



بنك الإمارات دبي الوطني  
Emirates NBD

## Economics

2 October 2018

# Saudi Arabia: Oil to drive cyclical recovery

## Summary

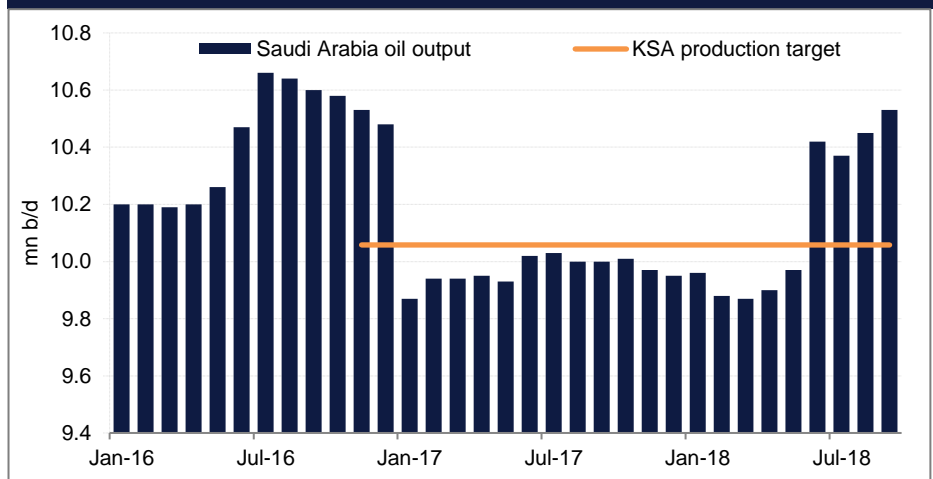
- Q2 data shows a gradual recovery in economic growth in Saudi Arabia following a recession last year. The rise in oil production seen at the end of Q2 is likely to be sustained through the rest of the year, underpinning growth in the oil sectors of the economy, as well as having a positive knock-on impact on manufacturing and transport & logistics.
- The PMI surveys and official GDP data also show non-oil sector activity recovering, supported by increased government spending. Private sector credit is showing signs of growth although liquidity conditions remain relatively tight, with government borrowing crowding out the private sector to some extent.
- Fiscal and external balances have improved dramatically from a year ago, but this is largely reflecting higher oil prices and increased oil production, rather than a structural change in the underlying dynamics of the budget or balance of payments.
- While significant progress has been made on fiscal and social reforms over the last two years, progress on more structural economic reforms, including privatisation and economic diversification efforts, have slowed this year. As a result, inward FDI has remained weak, and unemployment among Saudis has increased.

## GDP growth accelerated in Q2 2018

The Saudi economy expanded 1.6% y/y in Q2 2018, up from 1.2% y/y in Q1, despite contracting 1.3% q/q. **The main driver was a 1.7% y/y expansion in the oil sector, although non-oil GDP growth also accelerated to 2.1% y/y** in the second quarter from 1.5% y/y in Q1.

The increase in oil production since June followed OPEC's decision to reach 100% compliance with the November 2016 production targets, following significant over-compliance in 2017. The rise in GCC oil production since June is likely to be sustained for the foreseeable future as US sanctions on Iran come into force in November.

## Oil production has increased sharply since June



Source: Bloomberg, Emirates NBD Research

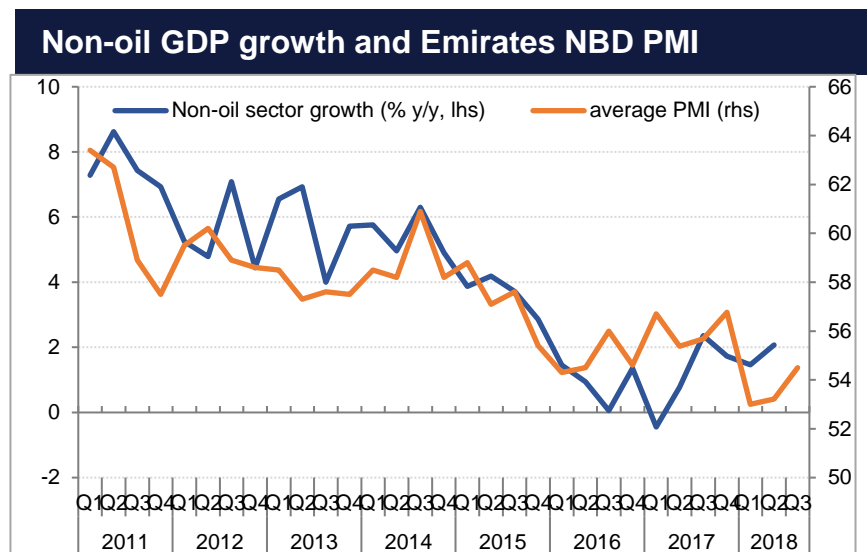
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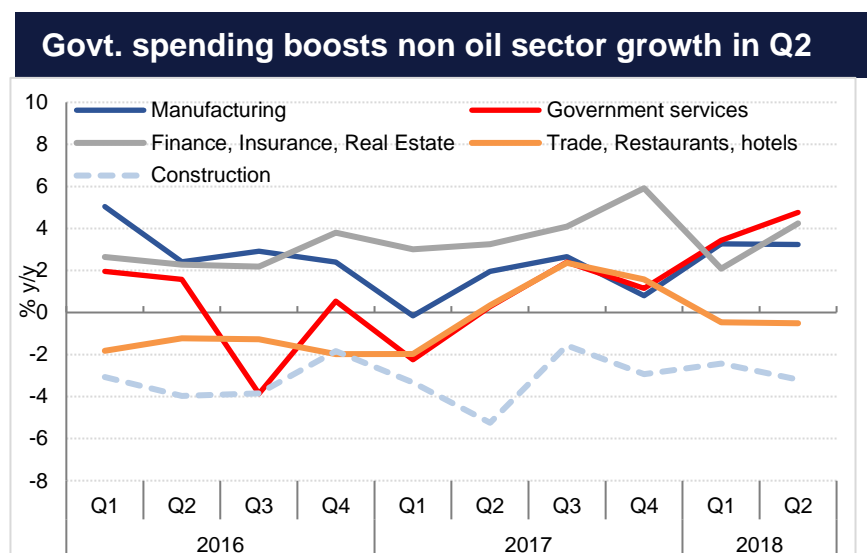
Within the non-oil sectors, government services grew 4.8% y/y in Q2 2018, the fastest growth rate in this component since Q1 2015, likely reflecting the rise in government spending on health & social development and other spending. Manufacturing grew 3.2% y/y while finance, insurance & real estate services grew 4.2% y/y in Q2.

Trade, restaurants & hotel GDP contracted -0.5% y/y, the second consecutive quarter of decline, as did transport, storage & communication. Construction also contracted -3.2% y/y, marking the 10<sup>th</sup> consecutive quarter of decline in this sector.

The faster non-oil sector growth reported in Q2 official data is consistent with the recent PMI surveys, which have recovered somewhat after a weak first quarter.



Source: Haver Analytics, IHS Markit, Emirates NBD Research



Source: Haver Analytics, Emirates NBD Research

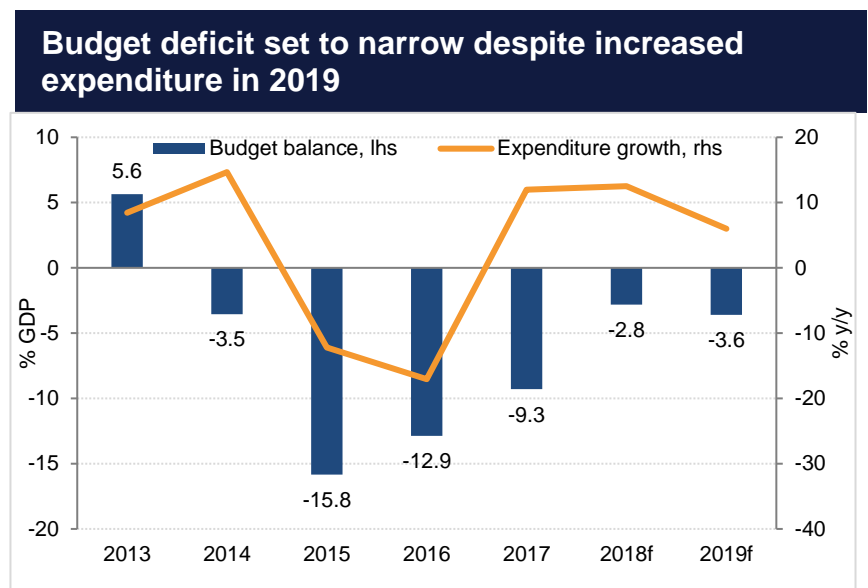
**Overall, GDP growth averaged 1.4% in H1 2018.** We expect the recent rise in oil production to be sustained through the rest of this year, and we expect this to boost the manufacturing and transport & logistics sector in H2 as well. Furthermore, government spending is likely to remain stimulatory for the next 12-18 months, which should also underpin non-oil sector growth in the Kingdom.

**As such, we retain our 2018 GDP growth forecast of 2.0%, rising to 2.4% in 2019.** This is broadly in line with the official growth estimates published by the

Ministry of Finance in the pre-2019 budget statement (2.1% and 2.3% respectively).

### Government set to boost spending further in 2019

The pre-2019 budget statement released by the finance ministry yesterday shows projected expenditure of SAR1.106tn in 2019, up 7.5% from the estimated 2018 spend. However, the revenue projection is (in our view) conservative at SAR 978mn, giving an expected deficit of -4.1% of GDP. Based on our USD 73/b average oil price forecast for next year, **we expect budget revenues to reach SAR 1.0tn, for a deficit of -3.6% of GDP in 2019**, slightly wider than our forecast of -2.8% this year.



Source: Haver Analytics, Emirates NBD Research

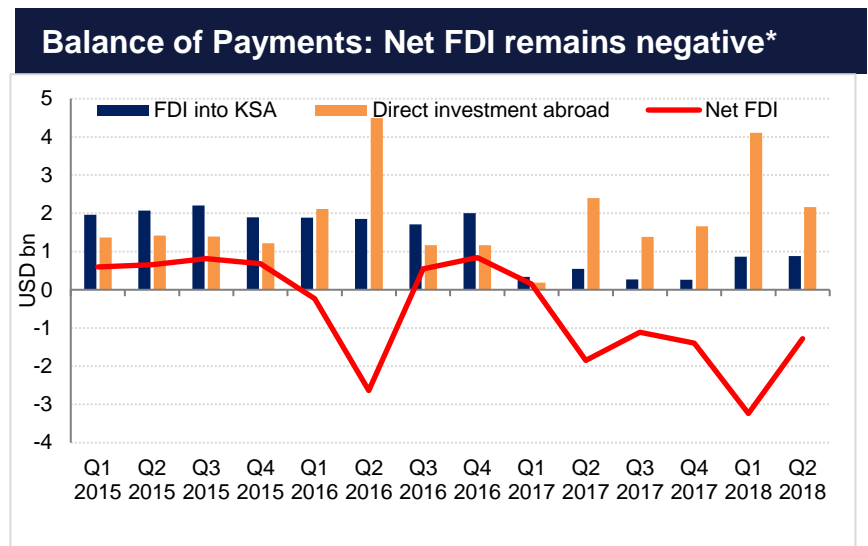
In H1 2018, government spending increased by more than 26% y/y. While the GDP data shows a boost in non-oil GDP, it appears modest relative to the size of the fiscal stimulus. Among the biggest beneficiaries of the increased spending year to date were the health & social development ministry (which likely included the disbursements through the Citizens Account program to mitigate the impact of higher energy prices) and defence, which received around 30% of the extra spending in H1 2018. As much of the defence budget is likely spent on purchase of equipment that is manufactured outside the Kingdom, the multiplier effect of this spending is probably limited.

The full budget for 2019 is due to be released towards the end of the year, and will set out the spending priorities for next year in greater detail.

It is important to recognise that even though there have been significant steps taken to reform the budget (subsidy cuts, introduction of new taxes and levies, improved financial controls within ministries), the budget remains heavily reliant on oil income. **Oil revenue accounted for just under 70% of total budget revenue in the first half of the year, higher than in 2016 and 2017.** The ability of the government to continue to boost expenditure even as the deficit narrows, is due primarily to rising income from oil sales. Another sharp correction in oil prices in the future will likely be followed by expenditure rationalisation and/or widening fiscal deficits.

## Wider current account surplus partially offset by financial account deficits

The current account surplus widened to USD 19.2bn in Q2 2018, bringing the total for H1 to USD 28.6bn compared with a deficit of -USD 27.4bn in H1 2016 and -USD 0.6bn in H1 2017. The current account surplus reflects higher oil export revenues (34% y/y in H1 2018). Goods imports only increased 2.2% y/y over the same period, reflecting the subdued demand in the domestic trade sector.



Source: Haver Analytics, Emirates NBD Research

\* SAMA reports BoP data using BPM6 methodology which reports the acquisition of assets abroad with a positive sign. We are looking at the flow of funds and show an outflow of funds with a negative sign.

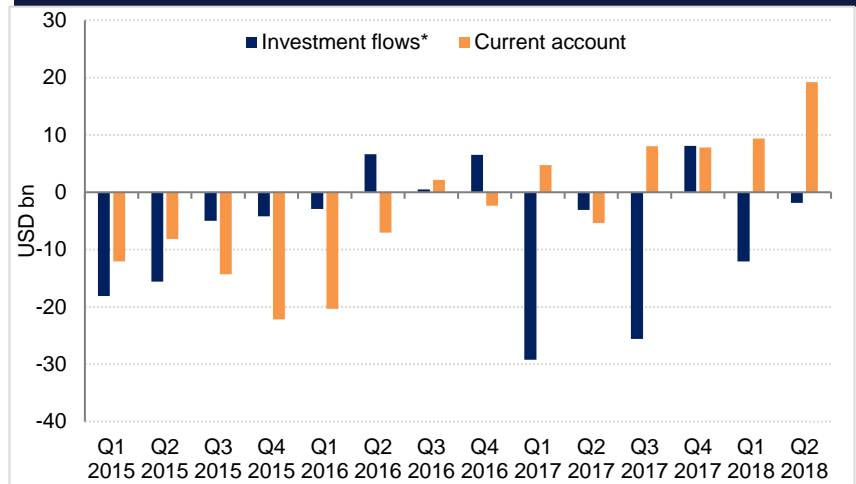
The wider surplus on the current account was partially offset by continued outflows on the financial account, although to a smaller extent than last year. **Although inward FDI increased y/y in H1 2018, it remains significantly lower than pre-2017 levels.** Moreover, outflows of FDI from the Kingdom to the rest of the world remain significantly higher, so the net FDI deficit widened to -USD 4.5bn in H1 2018 from -USD 1.7bn in H1 2017, an increase of 166% y/y.

To the extent that one of the key goals of the Vision 2030 programme was to boost inward FDI, with a view to accelerating diversification of the economy, enabling greater technology and human capital transfers and creating jobs for Saudis, there has been little progress on this front so far.

Where inward direct investment remains disappointing, net portfolio inflows surged in Q2 2018, largely reflecting external debt issuance. However, other investments also showed a significant net outflow in Q2 2018. The net result for investment flows (FDI, FPI and other investment) in Q2 2018 was thus a modest deficit of just under USD 2bn.

Errors and omissions (unrecorded capital flight) stood at -USD 4.2bn in Q2 2018, although it remains sharply lower than in 2016 when total unrecorded flows reached -USD 66.6bn for the full year, before narrowing to -USD 4.0bn in 2017.

### Current account surplus offsets investment outflows



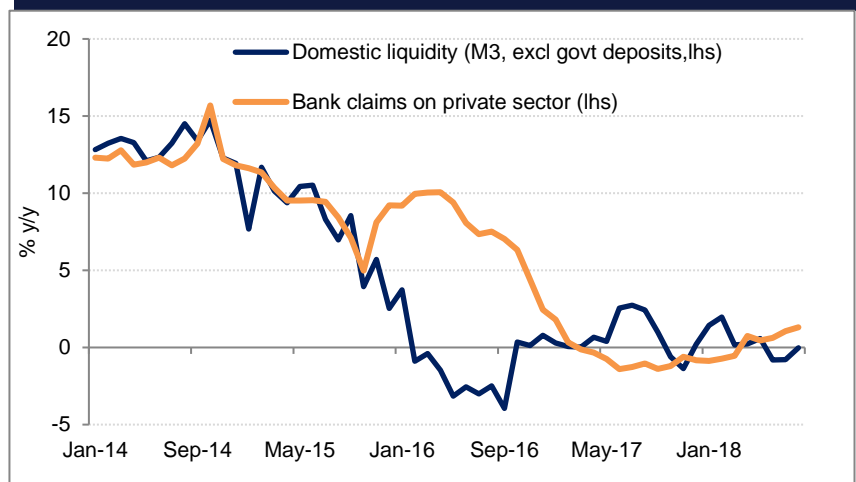
Source: Haver Analytics, Emirates NBD Research

\* Net FDI + FPI + other investment, where a negative figure indicates an outflow of funds from the Kingdom.

Overall, Saudi Arabia’s reserve assets increased by USD 13bn in H1 2018, compared with a decline of -USD 33.9bn in H1 2017, reflecting a much stronger external position for the Kingdom. However, as with the budget, we note that this improvement was primarily due to sharply higher oil revenues and is thus vulnerable to volatility in oil prices and oil export volumes.

### Money supply, private sector credit growth remain soft

#### Money supply and credit growth remain soft

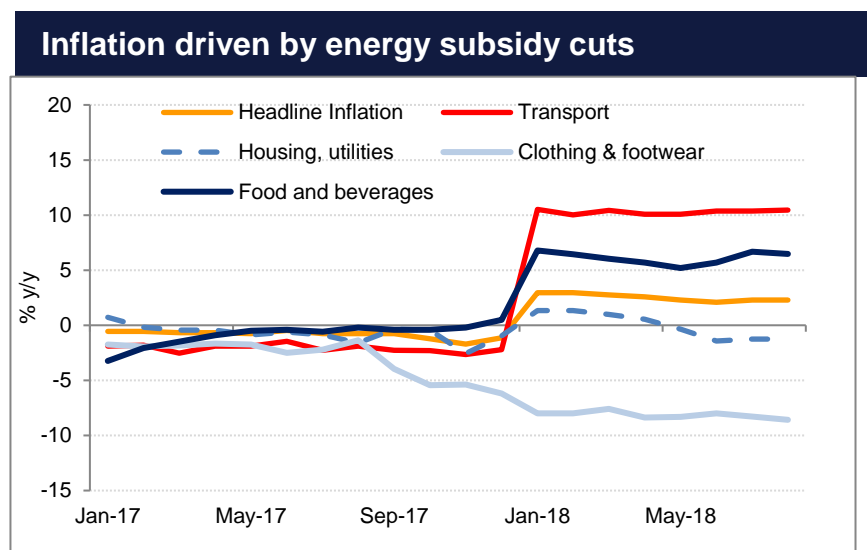


Source: Haver Analytics, Emirates NBD Research

The rebound in oil prices this year has not translated to improved liquidity conditions in the domestic banking system. Broad money supply growth was flat y/y in August after contracting marginally in the prior two months. Longer-term deposits have contracted on an annual basis for the last year. Commercial bank deposit data show government entities’ deposits declining on an annual basis since March 2018, although business & individuals’ deposits have grown modestly. Private sector credit has grown modestly since April 2018, after contracting for the prior 13 months. Public sector borrowing (including government bond issuance) has slowed but remains high at 21.7% y/y in August.

## Inflation averages 2.5% in the year to August

Inflation has slowed to 2.3% y/y in August from a high of 3.0% in January, as the impact of VAT and energy price hikes is factored in. Clothing and footwear prices have declined sharply this year despite the introduction of VAT in January. A stronger USD may have contributed to easing price pressures, although softer consumer demand likely also encouraged price discounting by retailers. Indeed, the PMI surveys point to average declines in selling prices in the Kingdom (across the whole private non-oil sector) this year. Housing & utilities costs, which account for more than 20% of the consumer basket, have also declined on an annual basis since May, helping to keep the headline inflation rate contained. However, evidence of higher fuel prices is evident in the transport component of the index (10.5% y/y in August) and likely contributed to higher prices for food.



Source: Haver Analytics, Emirates NBD Research

## Conclusion

Q2 data shows a gradual recovery in economic growth in Saudi Arabia following a recession last year. The rise in oil production seen at the end of Q2 is likely to be sustained through the rest of the year, underpinning growth in the oil sectors of the economy, as well as having a positive knock-on impact on manufacturing and transport & logistics.

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## Key Economic Forecasts: Saudi Arabia

National Income	2015	2016	2017	2018f	2019f
Nominal GDP (SAR bn)	2454	2419	2564	2884	3011
Nominal GDP (USD bn)	654	645	684	769	803
GDP per capita (USD)	20557	19693	20312	22224	22568
Real GDP Growth (% y/y)	4.1	1.7	-0.7	2.0	2.4
Hydrocarbon	5.3	3.6	-3.0	2.5	2.5
Non- hydrocarbon	3.2	0.2	1.0	1.6	2.3
Monetary Indicators (% y/y)					
M2	2.5	0.8	0.2	1.0	4.3
Private sector credit	9.2	2.4	-0.8	4.0	5.0
CPI (average)	1.2	2.1	-0.8	2.5	2.0
External Accounts (USD bn)					
Exports	203.5	183.6	221.1	283.2	289.9
Of which: hydrocarbons	153.0	136.2	159.5	228.2	233.9
Imports	159.3	127.8	119.3	122.3	125.4
Trade balance	44.3	55.8	101.7	160.9	164.6
% GDP	6.8	8.6	14.9	20.9	20.5
Current account balance	-56.7	-23.8	15.2	69.9	73.0
% GDP	-8.7	-3.7	2.2	9.1	9.1
SAMA's Net foreign Assets	608.9	528.6	488.9		
Fiscal Indicators (% GDP)					
Budget balance	-15.8	-12.9	-9.3	-2.8	-3.6
Revenue	25.0	21.5	27.0	33.5	33.2
Expenditure	40.8	34.3	36.3	36.3	36.8
Public debt	5.8	13.1	17.1	20.5	

Source: Haver Analytics, Emirates NBD Research

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