SAUDI ARABIA

FISCAL REFORM IS ONGOING

The economic recovery should be sustained in 2022 due to the sharp increase in hydrocarbon production following the OPEC+ agreements and due to stronger growth in household consumption. The current oil trend is favourable to public finances, while the process of fiscal consolidation and revenue diversification is expected to continue. It has already led to a significant reduction in the fiscal breakeven oil price and therefore less exposure to oil market volatility. In the meantime, tensions have emerged on the interbank market and have required an injection of liquidity by the central bank. The fast growth in bank lending and less pro-cyclical management of budget surpluses have forced banks to use external resources, and therefore to reduce their net external assets, in order to finance their activity.

STRONG REBOUND IN ACTIVITY

Economic growth is expected to reach 7.4% in 2022, mainly thanks to the increase in oil production. After a year of near stability in 2021 (+0.2%), the gradual increase in production quotas agreed by OPEC+ (OPEC member countries and Russia) should lead oil GDP (around 40% of total GDP) to grow by 14% in 2022. The increase in hydrocarbon production is also driven by the need to at least partially compensate for the reduction in Russian production. As a producer with most of the spare production capacity in the cartel, Saudi Arabia is the main contributor to the increase in production quotas.

Non-oil GDP is expected to grow by around 3.7% in 2022, driven mainly by household consumption. It is benefiting from the improving labour market and moderate inflation pressure. The unemployment rate has been steadily falling since 2020 and reached 10.1% of the labour force in Q1 2022. There has been a significant increase in women's employment since the implementation of favourable policies. Women's participation in the labour force grew from 19% in 2017 to 36% in 2021. Furthermore, the end of travel restrictions linked to the pandemic and the economic recovery in non-oil sectors should support the return of expatriates (the number of which had fallen by 4.6% in 2021). The increase in household credit (+17% year-on-year in December 2021) also drives private consumption.

The role of public expenditure in economic growth is changing. The government wants to reduce its very pro-cyclical nature, which has tended to favour overheating of the economy during periods of high oil incomes. Thus, despite favourable oil market and therefore rising budgetary income, budgetary expenditure should only rise moderately.

From a sector-based perspective, activity should be driven by services (particularly leisure, in the broad sense) and construction, supported by the Vision 2030 development programme, which aims to diversify the economy and develop infrastructure.

In 2023, economic growth should reach 3.3%, given the small increase in oil production (+2.2%). Non-oil growth is expected to strengthen to 4.1%.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	0.4	-4.1	3.3	7.4	3.3
Inflation, CPI, year average, %	-1.2	3.4	3.1	2.7	1.7
Central. Gov. balance / GDP (%)	-4.5	-11.2	-0.8	10.8	8.5
Central. Gov. debt / GDP (%)	23	32	30	25	24
Current account balance / GDP (%)	4.8	-3.2	6.8	14.3	9.2
External debt / GDP (%)	24	30	37	30	31
Forex reserves (USD bn)	500	454	456	539	582
Forex reserves, in months of imports	27	30	27	26	26

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SAUDI ARABIA: FISCAL BALANCE

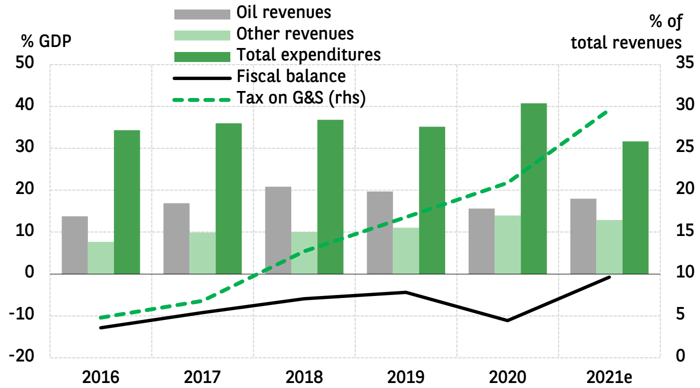

CHART 1 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

MODERATE INFLATION

Like most Gulf countries, inflation pressures should remain moderate in 2022. Consumer price inflation has stabilised at an annual rate of 2.2% in May 2022. Food prices were the main driver of inflation (+4.6% in May), while energy prices were virtually stable (+0.15%) thanks to continued government subsidies. In June 2021, the government introduced a cap on the increase in gasoline prices; it has borne the cost of any rise since then (the price of Brent rose by around 45% during this period). Rents (21% of the price index) have risen since March but only very slightly (+0.5% in May). More generally, the appreciation of the US dollar (to which the riyal is pegged) against major currencies is an important factor in moderating inflation.

FISCAL SURPLUSES AND REFORMS

In 2022, the Saudi public finances are expected to post their first surplus since 2013. Changes in the global oil market between 2015 and 2019 and the impact of the pandemic on activity in 2020 have weighed heavily on oil budget revenues. The budget deficit averaged

9.9% of GDP between 2015 and 2020. After an almost balanced budget in 2021, the increase in oil income should lead to a surplus of 10.8% of GDP in 2022. Assuming oil prices remain high in 2023, the surplus is expected to reach 8.5% of GDP.

The difficult period from 2015 to 2020 had a positive impact on public finances by forcing the government to take measures of fiscal consolidation and revenue diversification. The introduction of VAT in 2018 and the increase of its rate to 15% in 2020 had a strong impact on diversification. The share of taxes on goods and services increased from 7% of total fiscal income in 2017 to 26% in 2021. In addition, budgetary discipline has improved noticeably with the implementation of a medium-term fiscal stability program. Government spending should be equivalent to around 32% of GDP in the period 2021-2023 compared to an average of 37% in the period 2015-2020. Current expenditure is expected to rise slightly, while capital expenditure is expected to continue to fall. With regard to investment, the government's willingness is to transfer some of them to the Public Investment Fund (PIF), the Saudi sovereign wealth fund, as well as to develop partnerships with the private sector. This combination of factors translates into a sharp drop in the fiscal breakeven oil price. It has fallen from an average of USD 91/b in 2014-2018 to an expected USD 63/b in 2022. In this context, fiscal performance should be less exposed to oil market volatility, even if there will continue to be significant fiscal dependence on oil income in the medium term.

Government debt should decline thanks to fiscal surpluses. However, due to active debt management, the reduction will be slower than the expected budget surpluses suggest. After it reached a peak of 32% of GDP in 2020, government debt is expected to reach 24% of GDP in 2023. Even when there is a budget surplus, the government continues to issue debt in order to optimise its profile, to extend its average maturity (which already increased from 7.9 to 9.5 years between 2018 and 2021) and to reduce its cost (from 2.91% to 2.77% between 2018 and 2021). The government's solvency is therefore improving even though its net assets remain relatively modest. Government assets held at the central bank (assumed to be the most liquid) were equivalent to 18% of GDP in 2021, while assets held by the PIF were estimated to be around 55% of GDP in 2021.

TENSIONS ON DOMESTIC LIQUIDITY

Paradoxically, tensions over interbank liquidity have emerged since the start of the year despite the rise in oil income (which is traditionally associated with increased liquidity in the economy). The interbank interest rate (SAIBOR) has risen sharply since the beginning of the year (from 0.9% to a peak of 3.3% at the end of June) and reached its highest level since the financial crisis in 2008. Furthermore, the ratio of excess banking liquidity placed at the central bank (securities and REPO contracts) as a percentage of the money supply (M2) is currently at an all-time low (1.9% in May compared with 5.8% on average in 2021). In order to reduce liquidity pressure, the central bank injected USD 13 billion (2.2% of total bank deposits) into term deposits in the banking system in June 2022.

The main cause of these liquidity pressures has been the decoupling since March 2020 of the increase in credit to the private sector (+14.4% on average) with that of deposits (+9.4% on average). If banks do not access other resources (e.g. by issuing securities in the local market), this gap leads to a deterioration in banks' net external position since they must find external resources to meet the demand for credit. Banks' net external assets reached USD 8.9 billion in May 2022 compared

SAUDI ARABIA: COMMERCIAL BANKS' BALANCE SHEET, MAIN ITEMS

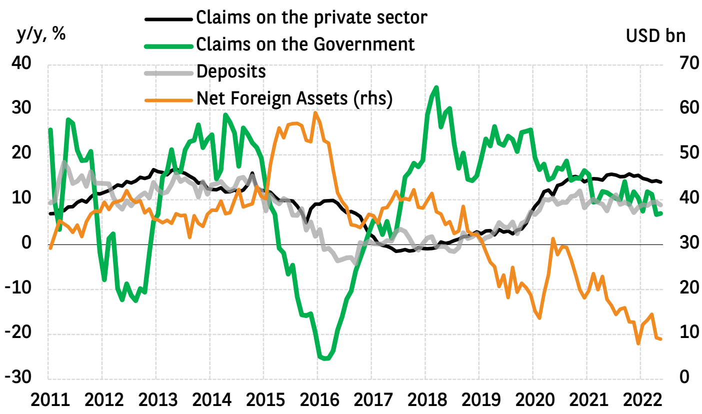

CHART 2

SOURCE: CENTRAL BANK, BNP PARIBAS

to USD 30 billion in mid-2020. Credit growth is particularly strong in consumer credit (+17% year-on-year in 2021) and real estate credit, which represents 29% of credit to the private sector (+28% in Q1 2022).

Furthermore, the change in the management of the budget surplus by the government could amplify this disconnection between banking claims and resources. In order to limit the effects of overheating caused by the injection of liquidity related to oil income, fiscal surpluses will be held in a government current account at the central bank instead of being partially deposited in the banking system. For the moment, the effects of this policy cannot be seen. The share of government deposits in total bank deposits remained stable (26% in May 2022). In the medium term, this policy should help to reduce the dependence of economic activity on the oil economy. In the short term, however, if it entails a slowdown in credit to the private sector due to a lack of local resources and the will to preserve banks' net external positions, it could be a constraint on non-hydrocarbon GDP growth.

Article completed on 1 July 2022

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