Saudi Arabia

First signs of recovery

The Saudi economy has recorded weak performances over the past three years. It has had to deal with the combined impact of reforms undertaken as part of the Vision 2030 plan and rather unfavourable oil market conditions, which have eroded public finances. Non-oil GDP growth has been slowing since 2016 due to sluggish domestic demand. Activity should pick up gradually in 2019 thanks to fiscal stimulus efforts and the steady normalisation of the labour market. Under this environment, fiscal deficits are accumulating, but the government's solvency is still solid.

The non-oil economy has been entered in a slowdown for roughly the past three years. Non-oil GDP growth has averaged 1.2% a year since 2016, compared to 5.7% in the period 2011-2015. This can be attributed to the deterioration in public finances, which has led to sharp cutbacks in public spending since 2015. Accelerated efforts to drive through labour market reforms have also strained economic activity. In 2018, real GDP growth was 2.2%, thanks mainly to a 2.8% increase in oil GDP.

Oil GDP is expected to decline

As OPEC's largest member, Saudi oil production is closely linked to the oil cartel's production decisions. The ongoing rise in US oil production since 2016 -- the US became the world's leading oil producer in 2018 -- has forced OPEC+Russia to maintain a restrictive quota policy to bolster prices. The July 2019 quota agreement renewed the production cuts approved last December. This agreement runs through March 2020, which means Saudi oil production should remain stable this year at about 10 million barrels per day (mb/d), compared to 10.3 mb/d in 2018. As a result, oil GDP (roughly 40% of total GDP) should decline by about 1.7% in 2019.

A sharp economic slowdown

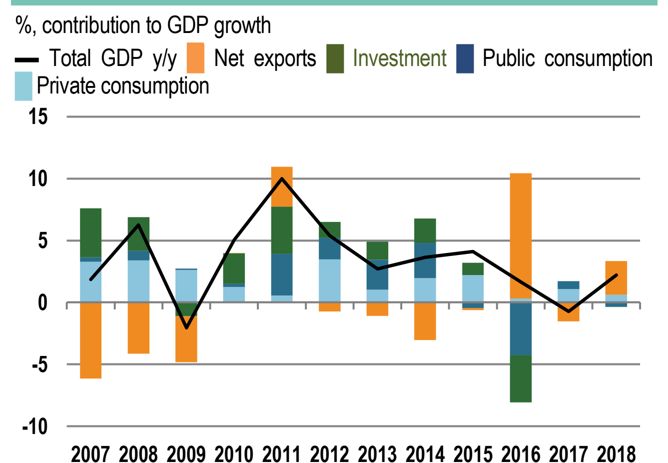
The non-oil economy has been idling since 2016. The sharp slowdown is due to the virtual stagnation of non-oil public sector GDP, and the acceleration of labour market reforms. In the past, public expenditure has been the main growth engine of Saudi domestic demand. Due to an unfavourable oil cycle, spending was cut in 2016 and 2017 to reach 36% of GDP, down from 41% in 2015. Saudization, the Saudi nationalisation scheme for the labour market (in which Saudi nationals replace expat workers in the non-oil private sector), has been stepped up over the past two years. The presence of non-Saudi workers has fallen sharply and is even forbidden in some retail sectors (jewellers or telephone service providers for example), which were traditionally owned by expats. At the same time, taxes were applied to expats and their families. This triggered an exodus of numerous expats and the consolidation of some sectors of the economy. Since early 2017, 1.8 million expats have exited the labour market. As a result, the total population of the country has declined by about 5% in two years. At the same time, employment has increased very slowly for Saudi nationals. The total number of working Saudis has increased slightly since year-end 2018 since private sector job creations have grown at a faster pace than the decline in public sector employment. These trends have obviously had negative consequences on domestic private demand,

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	-0.7	2.2	1.1	2.9
Inflation (CPI, year average, %)	-0.9	2.5	-1.7	1.8
Central. Gov. balance / GDP (%)	-9.2	-4.6	-8.1	-8.2
Central. Gov. debt / GDP (%)	17	19	28	35
Current account balance / GDP (%)	1.6	9.3	3.5	3.5
External debt / GDP (%)	23	25	30	34
Forex reserves (USD bn)	497	497	499	504
Forex reserves, in months of imports	30	28	28	27
Exchange rate USDSAR (year end)	3.75	3.75	3.75	3.75

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth slumps



Source: Ministry of the Economy and Planning, BNP Paribas

which rose only 2% on average between 2016 and 2018, compared to an average of 5.9% in 2011-2015.

A few signs of recovery in 2019

This negative momentum seems to have begun to turnaround since the beginning of the year. Real GDP growth slowed to only 1.7% in Q1 2019 (vs. 3.6% in Q4 2018) due to weak export growth (+5.1%), which contributes more than 45% of total GDP. Yet there seems to have been a rather net upturn in private consumption (about 35% of total GDP), which increased 4.8%, compared to 1.8% in full-year

2018. Private consumption will benefit from public sector wage increases, which employs about 45% of working Saudi nationals. Household lending rose only feebly (1.8% y/y in March 2019).

As to the labour market, according to the latest figures for Q1 2019 the number of working Saudis has increased since Q3 2018 (+2000 persons), thanks notably to the dynamic momentum of female employment. The number of working expats has also picked up since Q4 2018 (+224,000 persons). As to public spending, the government is clearly committed to an economic support policy with a private sector stimulus package equivalent to 7% of GDP spread over four years. According to Q1 data, public sector wages and investment rose 8% and 12%, respectively. This support should continue throughout the year with a nominal 9% increase in the total provisional budget. In real terms, the fiscal stimulus is even more significant since we are forecasting negative inflation in 2019 (-1.7% on average). From a sector point of view, some leading indicators (cement production, ATM withdrawals and import letters of credit) signal ongoing growth of non-oil GDP in Q2 2019.

All in all, we are forecasting non-oil GDP growth of at least 3% in 2019 (compared to 2.1% in 2018). As a result, total GDP growth is estimated at 1.1% in 2019 before accelerating to 2.9% in 2020.

The cost of housing drags down inflation

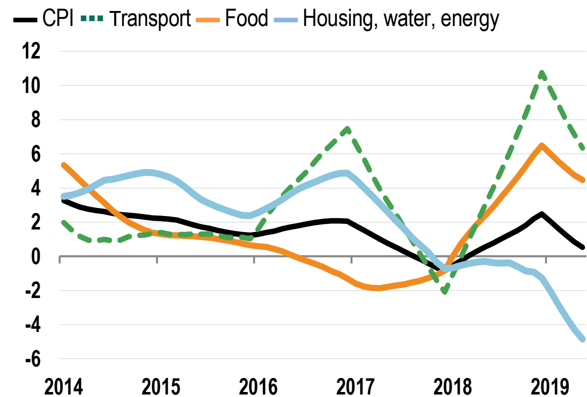
Reflecting the sluggish economy, year-on-year price inflation has been negative since the beginning of the year (-1.5% y/y in May 2019). In 2018, prices rose 2.5% on average (compared to -0.8% in 2017), mainly due to the introduction of VAT and cutbacks in fuel subsidies in early 2018. In 2019, we expect the consumer price index to trend downwards (-1.7% on average), mainly due to the ongoing decline in house prices. The housing, water and energy component contributes 25% of the CPI basket. The rental sub-component declined 6.8% on average in the year to May 2019. At this stage, however, it is too early to talk about a deflationary situation. According to our estimates, core inflation (excluding housing and food) averaged 1.8% in May.

Given the brighter growth prospects in 2019, and with the halting of the decline in the number of working expats in the country, consumer prices should begin to pick up again in 2020. Moreover, to reduce the dependency of public finances on oil price trends, the government will continue its policy of increasing non-oil revenues (VAT, for example) and reducing fuel subsidies, in order to move closer to market prices. This should also help boost prices. Consequently, our outlook calls for consumer price inflation to average 1.8% in 2020.

Public finances deteriorate

Fiscal deficits have been recurrently high since 2014 due to higher fiscal spending and a less favourable oil market for Gulf oil producers. Deficits will remain high in the years ahead given the constraints on oil production and expectations of price stability on the one hand, and the need to stimulate economic activity on the other. The fiscal breakeven price currently stands at more than USD 85 per barrel (benchmark Brent), which is much higher than market prices (USD 66/b on average in H1 2019). Our outlook calls

3- Cost of housing pulls down inflation



Source: SAMA, BNP Paribas

for the deficit to reach 8.1% of GDP in 2019 and 8.2% in 2020. Slower spending growth and higher non-oil fiscal revenues (currently about 30% of total revenues) should reduce the deficit to 7.5% of GDP in 2021. The government plans to return to a balanced budget by 2023. The observed increase in the share of non-oil revenues is a positive factor that should make this easier, however the economy is still highly vulnerable to oil prices fluctuations. Controlling fiscal spending is still the key to reaching this goal.

Despite the accumulation of deficits, public finances are not in danger for the moment. Government debt is moderate (at an estimated 28% of GDP in 2019). Moreover, it is offset by major government assets (about 75% of GDP by adding government assets of the Saudi Arabia Monetary Authority (SAMA) and the estimated assets of the Public Investment Fund). Saudi Arabia has also become a regular issuer on the Eurobond market. Considering the current appetite of investors, Saudi Arabia will continue to benefit from very favourable financing conditions.

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