Saudi Arabia: Maintaining the Vision

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- **The pandemic continues to test Saudi Arabia's economic resilience, forcing it to expand its fiscal reach. We expect sustained focus on Vision 2030.**
- **Reforms and exceptional fiscal measures to date have mitigated some of the economic slump. In Q3, non-oil revenues outstripped oil revenues.**
- **The G20 summit next week will be an opportunity for the kingdom to further showcase its reforms and diversification plans. The summit will not be a major game-changer given that reform momentum was already rapid prior to the G20 presidency.**

Table 1 – KSA: Macroeconomic Indicators[1]

	2016	2017	2018	2019	2020f	2021f
Real GDP Growth (%)	1.7	-0.7	2.4	0.3	-5.4	3.1
Crude Oil Production (M Bpd)	10.4	9.9	10.3	9.8	9.3	9.5
Oil GDP Growth (%)	3.6	-3.1	3.1	-3.6	-5.0	3.0
Non-oil GDP Growth (%)	0.2	1.3	2.2	3.3	-6.1	3.3
CPI Inflation (%)	2.0	-0.9	2.5	-2.1	3.6	3.7
Fiscal Balance (% of GDP)	-17.2	-9.2	-5.9	-4.5	-10.6	-6.0
C/A Balance (% of GDP)	-3.7	1.5	9.2	5.9	-2.5	-1.6
Total Gov't. Gross Debt (% of GDP)	13.1	17.2	19.0	22.8	33.4	34.3
Total Gross Extrn'l Debt (% of GDP)	24.6	18.2	19.2	23.2	29.9	29.1
Gross Official Reserves (Mos. of Imports)	31.7	28.3	28.6	33.2	26.2	23.1
Nominal GDP (USD B)	644.9	688.6	786.5	793.0	680.9	735.5
Population (Millions)	32.4	33.1	33.7	34.2	34.2	34.8

Looking for lost revenue

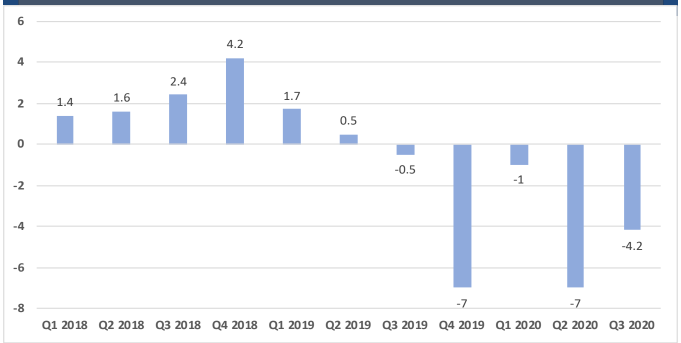
The IMF revised up its forecast for Saudi Arabia to a 5.4% contraction in 2020, from a 6.8% decline estimated in April. This compares with 0.3% growth in 2019, none of which suggests robust growth immediately ahead.

- The slight improvement in Saudi Arabia's IMF outlook, which would still be the kingdom's worst performance since the 1980s oil glut, is due to the government's sizeable fiscal response to the pandemic.
  - The latest data from Saudi Arabia's General Authority for Statistics (GaStat) show that the economy contracted for a fifth consecutive quarter on a YoY basis, declining by 4.2% in Q3 compared with the same period last year.
  - Despite this, there has been an easing in the slump on a quarterly basis this year. GDP expanded by 1.2% QoQ in Q3 from a contraction of 4.9% in the previous quarter (Figure 1). The rebound remains weak, however.
  - While a breakdown by sector was not released, a pick-up in activity had been expected with the easing of lockdown measures and with pent-up demand.
    - The non-oil sector has been improving in recent months. The IHS Markit Purchasing Managers' Index for Saudi Arabia rose to 51.0 in October from 50.7 the month before -- the highest reading in 10 months.
- For the year 2020 as a whole, we expect non-oil GDP to contract by 5% versus 3.3% growth last year, before expanding again in 2021 by 3%.
  - The Ministry of Finance's Q3 budget revealed the volume of total revenues at USD 57.4B, a 3% YoY increase, with non-oil revenue outstripping oil revenue for the first time.
  - Oil revenue in Q3 accounted for 43% of total revenue at USD 24B, a drop of around 50% YoY.
    - In a speech before the Shura Council, Crown Prince Mohammad bin Salman (MBS) said earlier this week that oil revenue is expected to drop by close to a third to around USD 110B this year.
  - Non-oil revenue, by contrast, grew by around 64% YoY to reach USD 30B in Q3. MBS is optimistic that non-oil revenue could grow by 14% this year to reach around USD 95B.
    - This is Saudi Arabia's highest non-oil quarterly revenue since the announcement of the first quarterly budget in 2018.
  - Revenue growth was primarily led by the increase in VAT to 15% in July and the acceleration in structural reforms under Vision 2030.
    - Following the tripling of VAT, inflation jumped to 5.7% in September. Average inflation is projected to remain elevated at 3.7% this year and 3.9% in 2021, before normalising back to 2% thereafter.
- The pace of recovery will remain slower than initially projected. While COVID-19 cases in the kingdom have been declining sharply since June, uncertainty remains elevated on fears of resurgence before a vaccine becomes accessible.
  - Rising unemployment rates are also expected to create economic and social pressures. Latest available data show unemployment jumped 30% QoQ to 15.4% in Q2.
    - More than 64K private-sector jobs were lost during Q2. GaStat data show that around 19K expats have lost their jobs during the same period.
    - GaStat data also show that the number of new private sector expat work visas issued in Q2 totalled 32K. This is significantly lower than the 342K issued in Q1 this year.
  - The recent reforms to the *Kafala* (sponsorship) system will come into effect in March 2021 and are expected to improve employment rates and attract more talent to the kingdom.
    - Under the new law, foreign workers will benefit from more flexibility as they no longer will need to seek employer permission to change jobs or leave the country.
- Despite the kingdom pushing along significant structural measures to contain spending growth, the government budget deficit is expected to soar to 12% of GDP this year, from 4.5% of GDP last year, before declining back to 5% of GDP in 2021.
  - As we have discussed previously in our reports, we expect the wide deficit will be temporary.
    - While the possible three-month extension of production cuts by OPEC+ will take a toll on the recovery early next year, the deficit will start to narrow again as oil prices gradually recover, pandemic effects subside, and the full year of the VAT increase takes effect.
    - But we believe this recovery cycle will be slower than previous ones. We expect that it may take until H2 2022 for the lost private sector output of 2020 to be fully recovered.

[1] Arabia Monitor; IMF.

- Given that Saudi Arabia is pushing for a delay in easing the OPEC+ oil output agreement, the government is expected to push ahead with more austerity measures to curb spending and accelerate its commitment to diversification as set out in Vision 2030.
  - The Public Investment Fund (PIF), the kingdom's sovereign wealth fund, is likely to support the recovery and offset some of the austerity effects as it expands on its domestic investments. From its overall assets of roughly USD 390B, between 75% and 80% are invested at home.
  - In 2019, local investments made by the PIF reached USD 15.5B and it is aiming for USD 25B by the end of this year.
  - MBS has announced that the PIF will be the key driver of growth over the coming two years as it plans to inject more than USD 40B into the economy. This is expected to rise each year until 2030.
    - Recent PIF domestic investments include the backing of MBS's mega-projects such as the large entertainment complex in Qiddya, the Red Sea Development Co., and the planned USD 500B NEOM
  - Additionally, the PIF will receive around USD 69B in instalments until 2028 from Saudi Aramco, linked to the PIF's 70% stake in Saudi Basic Industries. This is expected to boost investments and accelerate the economy away from oil.
- For now, the government and overall public sector balance sheet will continue to deteriorate but will nonetheless remain stronger than most 'A' category sovereigns. This is expected to keep debt issuance on a high this year and next.
  - Year-to-date, Saudi Arabia has issued the highest amount of new sovereign debt in the GCC amounting to USD 21.2B, followed by Abu Dhabi at USD 15B.
    - It has raised around USD 12B in international markets and borrowed nearly USD 10B from the domestic market. It is likely to tap international debt investors once more this year.
  - As a result, Saudi Arabia's debt-to-GDP ratio this year is expected to reach 34.4%, or USD 228B -- a 34% YoY increase from 2019. This is still quite low by international standards.
  - Debt issuance will also be complemented by drawdowns from the government reserve account. It is estimated that reserves, consisting of deposits at the Saudi Arabian Monetary Authority, will decline to 16% of GDP by 2020 and 12% of GDP in 2022, from 18% of GDP in 2019.
- We do not expect Fitch Ratings' recent downbeat view on Saudi Arabia's balance sheet to dampen investor confidence.
  - The outlook was cut to negative from stable. Although the sovereign remains rated 'A', on par with Japan and Iceland, the question is whether a credit downgrade is next.
    - If interest rates remain low (our base case) and inflation declines starting 2021, the kingdom could be saved from the exchange rate pressure it has experienced on a few past occasions.
  - According to Bloomberg, Saudi Arabia's U.S. dollar-denominated debt YTD has given investors more gains than average, with returns of about 10%.
    - Saudi Arabia is the second-best performer among emerging markets, after Uruguay (rated BBB- by Fitch Ratings) with a year-to-date debt return of 13.3%.
    - We expect the kingdom's bonds to continue to outperform, at least until President-elect Joe Biden takes office in January, when a potential cooling of US-Saudi relations could start to weigh in.

Figure 1 - GDP Growth (YoY, %)[2]



G20 Presidency: Building on reform momentum

Saudi Arabia's hosting of the G20 summit this week is an important milestone for the kingdom -- an opportunity to showcase its infrastructure and development projects under Vision 2030. But we do not expect the summit to be a major game-changer given that reform momentum is already rapid.

- As the only Arab country in the G20, the summit will be important for MBS to advance his domestic policies and engage with other Group members in a broader conversation on the kingdom's transformation plans.
  - But a G20 virtual meeting precludes hosting foreign leaders in Saudi Arabia and showing them first-hand the various projects underway.
- Still, with climate change and safeguarding the environment among the key themes under Saudi Arabia's presidency, we expect the kingdom will push for better energy efficiency through an improved regulatory and legal framework.
  - Building on previous conversations made by the G20 Ministers of Energy in past presidencies, Saudi Arabia is set to endorse the concept of a 'Circular Carbon Economy' as a tool to manage carbon emissions and foster access to clean energy technology.
  - In line with this, Saudi Arabia will likely work to attract more private investment in the green sector, to further roll out its USD 30B 2030 renewable investment plan.
- In the coming quarters, we also expect Saudi Arabia will increase its interest in investing in tech-driven companies.
- Creating a digital economy and moving away from oil are also principal themes under the kingdom's presidency this year.
- We expect the kingdom to take post-G20 presidency work as seriously as it has taken its preparatory year, to continue to reap maximum benefit from this once-in-20-years role.

[2] Arabia Monitor; Saudi Arabia's General Authority for Statistics.

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