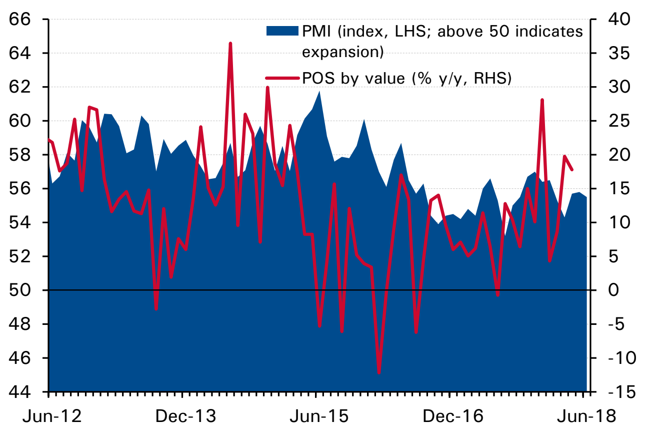
In the same quarter, the non-oil sector posted growth of 1.6% y/y, driven by gains in both the private and the government sectors, while oil GDP expanded by 0.6% y/y, helped by an increase in oil production, which the kingdom was able to achieve while still fulfilling its obligations to the OPEC production cut agreement.

Saudi crude production, which averaged 9.95 mb/d in 2017 (achieving a OPEC compliance rate of 122%), is expected to increase significantly during the second half of 2018 now that OPEC+ has announced its intention to boost aggregate output by a nominal 1 mb/d to relieve a tightening oil market and restrain oil prices from spiking higher. Without knowing the kingdom's share of this figure, we estimate conservatively that output could be 260,000 b/d higher on average at 10.2 mb/d compared to 2017. 2019 would see production rise further.

Meanwhile, the uptick in the performance of the non-oil sector in 1Q18 compared to 4Q17 was largely a reflection of output gains in the manufacturing, financial and real estate services sectors as well as in the government sector. Government spending is the lynchpin of the Saudi non-oil economy, with its expansive 2018 budget (SR978bn), private sector stimulus package (SR72bn over 5 years) and privatization drive as well as citizens and household account programs, which aim to mitigate the burden on low income families of the pull-back in energy and utility subsidies. The recently launched privatization program will sell state assets (utilities, hospitals etc.) and encourage the formation of more public private partnerships (PPP). In the process, the government hopes to net SR35-40bn in direct sales revenues and achieve savings of SR25-35bn, while creating 10,000-12,000 jobs in the private sector.

Recent POS and PMI data tend to confirm the rebound, albeit a moderate one, in non-oil activity. The value of POS transactions grew by 18% y/y in April, while the PMI, which indicates the level of business activity in the non-oil private sector, reached a 2018-high of 55.0 on higher output and new orders. (Chart 2.)

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



Source: SAMA, Markit/Emirates NBD

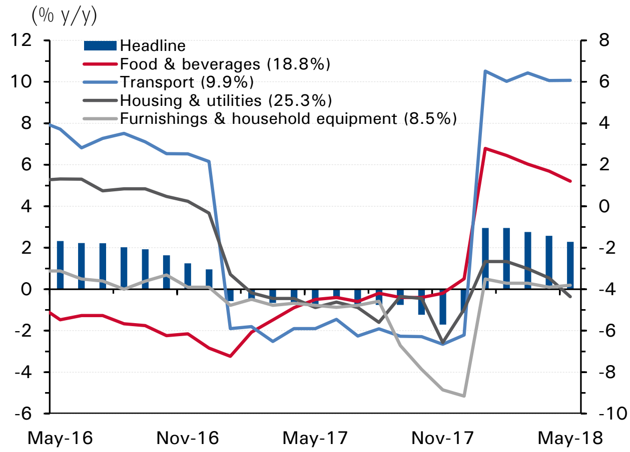
Bank credit growth to the private sector, however, continues to lag. At a lackluster 0.7% y/y in April, it is far below levels that would be commensurate with a deep-rooted and sustainable private sector recovery. (See Chart 5.)

Furthermore, Saudi unemployment continues to pose a challenge, more than two years into the government's Vision 2030 reform drive. The authorities intend to bring the unemployment rate down from 11.6% in 2015 to 7.0% by 2030. However, the rate keeps going up, reaching 12.9% in 1Q18—the fourth consecutive quarterly rise—as the labor force expands at almost twice the rate of employment. And this is despite an acceleration in the government's Saudization policy, (by penalizing employers that hire expatriates, for example) which has seen almost 700,000 expats leave the kingdom since the beginning of 2017.

Inflation slowing as effects of VAT wear off

Inflation has been moderating since the authorities rolled out the 5% value added tax (VAT) and instituted the second round of energy price hikes in January. Consumer prices surged 5.6% m/m and 6.8% y/y, with prices in the transport, food and restaurant & hotel categories in the CPI especially affected. (Chart 3.)

Chart 3: Inflation



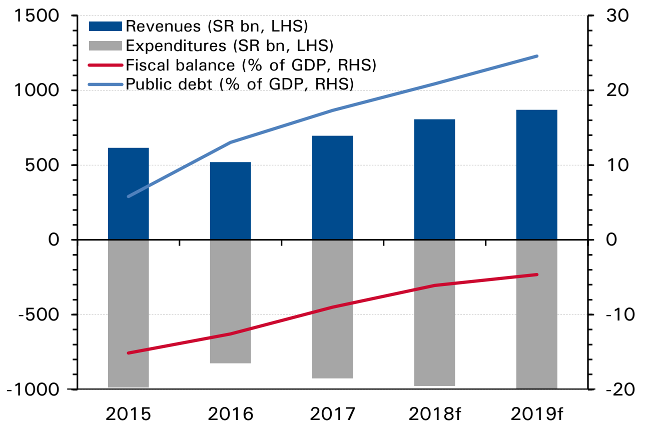
Source: Thomson Reuters Datastream / NBK

Nevertheless, we expect inflation to continue to ease to 2.9% (avg.) in 2018 as the one-off effects of January's price hikes wear off and given that housing and rental costs, which continue to fall due to a combination of weaker demand and government efforts to make housing more affordable, carry the largest weight in the consumer basket. As a corollary, growth in the Saudi real estate price index was -1.5% y/y in 1Q18.

Fiscal deficit to narrow on higher oil/non-oil revenues

The kingdom's public finances should continue to improve as the authorities realize some of the gains targeted in the Fiscal Balance Program (FBP). While the government's objective of a balanced budget has shifted to 2023 in order to lessen the impact of austerity policies on demand, the fiscal deficit is expected to continue to narrow from 9.0% of GDP last year to 6.1 and 4.6% of GDP in 2018 and 2019, respectively. The realization of higher oil revenues through higher oil prices is key, given that oil proceeds account for 63% of all treasury receipts and especially since the authorities intend to boost spending by 5.6% y/y with their largest ever budget, an estimated 20% of which is expected to be spent on infrastructure projects.

Chart 4: Fiscal balance and government debt



Source: Ministry of Finance / NBK estimates

The contribution of non-oil revenues, however, will continue to increase as the authorities capitalize on recently-added taxes such as the VAT, excise tax and the expat/expat dependents levy, which will increase again this year. Non-oil revenues have doubled since 2014 to SR256bn in 2017, equivalent to 36.7% of all revenues and 10% of GDP. Investment returns accrued to the treasury through the Public Investment Fund (PIF) should also rise, helped by higher US and global interest rates.

Government debt rises, but foreign reserves recover

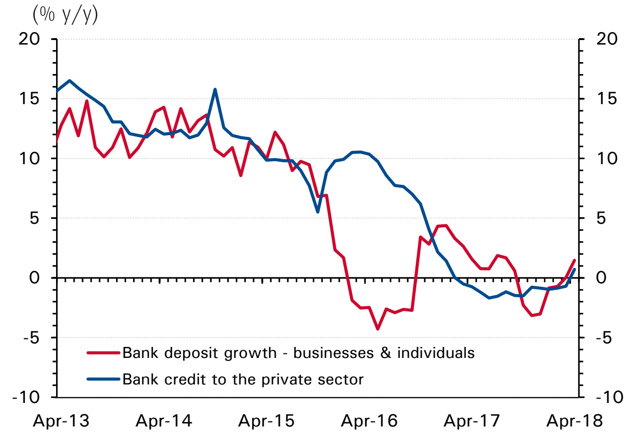
Central government debt is expected to rise from 17.3% of GDP last year to 24.6% of GDP by the end of 2019 amid continued local and international debt issuance. (See Chart 4.) The authorities have already sold $11bn worth of bonds this year, a figure that is expected to rise to around $37bn by year-end—similar to last year's volume which financed 61% of the deficit, with the remainder covered by reserves. We expect the authorities will increasingly try to minimize reserve drawdowns and rely more on debt issuance to take advantage of the still relatively low global interest rates. But while foreign reserve assets declined by 7.5% ($40bn) in 2017, as of April, they were actually up 10% at $506bn.

Tighter monetary conditions could weigh on growth

Saudi monetary policy is focused on preserving the peg to the dollar and keeping in step with US interest rates in order to minimize capital outflows. SAMA has already raised its benchmark repo and reverse repo rates twice this year, by 25 bps each time, to 2.5% and 2.0%, respectively. In March the repo was raised, preemptively, for the first time since 2009 after interbank rates fell below their USD Libor equivalent, sparking concerns about dollarization and capital flight.

The rise in the cost of funds comes at a particularly sensitive time for the authorities. Private sector credit, but also deposits, are barely increasing, which is weighing on economic activity. (Chart 5.)

Chart 5: Bank credit and deposits

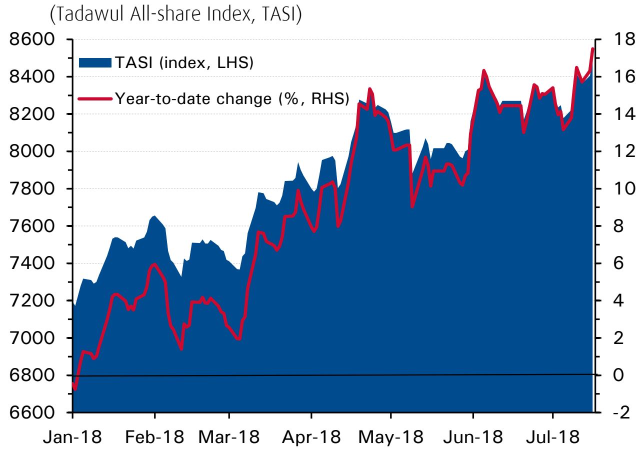


Source: Thomson Reuters Datastream

Equities boosted by MSCI/FTSE inclusion

Outperforming its GCC peers by a considerable margin, the main Saudi stock index (TASI) is up 17.5% at 8,490 so far in 2018, having been boosted by the bourse's recent inclusion in the MSCI and FTSE Russell emerging market indices. At least $10bn in passive foreign inflows are expected following the MSCI decision. Higher oil prices and affirmation of the sovereign's credit ratings by the likes of Moody's (A1) and Fitch (A+) have helped lift sentiments. Markets will be looking to the 5% IPO of Aramco, possibly in 2019, and further delivery by the regulator of financial reforms to spur positive sentiment.

Chart 6: Stock market



Source: Thomson Reuters Datastream

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