جدوى للإستثمار
Jadwa Investment

July 2018

Macroeconomic Update

Saudi economy adjusting to structural change

- We have revised our forecast for the Saudi economy and now expect to see growth of 2.2 percent in 2018 (compared to 1.5 percent previously). The sizable rebound in growth will be partly driven by an improvement in the oil sector.

- We expect Saudi crude oil output to average 10.3 million barrels per day (mbpd) over the course of the year, up from 10.1 mbpd previously. As oil outages continue from OPEC members such as Libya and Venezuela, and US sanctions begin to take effect on Iran, we expect Saudi Arabia to make up a large portion of the expected deficit in oil market balances in H2 2018.

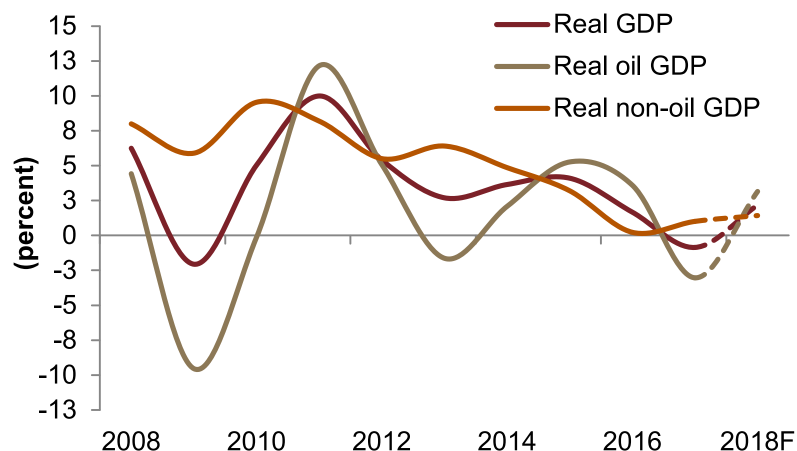
- On the non-oil side, we have maintained our forecast for non-oil GDP at 1.4 percent (compared to 1.0 percent in 2017). Within this forecast, we still expect to see non-oil private sector growth of 1.1 percent, compared to 0.7 percent in 2017.

- In fact, recently released GDP data shows that the Saudi economy is performing relatively well despite the implementation of major structural economic reform since the turn of the year. The Kingdom's economy expanded by 1.2 percent in Q1, with non-oil private sector GDP rising by 1.1 percent.

- Meanwhile, we have also revised our oil price forecast for 2018, and now expect Brent oil to average $68 per barrel (pb) in 2018, up from $60 pb previously. The combination of higher oil prices and crude oil production will push up government oil revenue to SR576 billion in 2018, against budgeted oil revenue of SR492 billion.

- That said, higher than budgeted oil revenue will not result in higher government expenditure, but rather, it will contribute to lowering the fiscal deficit. As a result, we now expect the Kingdom's fiscal deficit to decline to SR111 billion, or 3.8 percent of GDP, versus SR195 billion outlined in the 2018 fiscal budget statement.

Figure 1: Saudi Real GDP forecast



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We have revised our forecast for the Saudi economy and we now expect to see growth of 2.2 percent in 2018

The sizable rebound in growth will be partly driven by an improvement in the oil sector…

...as Saudi Arabia raises oil output , this will positively affect oil sector GDP, lifting it to 3.2 percent in 2018.

On the non-oil side, we have maintained our forecast for non-oil GDP at 1.4 percent during the same period.

Saudi economic growth will improve in 2018, but risks remain

We have revised our forecast for the Saudi economy and we now expect to see growth of 2.2 percent in 2018 (compared to -0.9 percent in 2017). The sizable rebound in growth will be partly driven by an improvement in the oil sector. As Saudi Arabia raises oil output (Box 1), this will positively affect oil sector GDP, lifting it to 3.2 percent in 2018, compared to a decline of 3.0 percent in 2017.

Box 1: Saudi Crude Oil Production

We have revised our forecast for Saudi Arabia's crude oil output to 10.3 million barrels per day (mbpd) over the course of the year, up from our previous forecast of 10.1 mbpd. Despite Saudi output averaging 9.9 mbpd year-to-May, we expect a rise in output following a recent OPEC non-OPEC Market Monitoring Committee meeting. The conclusion of the meeting back in late June resulted in OPEC and certain non-OPEC members allowing for higher quotas for production, at a total of 1 mbpd. As oil markets tighten, and oil outages continue from OPEC members such as Libya and Venezuela, we expect Saudi Arabia to make up a large portion of the agreed rise in output.

That said, with the US recently reapplying sanctions on Iranian oil, and aggressively pushing Europe, Japan and South Korea to reduce oil imports from Iran to zero by the November 4th sanctions deadline, there is a possibility that OPEC/non-OPEC's 1 mbpd of additional oil may not be sufficient to balance markets. Of Iran's circa 2.1 mbpd of current oil exports, around a third, or 700 thousand barrels per day (tbpd) is exported to Europe, Japan and South Korea. Therefore, assuming the US is successful in reducing the above countries Iranian oil exports to zero, oil markets would still be in deficit by 1 mbpd come Q4 2018, despite an additional 1 mbpd of OPEC/non-OPEC output, as per the June agreement (Figure 2).

On the non-oil side, we have maintained our forecast for non-oil GDP at 1.4 percent during the same period (compared to 1.0 percent in 2017). Within this forecast, we expect to see non-oil private sector growth to improve to 1.1 percent, compared to 0.7 percent in 2017. As we highlighted in our Saudi Economy in 2018 report, the implementation of VAT, expat fees & levies and energy price hikes, could all weigh-in on growth during the year. In fact, so far this year,

Figure 2: Oil markets may still be in deficit despite a 1 mbpd rise from OPEC/non-OPEC

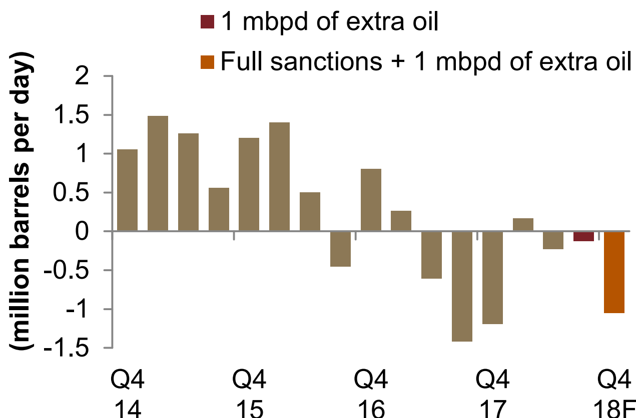
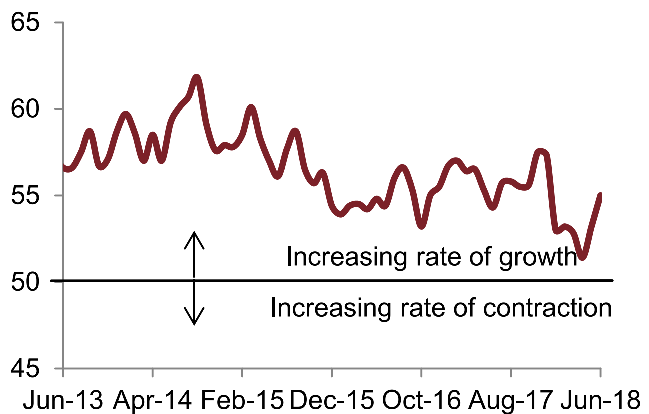


Figure 3: Non-oil PMI has recovered recently



So far this year, business surveys, whilst remaining in expansionary mode, have hinted to some fragility in the non-oil private economy.

business surveys, whilst remaining in expansionary mode, have hinted to some fragility in the non-oil private economy. The non-oil purchasing managers' index (PMI) averaged 53.1 year-to-June 2018, and despite recovering from a nine year low in April, the index is still lower than the full year average of 56.1 in 2017 (Figure 3). In addition, other indicators have not improved significantly. Credit to private sector has shown only marginal growth recently, whilst rising interest rates have added to the cost of funding for the private sector.

Box 2: Q1 2018 GDP Results

Data on Q1 real GDP showed that the economy expanded by 1.2 percent, year-on-year.

Data on Q1 real GDP showed that the economy expanded by 1.2 percent, year-on-year. In line with our full year forecasts, growth was seen across all macro sectors, with the oil sector improving by 0.6 percent, whilst non-oil GDP showed better growth, at 1.6 percent. Within the non-oil sector, non-oil private sector GDP was up 1.1 percent and the government sector's GDP rose significantly, by 2.7 percent (Figure 4).

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Marginally higher year-on-year crude oil production during Q1 2018, resulted in oil sector GDP rising by 0.6 percent. On the non-oil private sector side, the 'Construction', 'Transport & Communication' and 'Wholesale & retail' sectors showed yearly declines of 2.4, 1.6 and 0.5 percent, respectively. Meanwhile, 'non-oil Mining & Quarrying', 'Manufacturing', and 'Finance', up 6.3, 3.3 and 2.1 percent, were the stand out performers.

Overall, despite considerable efforts by the government to inject stimulus into the economy, our forecasts remain vulnerable to the downside.

Overall, despite considerable efforts by the government to inject stimulus into the economy, such as through the Citizen's Account and a rise in public sector worker's allowances, our forecasts remain vulnerable to the downside. Whilst the risk of sizable decline in oil prices has decreased, the major risk to the economy rests with how it will perform in light of necessary structural economic reform implemented at the start of the year. Additionally, any deviation from the government's plan to distribute government capital spending throughout the fiscal year, rather than in the final quarter of the year, could also affect growth (Figure 5). As the Ministry of Finance has stated, a more balanced approach to spending can help boost economic growth. Therefore, any delay in raising capital expenditure, with only 13 percent of budgeted capital expenditure having been disbursed in Q1 2018, could have knock-on effects on growth for the non-oil economy over the course of the year.

Figure 4: Quarterly Saudi GDP growth

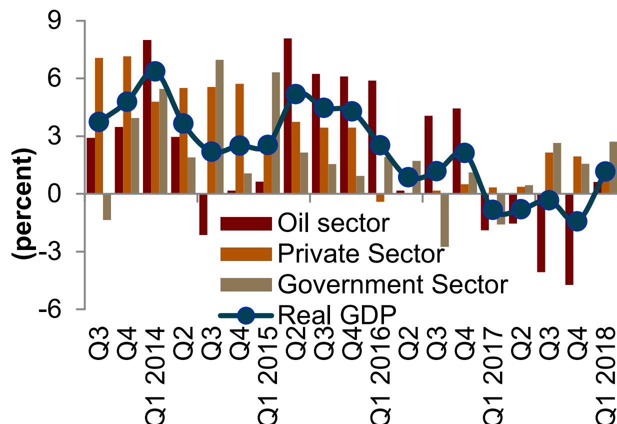
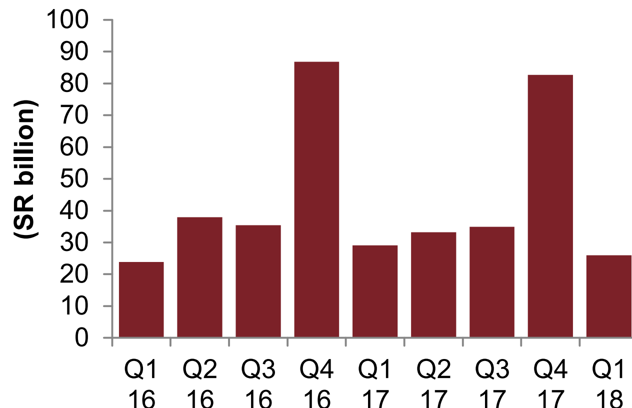


Figure 5: A more even distribution of capital expenditure could help boost growth



Improvement in oil revenue will reduce budgeted fiscal deficit

Brent oil prices are currently above $75 pb and year-to-date average stands at $71pb.

An improvement in the price of oil in 2018 will help improve government oil revenue. Brent oil prices are currently above $75 per barrel (pb) and year-to-date average stands at $71pb. As a result, we have revised our oil price forecast for 2018, and now expect Brent oil to average $68 pb in 2018, up from $60 pb previously.

As a result, we have revised our oil price forecast for 2018, and now expect Brent oil to average $68 pb in 2018, up from $60 pb previously.

According to our calculations, the combination of a higher Saudi export price with crude oil production at around 10.3 mbpd will result in oil exports totaling $223 billion in 2018. Applying a notional transfer ratio of 69 percent, we expect government oil revenue to rise to SR576 billion, against budgeted oil revenue of SR492 billion, and actual oil revenue of SR436 billion in 2017 (Figure 6). In our view, higher than budgeted oil revenue will not result in higher government expenditure, but rather, it will contribute to lowering the fiscal deficit. As a result, we now expect the Kingdom's fiscal deficit to decline to SR111 billion, or 3.8 percent of GDP, versus SR195 billion outlined in the 2018 fiscal budget statement.

We therefore expect government oil revenue to rise to SR576 billion, against budgeted oil revenue of SR492 billion.

Meanwhile, as the Q1 budget statement showed, the government's efforts to raise non-oil revenue have been successful so far, with this segment rising by 63 percent year-on-year, in the first quarter of 2018. Most of these gains came from 'Taxes on goods and services', which nearly tripled year-on-year, to SR22.6 billion. This rise was due to a number of initiatives which have been rolled out recently, including the introduction of VAT, expat levies and excise tax (*for more on this please see our Q1 2018 Quarterly Budget Statement report*). According to the updated Fiscal Balance Program (FBP), the government expects 'Taxes on goods and services' to rise by 82 percent year-on-year to an around SR85 billion in 2018, as a whole. Of this, VAT is projected to generate SR23 billion, excise tax SR9 billion, and expat levies SR28 billion. In fact, 'Taxes on goods and services' is expected to be the major contributor to non-oil revenue growth in 2018, with this segment showing the largest change overall (Figure 7).

Higher than budgeted oil revenue will not result in higher government expenditure, but rather, it will contribute to lowering the fiscal deficit...

On the expenditure side, despite higher than budgeted government oil revenue, we do not see this translating to major changes in government spending during the year. We fully expect the expenditure projections outlined under the FBP to be followed through as planned, with limited deviation from the budgeted

Figure 6: Saudi oil export price and government oil revenue

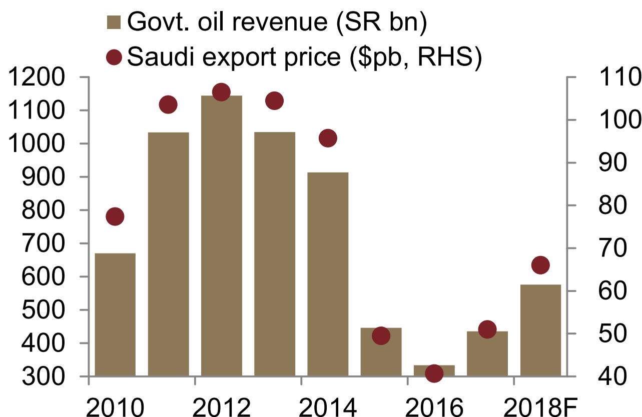
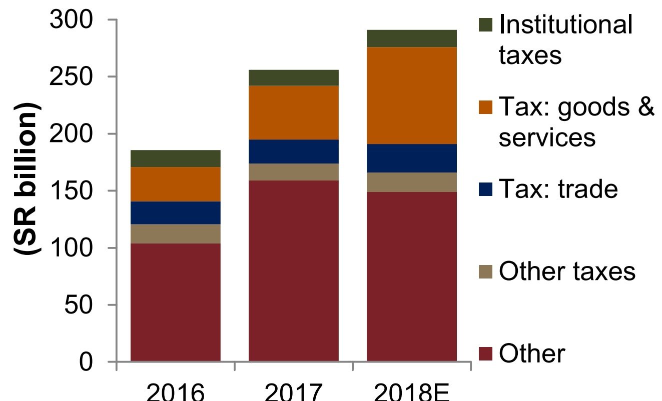


Figure 7: Non-oil revenue expected to rise significantly in 2018



...as a result, we now expect the Kingdom's fiscal deficit to decline to SR111 billion, or 3.8 percent of GDP…

government expenditure of SR978 billion for the year. In fact, when looking at the Q1 budget statement, despite current expenditure being pushed up by 24 percent year-on-year, as a result of rises in 'Compensation of Employees' and 'Social Benefits', it still totaled SR175 billion in the first quarter. As such, on a prorated basis, we expect full year government expenditure to be in line with the budgeted SR773 billion for current expenses, as outlined in 2018 fiscal budget.

...versus SR195 billion outlined in the 2018 fiscal budget statement.

That said, the capital spending side of the expenses, or 'Non-Financial Assets (Capital)', was down by 11 percent year-on-year, to SR26 billion, in Q1 2018. According to the 2018 fiscal budget, capital spending will total SR205 billion, compared to SR180 billion in 2017. Therefore, Q1 2018's spending represents around 13 percent of the total budgeted capital expenditure so far.

More international and domestic debt issuance expected

Current government debt at SR536 billion…

Public debt totaled SR443 billion at the end of 2017, but had risen to SR483 billion at the end of Q1 2018. The rise included circa SR18 billion in domestic sukuk issuances during Q1 and a SR60 billion syndicated loan refinancing, which expanded the original facility by SR22.5 billion.

...and we see a further SR23 billion in domestic bond issuances during the remainder of the year…

More recently, the government announced the issuance of a SR42 billion international bond and a further issuance of a total of SR12 billion in domestic sukuk. Adding this to the Q1 2018 total puts current government debt at SR536 billion. According to the Debt Management Office (DMO), the remainder of this year's debt issuance is likely to be raised domestically. As of June 2018, a total of SR94 billion of debt had been issued this year and we expect debt issuances not to exceed SR117 billion in 2018, as per the fiscal budget statement. At this rate therefore, we see a further SR23 billion in domestic bond issuances during the remainder of the year, taking total debt to SR560 billion at the end of 2018, equivalent to 19 percent of GDP (Figure 8).

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Current account will continue improving in 2018

Full year 2017 data showed that the current account moved into a surplus for the first time in three years. A notable rise in the trade balance helped push up the current account to a total of $15.2 billion

Figure 8: Government debt to total SR559 billion at the end of 2018 (19 percent of GDP)

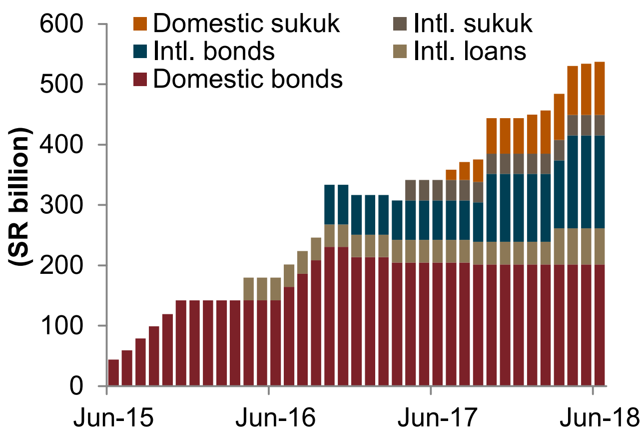
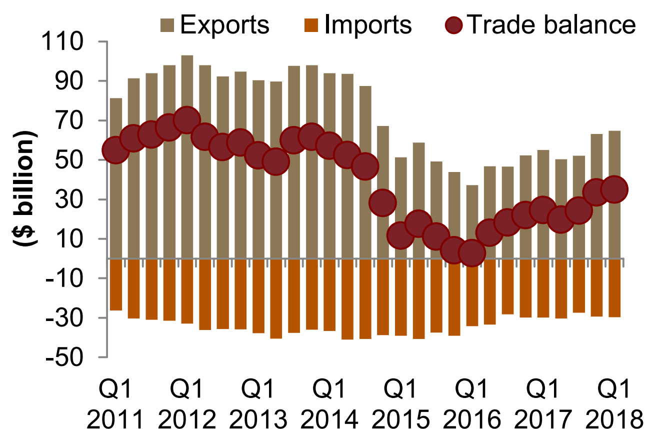


Figure 9: The trade balance continued to improve in Q1 2018



Full year 2017 data showed that the current account moved into a surplus for the first time in three years.

The surplus was helped by sizable rises in both oil and non-oil exports...

...and a decline in value of goods imported, which fell for the second consecutive year, by 7 percent year-on-year in 2017…

...with Q1 2018 balance of payment data showing this trend continuing, as total imports were down by 1 percent year-on-year.

We also expect higher levels of portfolio investment inflows to help strengthen the non-reserve financial account….

or 2.2 percent of GDP. Whilst the Kingdom saw higher oil exports, which improved by 25 percent or $33.6 billion year-on-year, there was also a notable rise in non-oil exports, which rose by 8 percent, or $3.8 billion year-on-year, as both petrochemical and plastic exports expanded.

The trade balance also benefitted from a decline in value of goods imported, which fell for the second consecutive year, by 7 percent year-on-year in 2017 (Figure 9). Whilst the combination of slower economic growth and the effects of a rising US dollar contributed to decreasing the Kingdom's import bill, we also believe the initiatives outlined in the government's FBP will have helped too. Specifically, the recently established Spending Efficiency and Realization Centre (SERC) and Strategic Procurement Unit (SPU), are expected to help achieve cumulative savings of SR220 billion by 2023. In fact, according the FBP, total savings of SR56 billion were realized in 2017, with some of these savings, in our view, coming from lower imports costs. Certainly, data from the Saudi Ports Authority does show that despite slower economic growth, import volumes remained positive in 2017 on a year-on-year basis, although the growth was marginal, at around 1 percent compared to average growth of 8 percent per annum seen in the previous five years (Figure 10).

Looking ahead, we expect import values to remain marginally subdued during 2018. According to recently released Q1 2018 balance of payment data, total imports were down by 1 percent year-on-year, and whilst we expect some recovery as the economy adapts to structural economic reforms, we do nevertheless expect a stronger dollar (and riyal) to help result in another yearly decline in value of imports, but not necessarily volumes. Overall, as Q1 2018 data has shown, with the trade balance hitting levels not seen since Q3 2014 (Figure 9), an improving trade balance will help maintain a positive current account balance. As such we forecast a surplus of $73 billion in 2018, or 9.3 percent of GDP, up from 2.2 percent in 2017.

Whilst an improvement in export revenue will be one of the main factors behind a rise in SAMA FX reserves during the year, we also expect higher levels of portfolio investment inflows to help strengthen the non-reserve financial account, and hence FX reserves. In fact, net purchases of SWAPs and buying by qualified foreign investors (QFIs) contributed to pushing the financial account into a surplus of $9 billion in Q1 2018, as portfolio inflows totaled $12.4 billion during

Figure 10: Saudi import volumes rose year-on-year in 2017 whilst values dropped

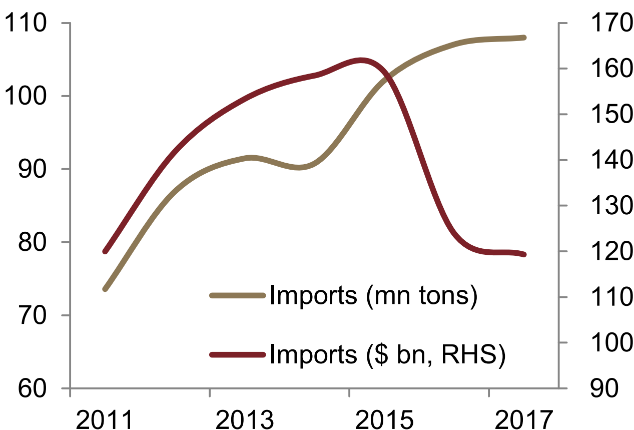
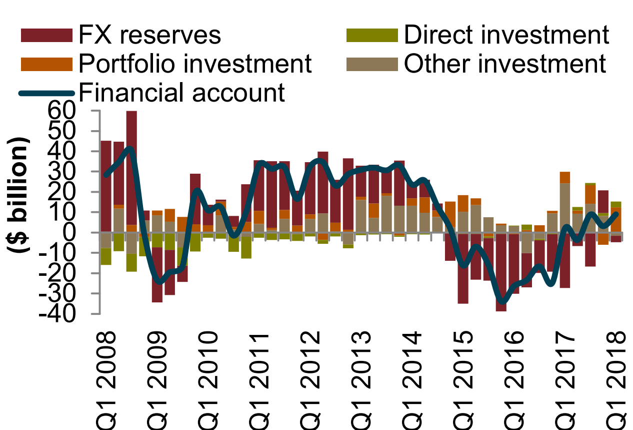


Figure 11: The financial account saw portfolio inflows of $12.4 billion in Q1 2018



...especially following MSCI's announcement, in June 2018, to include Tadawul into MSCI EM index.

the first quarter (Figure 11). Looking ahead, we expect this inflow to continue for the foreseeable future, especially following MSCI's announcement, in June 2018, to include the Saudi Stock Exchange (Tadawul) into its emerging market index (MSCI EM). We believe this will result in continued rises in portfolio inflows as certain QFIs, such as hedge funds, position themselves to take advantage of the anticipated flows ahead of Tadawul's actual inclusion into the EM index in 2019.

Overall, the above factors will help push up FX reserves by $40 billion during the year, to a total of $536 billion at the end of 2018.

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Credit growth remains weak, some pick up expected

The US FOMC recently raised the median policy projection for this year from three to four interest rate hikes.

In June 2018 the US Federal Reserve (Fed) hiked interest rates by 25 basis points for the second time during the year, pushing funds rate target to 1.75 percent to 2 percent. The Saudi Arabian Monetary Authority (SAMA) mirrored this rise by increasing its key policy repo rate by 25 basis points (bps) to 2.5 percent, and its reverse repo rate to 2 percent.

Meanwhile, latest survey data shows that market expectations about four Fed rates hikes are less certain…

Following the most recent hike, in June, the Fed outlined a very upbeat outlook for the US economy, with macro indicators underlining positive trends. Latest actual data shows that US Q1 2018 GDP registered growth of 2.2 percent, compared to 2.9 percent in Q4 2017 and 1.2 percent in Q1 2017, whilst unemployment is currently at 4 percent, the lowest in almost 18 years. Tightening labor markets have also put pressure on prices, with core inflation at around 2 percent since the start of the year, and expected to rise further as the US heads towards full employment. With that in mind, the Federal Open Market Committee (FOMC) raised the median policy projection for this year from three to four interest rate hikes. Meanwhile, latest survey data shows that market expectations about four Fed rates hikes are less certain. Currently, the market expects no change in US interest rates in August, but expects one 25 basis points (bps) hike in either September or November (Figure 12).

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SAMA has been raising the reverse repo rate over the past two years, in-line with US rate changes, but in March 2018, the Kingdom saw repo rates rise by 25 basis points for the first time since 2009. Unusually, however, the rise in March was done just prior to a hike in interest rates by the US Fed. We see this preemptive action by

Figure 12: Survey data suggests high probability of a third US rate hike but not fourth in 2018

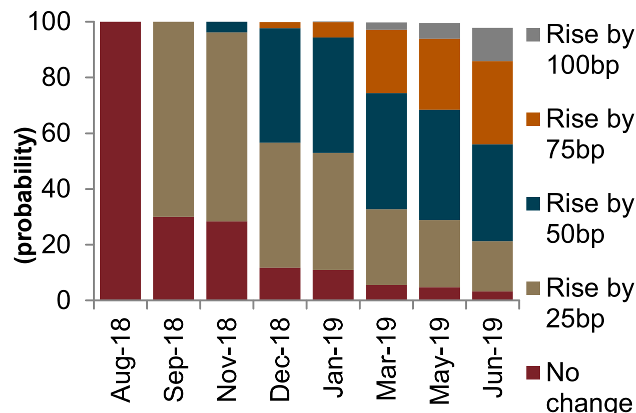
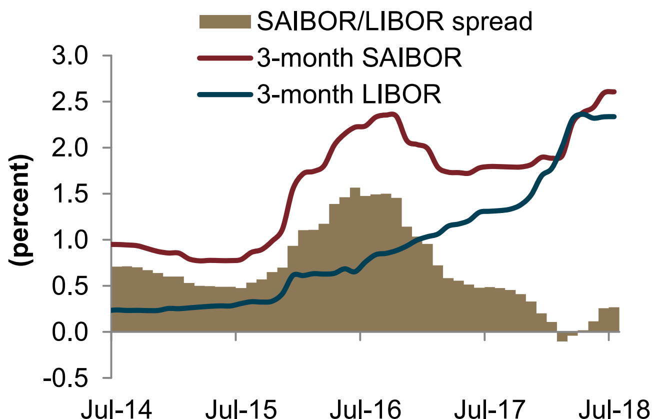


Figure 13: SAIBOR has eased recently after rising steeply in early 2018



Bearing in mind latest US survey data suggesting three, rather than four, US rate hikes being more likely in 2018…

SAMA being taken as a result of US LIBOR exceeding SAIBOR during both February and March. Additionally, in response to the negative SAIBOR/LIBOR spread, the Saudi central bank allowed government deposits at commercial banks to mature, thereby draining excess liquidity within the banking system, and, in turn pushing the SAIBOR/LIBOR spread back into the positive. As a result, the cost of funding within the Kingdom has been trending upwards, with three month SAIBOR increasing to 2.61 percent in July 2018, compared to 1.89 percent in January 2018 (Figure 13).

...we expect SAMA's base lending rate to reach 2.75 percent by the end of year, up from 2.5 percent currently.

Looking ahead, further rises in US interest rates and the continued policy of draining excess liquidity within the banking system in order to maintain a positive SAIBOR/LIBOR spread will continue to add upside pressure to the cost of funding. That said, bearing in mind latest US survey data suggesting three, rather than four, US rate hikes being more likely in 2018, we expect SAMA's base lending rate to reach 2.75 percent by the end of year, up from 2.5 percent currently.

So far in 2018, credit growth has not risen significantly, with only April and May showing modest yearly rises in bank credit to the private sector, since the turn of the year.

So far in 2018, credit growth has not risen significantly, with only April and May showing modest yearly rises in bank credit to the private sector, by 0.7 and 0.4 percent respectively, since the turn of the year. When taking a closer look at bank credit by maturity, we can see that whilst year-on-year growth in long term bank credit has been declining, short and medium term credit has in fact been rising. (Figure 14).

Moving forward, we expect some uplift in credit as a result of improving economic sentiment related to higher oil prices and due to the larger disbursement of government capital spending.

Moving forward, we expect some uplift in credit as a result of improving economic sentiment related to higher oil prices and due to the larger disbursement of government capital spending. To a lesser extent, we also expect some rises to come about due to the de-facto lifting of a ban on women driving. According to the latest population survey, there are 9 million females of driving age in the Kingdom. Whilst all these females will not choose to drive, and indeed an even smaller number are expected to obtain driving licenses during 2018, this still offers potential for growth in car loans going forward. That said, overall, we expect to see bank credit to the private sector rising only marginally in 2018, by 1 percent year-on-year.

Inflationary pressure due to VAT and utility price hikes

Prices have risen by an average of 2.7 percent year-to-May due to

Figure 14: Credit growth has remained subdued so far in 2018

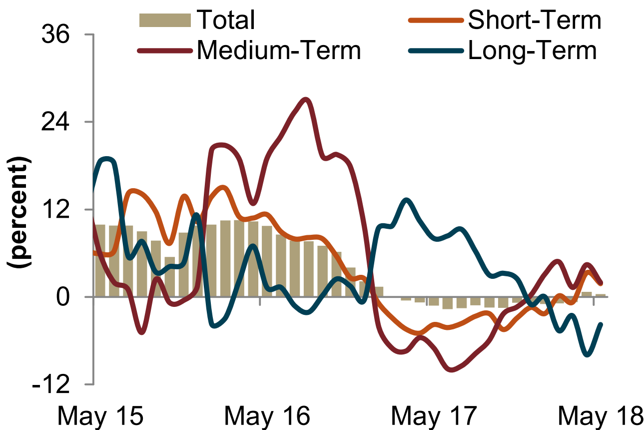
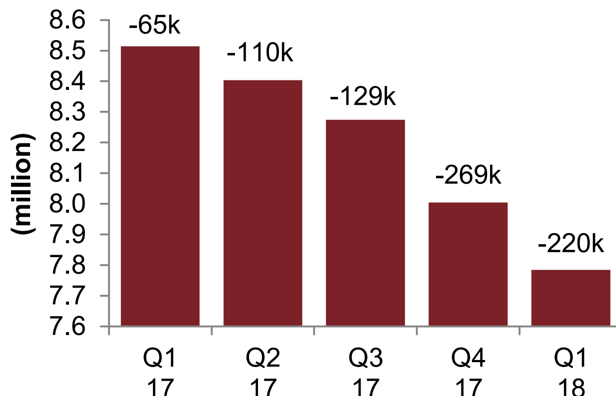


Figure 15: 796 thousand foreigners have left the Saudi labor market since the start of 2017



Prices have risen by an average of 2.7 percent year-to-May due to the introduction of VAT and energy price reform enacted at turn of the year.

the introduction of VAT and energy price reform enacted at turn of the year. 'Food and beverages' prices (19 percent weight of CPI basket) rose by 5.2 percent year-on-year in May, and although 'Housing and utilities' prices (25 percent of weight) declined by 0.4 percent in May, the sub-item of 'Electricity and Fuels' rose by 24.4 percent year-on-year.

Overall we still expect inflation to average around 3.1 percent for 2018, up from -0.3 in 2017, as per outlined in our *Inflation Update*, published June 2018.

Risks to forecast

As recent Q1 GDP data has shown, economic growth remains solid despite major structural economic reform…

...but risks do nevertheless remain.

In particular, the net effect of both the expat dependency fee and expat levy will mean a declining number of foreigners residing in the Kingdom…

...and this will inevitably have a negative aggregate effect on overall consumption in the Kingdom.

As recent Q1 GDP data has shown, economic growth remains solid despite major structural economic reform being implemented at the start of the year. Although we do see the set of expansionary measures, implemented via the private sector stimulus package, as well payments received under the Citizen's Account, plus the cost of living allowances, as being sufficient to continue bringing about solid growth in the non-oil private sector, risks do nevertheless remain. In particular, as was evident through weaker performance of 'Wholesale and Retail' sector in Q1 GDP data, consumer spending will continue to remain pressured due to two overriding factors. Firstly, a larger number of expat dependents are likely to be repatriated, as the expat dependency fee rises from SR100 to SR200 per dependent per month, from July 2018 onwards. Secondly, faced with rising operating costs related to the commencement of a monthly expat levy, many corporates will have reassessed the costs and benefits of hiring foreign labor, resulting in a rising number of expat redundancies. Indeed, recently released Q1 labor market data from the General Authority of Statistics (GaStat) confirms this trend. According to the data, a total of 796 thousand foreigners have left the Saudi labor market since the start of 2017 (Figure 15). The net effect of both the expat dependency fee and expat levy will mean a declining number of foreigners residing in the Kingdom, and this will inevitably have a negative aggregate effect on overall consumption in the Kingdom, not only in 2018, but also over the next few years.

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Key Data

	2010	2011	2012	2013	2014	2015	2016	2017	2018F
Nominal GDP									
(SR billion)	1,981	2,517	2,760	2,800	2,836	2,454	2,419	2,575	2,944
($ billion)	528	671	736	747	756	654	645	687	785
(% change)	23.1	27.1	9.6	1.5	1.3	-13.5	-1.4	6.5	14.3
Real GDP (% change)									
Oil	-0.1	12.2	5.1	-1.6	2.1	5.3	3.6	-3.0	3.2
Non-oil private sector	10.5	8.1	5.6	7.0	5.4	3.4	0.1	0.7	1.1
Non-oil government	7.4	8.4	5.3	5.1	3.7	2.7	0.6	1.7	2.2
Total	5.0	10.0	5.4	2.7	3.7	4.1	1.7	-0.9	2.2
Oil indicators (average)									
Brent ($/b)	80	112	112	110	99	52	43	54	68
Saudi ($/b)	78	104	106	104	96	49	41	51	66
Production (million b/d)	8.2	9.3	9.8	9.6	9.7	10.2	10.4	10.0	10.3
Budgetary indicators (SR billion)									
Government revenue	742	1,118	1,247	1,156	1,044	616	519	692	867
Government expenditure*	654	838	916	994	1,140	999	935	930	978
Budget balance	88	280	331	162	-96	-383	-416	-238	-111
(% GDP)	4.4	11.1	12.0	5.8	-3.4	-15.6	-17.2	-9.3	-3.8
Gross public debt	177	135	99	60	44	142	317	443	560
(% GDP)	8.9	5.4	3.6	2.1	1.6	5.8	13.1	17.2	19.0
Monetary indicators (average)									
Inflation (% change)	3.8	n/a	2.9	3.5	2.2	1.2	2.1	-0.8	3.1
SAMA base lending rate (%, end year)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.75
External trade indicators ($ billion)									
Oil export revenues	215	318	337	322	285	153	137	170	223
Total export revenues	251	365	388	376	342	204	184	221	275
Imports	97	120	142	153	158	159	128	119	116
Trade balance	154	245	247	223	184	44	56	102	159
Current account balance	67	159	165	135	74	-57	-24	15	73
(% GDP)	12.6	23.6	22.4	18.1	9.8	-8.7	-3.7	2.2	9.3
Official reserve assets	445	544	657	726	732	616	536	496	536
Social and demographic indicators									
Population (million)	27.4	28.2	28.9	29.6	30.3	31.0	31.7	32.6	33.4
Saudi Unemployment (15+, %)	11.2	12.4	12.1	11.7	11.7	11.5	12.5	12.8	12.5
GDP per capita ($)	19,261	23,827	25,471	25,223	24,962	21,095	20,318	21,057	23,495

Sources: Jadwa Investment forecasts for 2017 and 2018. General Authority for Statistics for GDP and demographic indicators, Saudi Arabian Monetary Agency for monetary and external trade indicators, Ministry of Finance for budgetary indicators.