Jadwa Investment

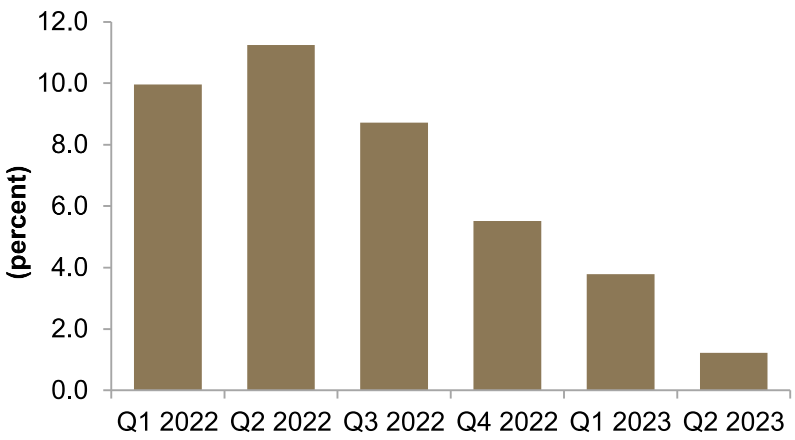
September 2023

Q2 2023 GDP Update

Non-oil GDP growth accelerates in Q2-23

- 'Non-oil Activities' real GDP growth accelerated to 6.1 percent, year-on-year, in Q2-23, pushing up the average for the past four quarters to 5.9 percent. Meanwhile, 'Government Activities', which is separate, eased back to 2.3 percent growth following a spike in Q1-23. Overall GDP growth was weighed down by cuts to oil production, and fell to 1.2 percent from 3.8 percent in Q1 (Figure 1).
- Non-oil output is being powered by both consumption and investment. 'Gigaproject' rollout continues to gather pace, while consumption has been boosted by a surge in religious pilgrim inflows, along with ongoing gains in female labor force participation.
- From a sectoral perspective, Transport has been growing robustly as mass transit is expanded and wholesale and retail logistics further developed. Yet Domestic Trade contributed the most to growth in Q2 and has considerable further growth potential.
- Non-oil Manufacturing, which is dominated by petrochemicals, also saw solid year-on-year growth. This was despite a precipitous decline in non-oil exports, which fell by almost a third in Q2, year-on-year, as China (the main market) rolls out its own chemicals capacity.
- More recently, there have been signs of some cooling in domestic activity, with the PMI edging down to 56.6 in August. This is still comfortably above the 50 breakeven level, but might indicate some shortages of construction workers in various segments of the projects market. Looking at the broader universe of non-oil firms, the PMI indicates that enhanced competition is putting pressure on margins.

Figure 1: Change in Real GDP, year-on-year (2010 prices)



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'Non-oil Activities' real GDP accelerated to 6.1 percent in Q2, year-on-year, from 5.4 percent in Q1.The average for the past four quarters reached 5.9 percent.

Official real GDP estimates indicate that non-oil economic activity picked up sharply in Q2-23. The data show 'Non-oil Activities' expanding by 6.1 percent, year-on-year, up from a revised 5.4 percent in Q1-23 (Table 1). Non-oil Activities equals the output left once a) oil production, b) oil refining, and c) government activities have been subtracted. Note however that 'Government Activities' in GASTAT's definition does not appear to include government capex, which therefore remains in the 'Non-oil Activities' line. Either way, 'Government Activities' in this release eased to 2.3 percent growth, which is more in line with historical averages, following a 4.9 percent spike in Q1-23. (Figure 2).

Overall real GDP was dragged lower by cuts to oil production. With oil GDP sagging by 4.3 percent, real GDP growth eased to 1.2 percent.

Almost all non-oil sectors showed an expansion. The exception was Non-oil Mining, which contracted by 1.1 percent. However, the sector had expanded by a quarterly average of five percent since mid-2020, so a "pause for breath" was inevitable.

Table 1: GDP by Main and Kind of Economic Activity, year-on-year percent change, Q2-23 vs Q2-22 (2010 prices)

	Q2 2022	Q2 2023
Overall GDP	**11.2**	**1.2**
By main economic activities		
Oil Activities	22.9	-4.3
Non-oil Activities	5.7	6.1
Government Activities	2.4	2.3
By kind of economic activity		
Agriculture, Forestry & Fishing	3.5	3.5
Mining & Quarrying	23.3	-3.9
a) Crude Petroleum & Natural Gas	23.5	-4.0
b) Other Mining & Quarrying	10.1	-1.1
Manufacturing	13.3	0.3
a) Petroleum Refining	16.6	-8.3
b) Manufacturing excluding petroleum refining	12.1	3.7
Electricity, Gas and Water	3.0	1.1
Construction	8.8	4.0
Wholesale & Retail Trade, Restaurants & Hotels	4.0	9.8
Transport, Storage & Communication	7.8	12.9
Finance, Insurance, Real Estate & Business Services	2.0	2.5
a) Real Estate	1.9	1.1
b) Finance, Insurance and Business Services	2.2	4.2
Community, Social & Personal Services	1.2	9.0
Producers of Government Services	2.4	2.3

Figure 2: Government activities returned to trend growth following a spike in Q1

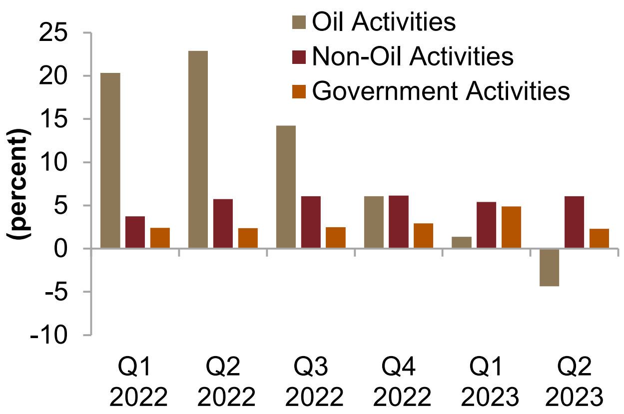
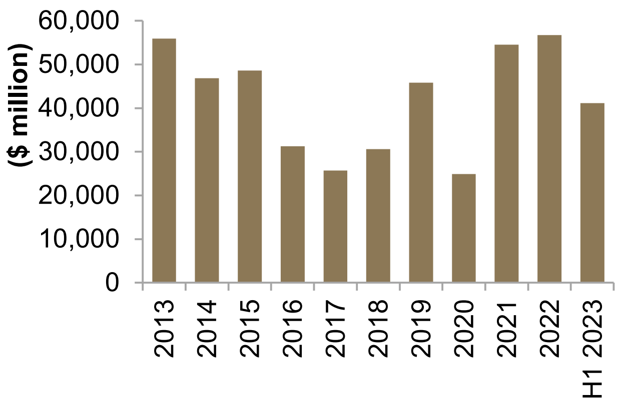


Figure 3: Value of Contracts Awarded by Year



The weak headline GDP growth figure should not detract from the vitality of the domestic economy.

Transport made a striking contribution to domestic growth, growing by 12.9 percent, year-on-year. The sector has been bolstered by the ongoing rollout of mass transit catering to ever larger numbers of tourists.

Much of the pick-up in non-oil growth came from consumption, which is underpinned by female labor force entry. While the participation rate has increased sharply in recent years, closing the gap to OECD rates could add a further 1.6 percentage points of GDP growth per year.

The sharp fall in oil production had a significant impact on overall economic output. Additional OPEC Plus-mandated cuts to crude output meant that real oil GDP declined by 4.3 percent, year-on-year. This was enough to push overall GDP growth down to just 1.2 percent in Q2, the weakest quarter since the Covid-19-impacted Q1-21.

Notwithstanding this weak headline GDP figure, the focus should be on the strength of the domestic economy. Consumption remains the engine of non-oil GDP, and this is being fuelled by female labor force participation growth, enhanced financial inclusion, and a burgeoning tourism sector. Hajj was particularly strong this year, with visits from 'external pilgrims' reaching 1.66 million, more than double the 781,000 last year. True, this is still a bit less than the pre-Covid-19 level, but foreign pilgrims have been staying longer in-Kingdom, boosting hospitality and retail. On the investment front, work on 'gigaprojects' has been stepped up, with contract awards in H1-23 already at 73 percent of the 2022 total, while the value of contracts in execution ($331 billion) was almost a third higher than a year ago according to MEED (Figures 3 and 4).

Looking at GDP by sector, 'Transport, Storage & Communication' saw the biggest year-on-year gain, expanding by a whopping 12.9 percent, and pushing average quarterly real growth up to 9.7 percent for the past 6 quarters (Figure 5). Transport has naturally been boosted by the expansion of public transit, which has been needed to ferry ever-larger numbers of tourists around the country, while the logistics to support the growth of wholesale and retail trade has also given the sector a fillip. The 'Communications' element has also been supported by ongoing broadband rollout. Nevertheless, the sector's recent breakneck growth should be kept in perspective: output from the sector is only about 4 percent bigger than it was in Q1-20 before Covid-19 mothballed much transport activity.

The biggest real gain (in terms of overall output) came from 'Wholesale & Retail Trade, Restaurants & Hotels', which grew by just under ten percent, delivering more than a third of the total change in Non-oil Activities' GDP (Figure 6). The tailwinds pushing this sector, both cyclical and structural, are formidable. Female employment has surged over the past five years, to some 37 percent of the workforce, but still has quite a way to run given that the international average is a little shy of 50 percent. If the gap with the OECD level of participation (55 percent) were closed then this could add an annual

Figure 4: Projects Market by Status

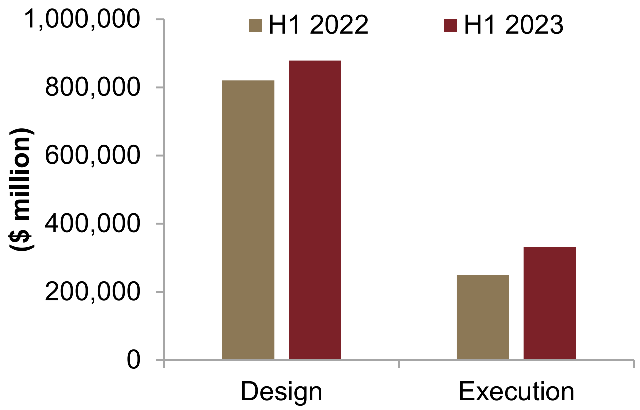
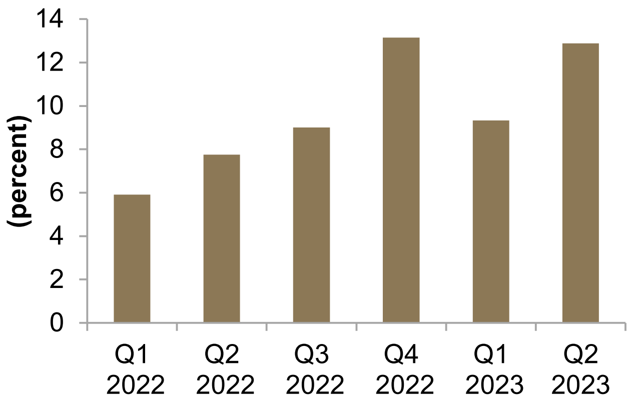


Figure 5: Real growth in the transport sector has been phenomenal, though part of this reflects payback for contraction during the Covid years



Greater household leverage would also support consumption. Credit is still under-developed in the Kingdom.

average 1.6 percentage points to GDP growth, according to the IMF. Meanwhile, leverage is still very small by international standards. Personal (unsecured) credit is less than 11 percent of GDP and even if one adds in mortgage debt the ratio is just 15 percent of GDP. This compares with, for example, 29 percent in Morocco, 73 percent in Malaysia, and 62 percent in China, while OECD countries typically have household debt (including mortgages) of at least 70 percent of GDP.

Clearly, debt is not necessarily a good thing, and the fact that personal debt for public sector employees in the Kingdom is salary-assigned is understandable from a prudential perspective. But the large credit gap-to-GDP indicates that there is very little chance of overheating, while the credit gap-to-international peers highlights the size of untapped spending power.

Bank credit is itself bumping up against constraints caused by inadequate deposit growth. For most countries, 10 percent year-on-year deposit growth would be more than adequate, but this is not the case in the Kingdom, such are the ambitions of the V2030 program.

The sector to capture and release this demand would be 'Finance, Insurance, Real Estate & Business Services'. The sector grew by 2.5 percent, year-on-year, in Q2, down from an average 4 percent since Q1-21. Finance has had to deal with the headwind of higher interest rates, which has sapped demand for mortgages in particular. Other demand, from private firms and those involved in the gigaprojects is strong, but with banks' lending to the private sector almost at 100 percent of (unweighted) deposits, there is a constraint on supply (Figure 7). The current 10 percent rate of deposit growth would be fine in most circumstances, but not in the context of the Vision 2030 ambitions. Other sources of funding—most likely debt—will need to be developed both by banks and state agencies. Indeed there were reports in mid-September that the authorities are planning to raise $11 billion in a syndicated loan in order to help finance investment.

In any event, 'Construction' had a solid Q2, growing by 4 percent, year-on-year, though this does represent something of a slowdown from the near 6 percent growth witnessed in the previous four quarters. The sector has naturally benefitted from the gigaproject push, along with plenty of routine investments—in roads, bridges, power plants, water treatment facilities—which need to be rolled out to meet the needs of a rising population. That said, there are some signs of tightness in the contracting market (see below).

One sector that held up surprisingly well is 'Manufacturing' (excl. Refining). This segment is dominated by chemicals and rubber products, which together account for some 45 percent of non-oil exports. The main market for these products is China, which has

Figure 6: Change in Real Domestic Trade GDP, year-on-year (2010 prices)

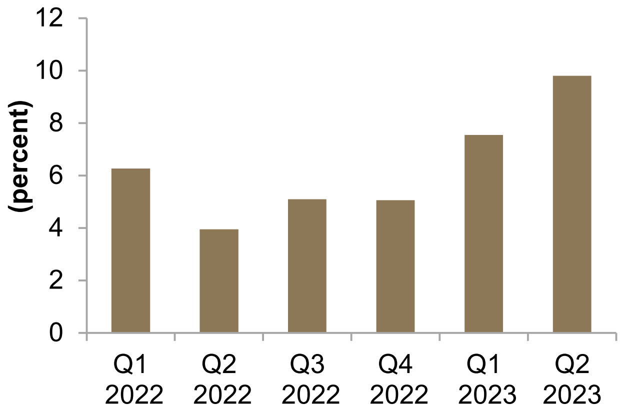
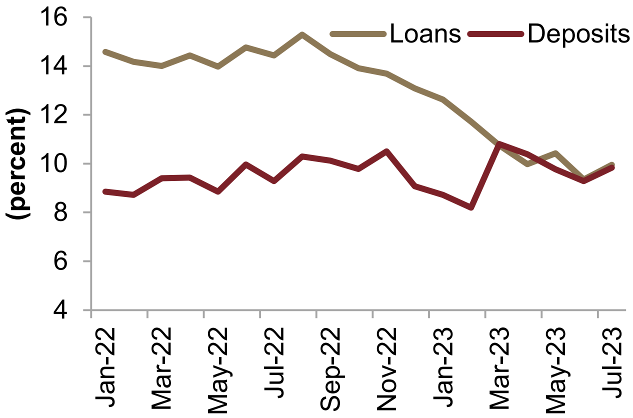


Figure 7: Saudi Arabia: Private Sector Credit vs Deposits (percent change, y-o-y)



Manufacturing showed surprising resilience given the sharp downturn in non-oil exports (32 percent year-on-year). This reflects an increasingly challenging Chinese market for the Kingdom's petrochemicals producers.

been rapidly building out its own refining and chemicals capacity (in fact, there are signs of overcapacity) leaving Saudi suppliers increasingly out in the cold. Total Saudi exports of chemicals and plastics declined by an alarming 37 percent in the 12 months to the second quarter, according to GASTAT, pulling overall non-oil exports down by 32 percent (Figure 8). It is not easy to square this with the Manufacturing sector's 3.7 percent year-on-year gain. It is possible that the domestic market is providing some offset: the manufacturing element of the Index of Industrial Production was up almost 9 percent in the 12 months to July.

More recent indicators point to some cooling of activity in July and August.

Since recording the impressive 6.1 percent growth rate there have been some signs of activity easing a bit in the non-oil economy. In July, the non-oil PMI declined to 57.7 from an average of 59.2 in Q2, and in August it eased further to 56.6 (note that the PMI is seasonally-adjusted). This was still well above the 50 breakeven level, but it was also the slowest rate of improvement in almost a year. Many respondents in the accompanying survey said they were experiencing weaker sales growth than earlier in the year, with "increased competition" the main reason. Enhanced competition is a good thing for the economy as a whole, but not so good for individual firms who are having to absorb costs in order to maintain market share, with significant pressure on margins. The PMI data show input costs outstripping output prices so far this year (Figure 9).

Non-oil firms' margins are under pressure as competition hots up.

The PMI also showed that non-oil firms increased employment in August, extending a period of growth that began in April 2022. Moreover, the pace of hiring picked up from the previous month, with wholesale and retail firms attributing this to stronger new business and the hiring of marketing staff. This contrasts with construction companies, which reported the weakest rise in employment. The latter is likely a result of shortages of construction workers rather than any meaningful softening of demand. The authorities are understood to be keen to expand the number of construction firms participating in the Vision 2030 gigaprojects in order to loosen up some of the bottlenecks. However, there are no quick fixes to labor shortages, and wages will likely need to rise.

There are also some indications of labor supply constraints in the project market.

Figure 8: Saudi Non-oil Exports

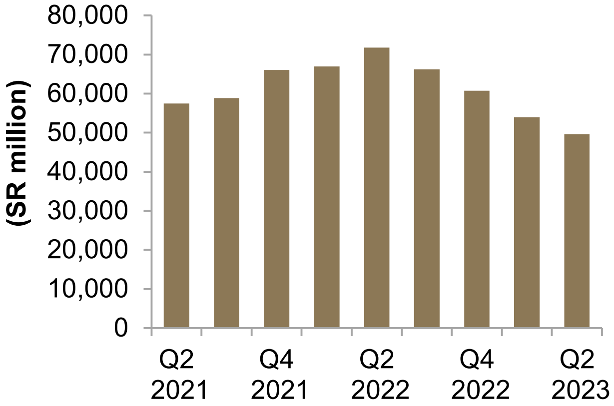
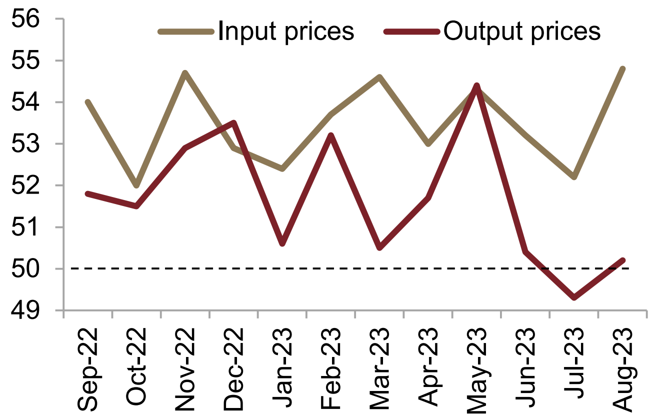


Figure 9: Saudi Arabia: PMI Input Prices vs Output Prices (>50 denotes m-o-m expansion)



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