Jadwa Investment

July 2023

Macroeconomic Update

Raising our non-oil GDP forecast

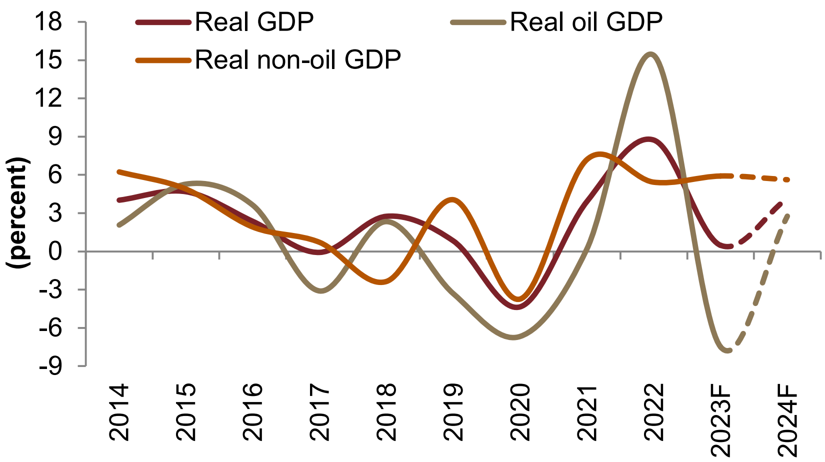
- The Saudi domestic economy continues to grow robustly. Real non-oil GDP expanded by 5.4 percent in Q1-23, with Domestic Trade, Construction, and Transport leading the way. Available data for Q2 indicate that activity in these sectors continues at a brisk pace. Manufacturing was the only sector to record a year-on-year decline, with Refining contracting in the face of soft regional demand, and Petrochemicals exports to China struggling to gain traction. Nevertheless, Saudi domestic manufacturing demand is strong and new factories continue to be rolled out. Thus, we raise our non-oil GDP growth forecast to 5.9 percent this year, with a similar rate of expansion anticipated for 2024 (Figure 1).

- While our non-oil GDP growth forecast increases, we have been obliged to reduce our overall real GDP forecast. We had anticipated a small fall in hydrocarbons GDP this year, but this is now set to be considerably steeper given cuts to Saudi oil production made as part of OPEC Plus agreements. Thus, we now see hydrocarbons real GDP falling by some 7.5 percent, which will mean the overall economy grows by just 0.5 percent.

- We have also revised our oil price forecast. The physical market is tightening (particularly for sour crudes) and we think this will gather pace during the rest of the year, pushing prices higher. Yet there is no escaping the weakness in H1, and we have therefore lowered our full-year forecast for Brent to an average $84 per barrel, from $90 pb previously. We are sticking with our 2024 forecast of $87 pb in the anticipation that interest rate cuts will bolster demand, even as OPEC production is increased.

- Lower oil prices and production will push the fiscal position into a small deficit of some 1.1 percent of GDP this year, though financing should be straightforward. The current account is expected to remain in surplus, helped by buoyant tourism earnings. Both the fiscal and current accounts should be in surplus in 2024.

Figure 1: Saudi Arabia's Real GDP forecast



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We have reduced our oil price forecast for 2023 largely on the back of a much weaker-than-expected performance in H1. We still expect the market to tighten in H2 and into 2024.

Overview:

The outlook for oil production and prices has changed since we published our [Saudi Economy 2023] report in February. The Kingdom has opted to cut production sharply this year—a move that we had not anticipated. Meanwhile, although physical oil markets have now begun to tighten, they were soft for much longer than we expected. Thus, we now see Brent averaging $84 pb, down from our earlier forecast of $90 pb, and Saudi oil sector real GDP contracting by 7.5 percent this year. The weaker oil profile means that we now expect the fiscal position to shift into a modest deficit of 1.1 percent of GDP this year, though the position should return to surplus in 2024 as oil prices and production rebound. The current account should remain in surplus thanks to a very strong showing from Tourism.

Domestic activity is buoyant, with particularly strong showings from Construction and Domestic Trade. As a result, we have raised our 2023 non-oil GDP growth forecast to 5.9 percent.

In contrast with the oil position, domestic economic activity is vigorous and should remain so for the rest of this year and into 2024. Therefore, we have increased our non-oil GDP growth forecast to 5.9 percent. Construction and Domestic Trade are the main growth engines, although non-oil exports have disappointed (owing to a surfeit of petrochemicals in China). The main constraint to domestic growth remains financing, though there is plenty of scope to raise long-term debt.

Oil activities:

GDP from oil activities is set to contract by around 7.5 percent this year. The main reason for this is the cut to oil production.

Saudi crude production is now set to contract sharply in 2023, confounding our earlier expectations of a minor decline. The authorities made a commitment to reduce output by roughly 500,000 bpd from May, and by a further 1 mbpd from July. We assume both of these cuts will be rolled over for the rest of the year, meaning that total output is set to contract by 7-8 percent in 2023. Gas production, which is mainly “associated’, will offer little support.

Overall, therefore, we see hydrocarbons GDP contracting this year by around 7.5 percent in real terms, considerably deeper than our earlier projection of a 0.2 percent decline (Figure 2).

Non-oil activities:

Following a strong, albeit moderating, performance last year, our non -oil private sector composite index bounced back forcefully in Q2 with a 4.4 percent quarterly gain (Figure 3). This reflects a broad-based increase in activity with virtually all non-oil sectors expanding briskly, prompting us to raise our real non-oil GDP growth forecast to 5.9 percent.

Figure 2: Oil GDP is expected to decline in 2023
(year-on-year)

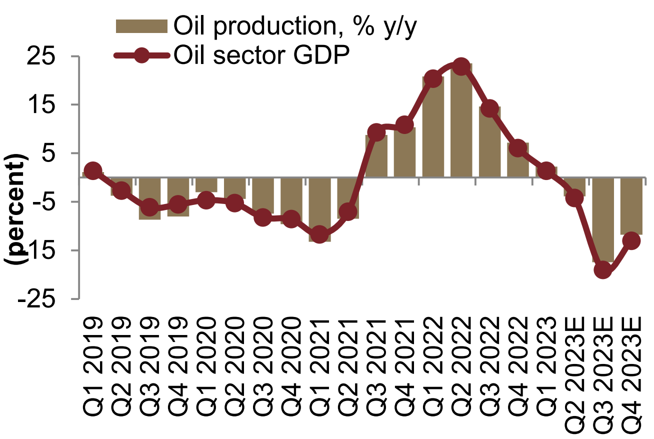
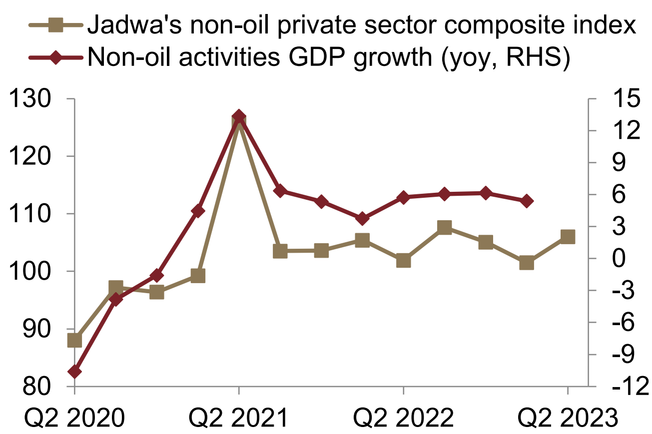


Figure 3: Non-oil private sector is set to continue expanding in 2023



Petrochemicals exports have been held back by a build up of stocks (and capacity) in China. However, domestic rollout of industrial projects continues.

The one under-performing sector is also the largest: ‘Manufacturing’. Official GDP data are only available to Q1, but these show the sector declining slightly, year-on-year, weighed down by a contraction in Refining and soft Petrochemicals growth. The anticipated rebound in China (the Kingdom’s main petrochemicals export market) has been underwhelming. Moreover, China’s petrochemicals’ stocks (and indeed capacity) are much higher than we expected, and this has weighed heavily on the Kingdom’s chemicals’ exports and prospects. Thus, Q1 exports of ‘petrochemicals’ and ‘plastics’ continued the sharp downward trend seen since 2021 (Figure 4). Meanwhile, Refining (which is part of the Manufacturing space in GDP by Sector) has had a tough couple of quarters, and contracted by 7.6 percent in Q1. Weak MENA demand has been the main headwind here.

Nevertheless, we expect a better performance in the broader Manufacturing sector in H2, given that the Index of Industrial Production (IIP) rose by an average of 13.5 percent in the year to May, despite the softness in exports. In addition, output is likely to be enhanced by more than 400 new industrial factories that started production in the year to May (worth SR11 billion of investment). These should create some 14 thousand new jobs.

Wholesale and Retail Trade continues to witness rapid growth as more women join the workforce. The surge in Umrah and Hajj visitors is also supporting the sector.

Following ‘Non-oil Manufacturing’ by size in non-oil GDP is ‘Wholesale and Retail Trade’, which has seen impressive growth over the past few years. The sector expanded by 7.5 percent in Q1 and now accounts for just under 10 percent of overall GDP. In general, demand is being boosted by more women joining the labor force (up from 33 percent in Q1 2022 to 36 percent in Q1 2023). In the year to May 2023, consumer spending (POS plus e-commerce transactions and ATM withdrawals) rose by 8.7 percent, year-on-year. We expect consumer spending to remain strong for the remainder of 2023, especially with the rollout of entertainment, leisure and sports events. Moreover, the rebound in the number of Umrah and Hajj visitors should also help lift spending within the sector.

The Construction sector is benefitting from the rollout of various Giga-projects, though Housing is also a helpful tailwind.

Meanwhile, the ‘Construction’ sector appears to have rebounded quite forcefully, growing by 5.5 percent year-on-year in Q1. This consolidates an upward trend following a challenging couple of years related to Covid-19 (Figure 5). The increase in public sector investment, especially around giga-projects, has undoubtedly benefited the industry, but housing construction has also been a substantial tailwind.

Also doing well is the ‘Transport, Storage and Communication’ sector, which expanded by 9.3 percent year-on-year in Q1,

Figure 4: Exports from ’petrochemicals’ and ’plastics’ continue to slide

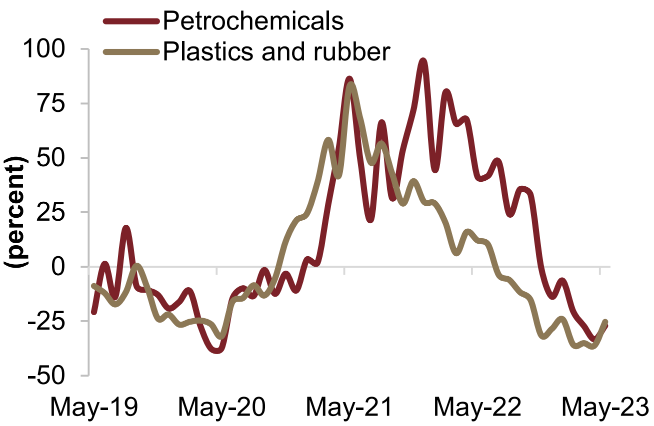
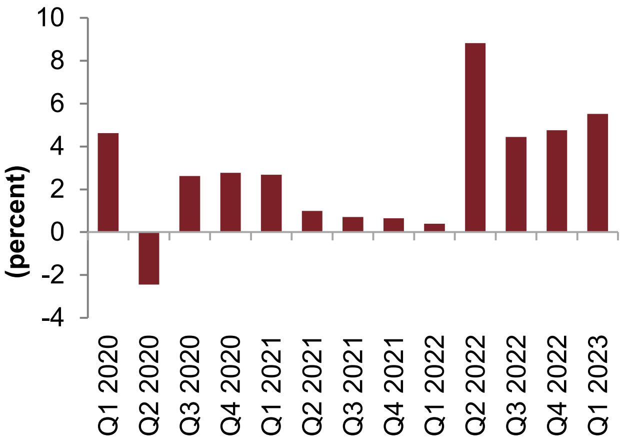


Figure 5: Change in Real Domestic Construction GDP, year-on-year (2010 prices)



Transport has benefited from Construction activity, but also from sector-specific developments such as the launch of a new airline and greater volumes of cargo and passengers on Saudi Arabia Railways.

outstripping even the impressive 8 percent average rate of the past six quarters. The sector has been bolstered by a number of positive developments and prospective projects, such as the official launch of Riyadh Air, the Kingdom's newest national airline, which will start operations by 2025. Meanwhile, Saudi Arabia Railways (SAR) carried more than 2.2 million passengers in Q1, more than double the number in the same period last year. The railway also saw a 7 percent rise in cargo transportation. The growing number of religious pilgrims, along with other tourists, should provide a further boost to Saudi railways in the years ahead.

Fiscal:

The fiscal outlook has been impacted by the weaker oil price and production profile.

The government's fiscal outlook has deteriorated somewhat as a result of the change to our oil production and price assumptions (Box 1). The outlook has also been impacted by a much larger-than-expected surge in government spending in Q1-23.

Nevertheless, there should be a partial offset from buoyant non-oil revenue, such as VAT and Customs.

The changes to our oil assumptions indicate that hydrocarbons revenue will fall by 14 percent this year, putting it just below SR735 billion compared with SR857 billion last year. The non-oil revenue picture is much more buoyant. The strength of domestic demand indicates that VAT takings (far and away the biggest element of non-oil revenue) will be higher than our earlier projections, with growth of some 11 percent this year. Another likely area of strength is customs revenue given the surge in imports witnessed so far this year. This indicates that overall non-oil revenue will reach SR430 billion this year—a 5 percent gain on 2022—and give overall revenue for the year of SR1164 billion, down around 8 percent from last year.

Box 1: Oil Prices

Oil prices have been lower than we expected, with traders focusing on China's underwhelming post-Covid re-opening.

So far this year, oil prices have been weaker than we anticipated. Although the physical market has been tightening (gradually) traders have been pre-occupied by the demand outlook, given the underwhelming Chinese recovery and a likely economic downturn in the US.

It is difficult to dispute that China's recovery has been disappointing, with weakness in manufacturing and real estate weighing heavily on the demand picture. It is also probable that the US will weaken this year. However, we think the picture is more nuanced and demand growth is set to surprise on the upside. First, China's government has already rolled out some measures in support of the property sector, and they could deploy more monetary support to the broader

Figure 6: Russian crude oil exports have been resilient, but are now coming under pressure

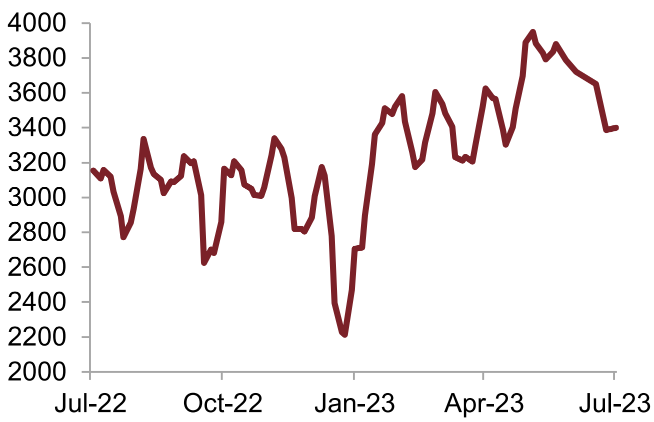
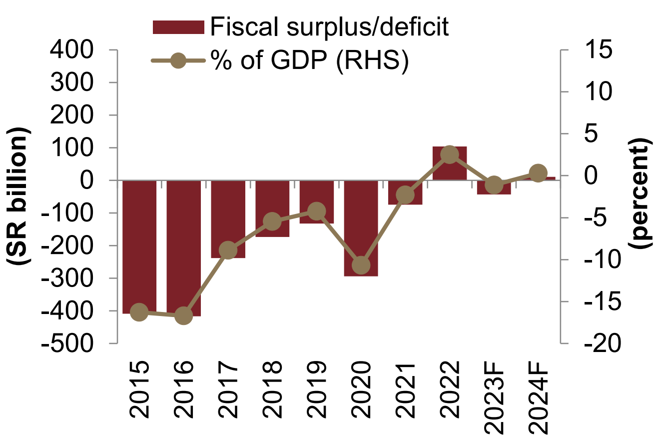


Figure 7: The fiscal position is set to slip into a small deficit this year, before recovering



While accepting that China's recovery has been disappointing, we note strong performances from other Asian economies, not least India's.

economy. Second, other big oil consumers are in fairly good shape economically. India's appetite for crude oil is very strong and growing, while industrial activity in Malaysia, Indonesia, the Philippines and Vietnam is also pretty healthy. There are already plenty of signs of tightness in Asian product markets, for example. Other big consumers such as Brazil, seem likely to cut interest rates this year, which should also boost demand, while Japan too is on an upswing. Third, any slowdown in the US seems likely to be short and shallow, with the prospect of a fairly rapid return to growth next year as the Federal Reserve switches to rate cuts.

Russia's exports have been surprisingly resilient, but there are nascent signs of a downturn as the government diverts more crude for domestic refining in order to support its war effort.

On the supply side, oil Bears point to the resilience of Russia's output and robust US production. True, Russia's output has held up much better than expected, but there are recent signs of a softening in the country's crude exports (Figure 6) reflecting a political imperative to divert more crude for domestic oil refining (e.g. diesel and gasoline for its war effort). In addition, Russia's exports seem set to ease further in August in line with its latest agreed OPEC Plus cuts. It is also true that US supply has been robust (8 percent up in the year to end-April) but this might not last too much longer given the ongoing downturn in operating wells in the shale sector. Finally, Saudi Arabia's pledged and actual production cuts have yet to fully work through the market. The Kingdom has pledged to cut around 1.5 mbpd, and we expect these to be rolled over for the rest of the year. All of this suggests to us that the market will continue to tighten in the second half of this year.

While fundamentals should continue to tighten, there is no escaping the price weakness in H1. Thus, we've reduced our Brent forecast to $84 pb for this year, though our 2024 forecast is unchanged at $87 pb.

That said, there is no escaping the softness of H1, when Brent averaged $81 pb (down from $98 pb in the previous 6 months). While we still expect prices to rise in H2, the annual average is unlikely to reach our earlier forecast of $90 pb for Brent, and we have therefore cut our expected average to $84 pb for the year. Still, prices should push higher into 2024 as interest rate cuts boost demand, and we think Brent will average $87 pb next year.

Government spending was very brisk in Q1. The pace is unlikely to be maintained for the rest of the year, though it is still likely to be a bit stronger than we assumed earlier.

Meanwhile, spending surged by 29 percent in Q1, year-on-year, which was unusual given that spikes tend to occur in Q4. The acceleration was broad-based, though capex and procurement contributed the biggest nominal increases (the two are closely related). This pace of spending seems unlikely to be maintained for the rest of the year, if only because the oil revenue outlook has soured somewhat since the first quarter. Thus, we see spending reaching SR1207 billion this year, a 3.7 percent gain. This is less than the 12 percent rate recorded in 2022 and below the five-year average of 5 percent. Note that while we expect central government spending growth to slow, non-oil GDP growth will continue to be bolstered by the PIF's investments.

Given the above, a modest fiscal deficit of SR43 billion is in prospect for 2023, worth some 1.1 percent of GDP (Figure 7). Financing, largely through debt issuance, should pose no difficulties.

The 2024 fiscal outlook is bolstered by the prospect of a "performance-related dividend" from Aramco.

The outlook for 2024 is supported by two things. First, oil prices and production should recover somewhat, allowing oil revenue to rise by around 5 percent next year. Second, there is the promise of a "performance-related" dividend from Aramco. This dividend relates to results in the previous year (i.e. 2023) but will be paid in 2024. Given that the central government's accounts are on a cash rather than accrual basis it will be part of the 2024 fiscal performance. Projecting this dividend is not straightforward (see our *Q1 Budget Performance* Report for more details) but the dividend should be worth around 2 percent of GDP. With non-oil income to continue growing briskly we project overall revenue growth (including the dividend) of 6 percent.

We think the government will be keen to return the fiscal balance to surplus, and therefore expect spending growth to cool to just under 2 percent. This should allow a small surplus worth around 0.3 percent of GDP.

Current Account:

The current-account outlook has been impacted by the revisions to our oil assumptions, but these are largely offset by what is likely to be a very strong performance from Tourism.

We had been assuming a sizeable current-account surplus this year, based on expectations of firm oil prices and at least stable oil production. However, our oil price forecast has been revised down (Box 1) while production will be substantially lower given a number of agreements that the Kingdom has made with its OPEC-Plus partners. That said, the Kingdom's earnings are diversifying and we think that exponential growth from tourism revenue will help to keep the current account in surplus this year.

Saudi Arabia recorded a decent current-account surplus of around $18 billion in Q1-23, though this was less than half of the Q1-22 amount. Oil and non-oil earnings were down, with oil earnings sliding by around 15 percent year-on-year as weaker prices more than offset higher output. Non-oil exports were hit hard by much weaker Chinese demand for chemicals and plastics; indeed, subsequent data for April and May show these continuing to slide.

Meanwhile, import spending continues to soar (it grew by 24 percent year-on-year in Q1), propelled by buoyant consumer and investment demand. This means that the overall trade surplus—while in no danger of moving into deficit—has narrowed quite sharply, easing to $36 billion in Q1-23, a 39 percent decline on the year earlier. Import demand is unlikely to soften materially during the remainder of the year, given the outlook for domestic activity, while export earnings should record a further decline in Q2, before stabilizing in H2 as reduced oil output is offset by an expected rise in prices. This should allow a trade surplus of $135 billion.

Enhanced Tourism earnings reflect not only higher visitor numbers, but also the impact of more Saudis choosing to spend their vacations in the Kingdom.

Until recently, the most important component of the invisibles account was workers' remittances outflows. These are volatile but have averaged around $10 billion a quarter over the past few years. Recently, however, tourism earnings have provided a very helpful offset. In fact, net tourism inflows were a record $6 billion in Q1 thanks mainly to a surge in religious visitors, combined with the fact that more and more Saudis are opting to spend their money at home rather than abroad. Tourism earnings should see additional substantial gains this year given a spike in Hajj visitors, and as increasing numbers of non-religious tourists visit the Kingdom.

We still expect a current-account surplus this year, albeit a bit smaller than previously. The surplus should be worth 5.5 percent of GDP.

Overall, the surge in tourism revenue should be enough to keep the current account in surplus. We anticipate a surplus of $57 billion, equivalent to 5.5 percent of GDP. Similar dynamics are likely to prevail in 2024, with an uplift in oil export revenue probably outstripped by further gains in import spending. Yet further robust tourism earnings should keep the current account in surplus at around 5.7 percent of GDP (Figure 8).

Interest rates, liquidity and credit:

Since the start of the year, data on monetary aggregates as well as bank loans and deposits have continued to show strong growth. In the year to May, the broad measure of money supply (M3) was up by 8.8 percent, driven by time and savings deposits, which rose by 37 percent (and now account for 28 percent of M3). However, this was mirrored by an ongoing decline in demand deposits (51 percent of M3), down by almost 3 percent in the year to May (Figure 9). As we previously discussed in the *Saudi Economy 2023* report, we think that businesses –and many households—are looking for better

Higher interest rates have prompted a pronounced shift away from Demand deposits into Time and Savings instruments. Overall deposit growth remains strong, at around 10 percent year-on-year, but is on a softening trend.

returns and shifting into time deposits to benefit from rising interest rates. We also believe that more spending opportunities in the local economy are pressurizing household demand deposits.

The same is true of private credit, which is also softening in year-on-year terms. The main drag has been mortgage demand, which has continued to shrink.

Meanwhile, total bank claims rose by 11.4 percent in the year to May. The main driver here was lending to the private sector (firms and households). Private credit growth remains strong, at around 10 percent, but has been on a softening trend for the past year or so. In the year to May, net new credit varied between sectors, with ‘Utilities’, ’Finance’ and ’Real estate’ seeing the highest rises. The latter is being helped by robust demand from various housing projects around the Kingdom (to meet higher rental demand), added to higher demand for commercial real estate (demonstrated by a recent pick up in commercial real estate prices). The main drag on private credit demand has been from mortgages, which were down by 35 percent in the year to May. Higher interest rates are stifling demand, especially for land mortgages. Weakness in mortgages has been the main reason for the cooling rate of overall private credit growth.

Private sector credit should accelerate a bit as interest rates come down next year. But further material growth will require raising the banking sector’s deposit base.

Looking ahead, this trend of cooling private credit growth is likely to stay in place for the remainder of the year given that we now expect SAMA to raise its key policy interest rates by a further 50 basis points before year-end. The 2024 outlook is brighter since we expect the next monetary easing cycle to commence probably around Q2. That said, there is an obvious brake on any credit acceleration given weakening deposit growth. Banks are near statutory limits on their loan-deposit ratios and will need to find new ways of raising deposit growth (or find new capital) to meet any significant increase in credit demand.

Inflation:

Saudi inflation remains contained, with food prices held in check by weaker international prices and domestic subsidies for basic items. The main impulse is coming from rents as mortgages become less affordable.

Saudi Arabia continued to witness stable and modest consumer price growth despite the trend of sharp rises in global inflation, with a gain of just 2.9 percent in H1. Declining international food prices have fed through into local prices, and mark a sharp contrast with last year when global food price indices were elevated (Figure 10). Domestically, the main price pressures are coming from housing, with sub-group ‘rentals for housing’ rising significantly amid high demand. In large part this reflects the high interest rates noted above, with many Saudis opting to rent rather than buy.

In H2, prices in ’food and beverages’ are expected to ease further in line with global trends. Against this, the rental market is likely to remain tight for the remainder of the year given the high interest rate

Figure 8: The current account will be supported by strong Tourism earnings

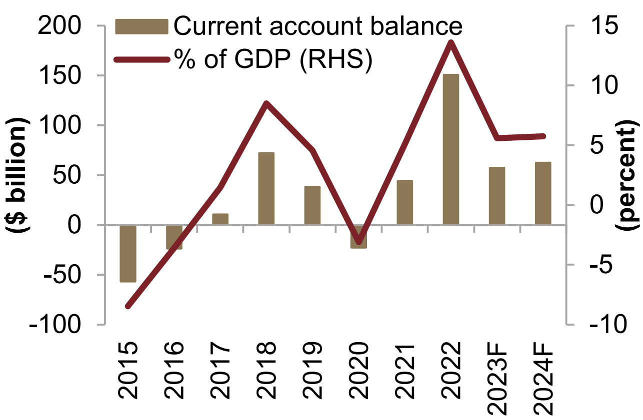
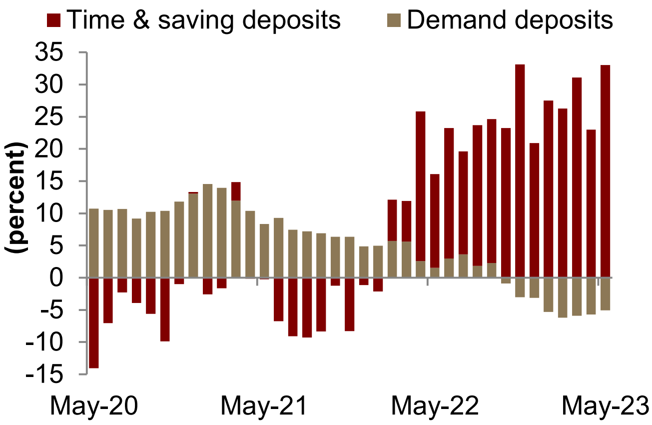


Figure 9: Annual growth in private deposits (year-on-year)



That said, rental demand is unlikely to soften appreciably even when interest rates begin to ease given strong demand from expatriates.

environment and the ongoing influx of expatriates. Thus, prices will continue rising within the 'housing and utilities' segment, which accounts for 25 percent of the CPI basket, driven by the 'rentals for housing' sub-group item.

If, as we expect, interest rates begin to ease in 2024 then this should see some softening in rental demand from Saudi nationals as they shift their attention back towards the mortgage market. Yet overall rental demand in the Kingdom is likely to remain firm given robust levels of non-oil growth anticipated in 2023 and 2024.

Overall, inflation should be well contained at around 2.6 percent for consumer prices.

In addition to 'housing and utilities', we expect sectors such as 'transport', 'hotels and restaurants', and tourism in general to see rises in demand, as tourism and entertainment events continue to be expanded around the Kingdom, with a larger number of visitors from outside the Kingdom expected this year. That said, we still expect lower inflation rates in H2 than in H1. As a result, we maintain our inflation forecast for full year 2023 at a maximum of 2.6 percent (Figure 11).

Risks to the forecast:

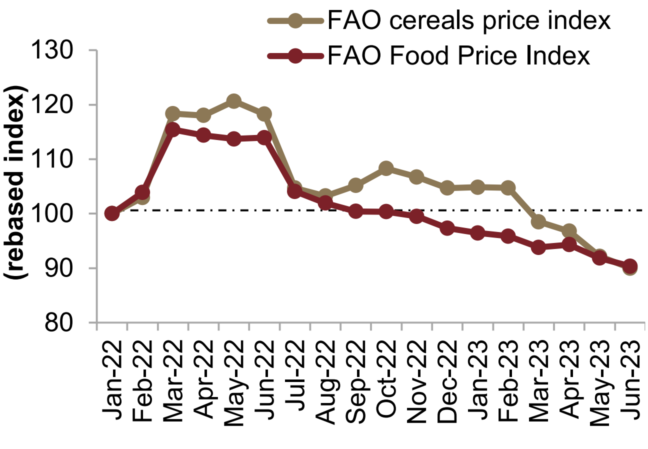
The main risk is oil-related and concern the possibility that supply (mainly from Russia and the US) could be much greater than we are currently anticipating.

The oil price outlook is a constant source of uncertainty. Our general view is that the physical market will tighten during the rest of 2023 and well into next year as US output begins to soften and as Russia struggles to find markets for its crude. However, we accept that there is often a long lag between the downturn in US shale investment and actual falls in oil output, while the resilience of Russia's production could continue to surprise. The downturn in US economic activity could also be sharper than we are anticipating. Thus, the risks to our oil price forecast are weighted to the downside. Softer prices could lead the government to rein in capital spending, which could in turn weaken the non-oil growth outlook.

Contracting and financing constraints also have the potential to inhibit growth prospects. However, the authorities are expanding their list of eligible contractors, while there is plenty of potential to issue more debt.

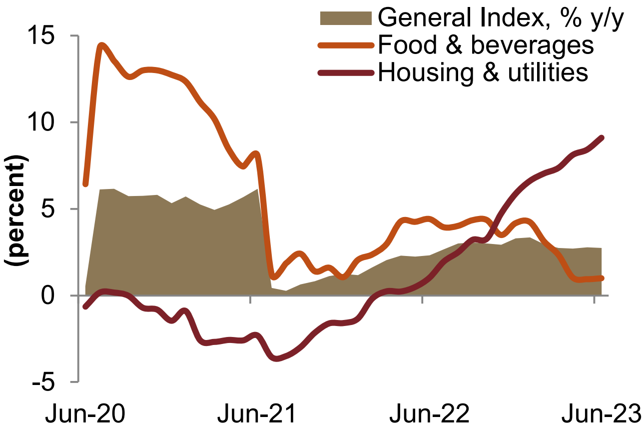
The other main risk is capacity constraints, both in terms of contractors and financing. Simply put, more contractors and materials' suppliers could well be needed if the Kingdom is to fulfill its Vision 2030 ambitions. To fix this, the authorities are working hard to invite more contractors to prequalify. Meanwhile, the banking sector is near the limits of what it can provide to the domestic economy, which could also begin to impinge on growth prospects. Nevertheless, there is scope for the authorities to raise more long-term debt, while the government could lever its very strong balance sheet by using guarantees more frequently.

Figure 10: Global food prices have declined recently (rebased, January 2022=100)



**The FAO (Food and Agriculture Organization by the United Nations) Food Price Index is a measure of the monthly change in international prices of a basket of food commodities.*

Figure 11: Food price and Rental inflation heading in different directions



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Key Data

	2017	2018	2019	2020	2021	2022	2023E	2024F
Nominal GDP								
(SR billion)	2,681	3,175	3,145	2,754	3,257	4,156	3,871	4,078
($ billion)	715	847	839	734	869	1,108	1,032	1,087
(% change)	7.4	18.4	-0.9	-12.4	18.3	27.6	-6.9	5.3
Real GDP (% change)								
Oil	-3.1	2.3	-3.3	-6.7	0.2	15.4	-7.5	2.8
Non-oil activities	3.0	-2.4	4.1	-3.7	7.2	5.4	5.9	5.6
Government activities	0.3	3.9	1.7	-0.6	1.1	2.6	4.6	2.1
Total	-0.1	2.8	0.8	-4.3	3.9	8.7	0.5	4.2
Oil indicators (average)								
Brent ($/b)	54	71	66	42	71	104	84	87
Production (million b/d)	10.0	10.3	9.8	9.2	9.1	10.6	9.7	10.0
Budgetary indicators (SR billion)								
Government revenue	692	906	926	782	965	1,268	1,164	1,237
Government expenditure	930	1,079	1,059	1,076	1,039	1,164	1,207	1,226
Budget balance	-238	-173	-133	-294	-74	104	-43	11
(% GDP)	-8.9	-5.5	-4.2	-10.7	-2.3	2.5	-1.1	0.3
Gross public debt	443	560	678	854	938	990	951	959
(% GDP)	16.5	17.6	21.6	31.0	28.8	23.8	24.6	23.5
Monetary indicators								
Inflation (% change, average)	-0.8	2.5	-2.1	3.4	3.1	2.5	2.6	2.2
SAMA base lending rate (%, year end)	2.0	3.0	2.25	1.00	1.00	5.0	6.25	5.25
External trade indicators ($ billion)								
Oil export revenues	170	232	200	119	202	327	264	277
Total export revenues	222	294	262	174	276	411	353	368
Imports	135	137	153	138	153	190	217	224
Trade balance	87	157	108	36	123	221	135	144
Current account balance	10	72	38	-23	44	151	57	62
(% GDP)	1.5	8.5	4.6	-3.1	5.1	13.6	5.5	5.7
Official reserve assets	496	497	500	454	455	460	465	479
Social and demographic indicators								
Population (million)	31.0	30.2	30.1	31.6	30.8	32.2	32.9	33.7
Saudi Unemployment (15+, %)	12.8	12.7	12.0	12.6	11.0	8.0	7.8	7.6
GDP per capita ($)	23,081	28,036	27,893	23,271	28,215	34,441	31,370	32,313

Sources: Jadwa Investment forecasts for 2023 and 2024. General Authority for Statistics for GDP, external trade and demographic indicators, Saudi Arabian Monetary Agency for monetary indicators, Ministry of Finance for budgetary indicators.