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مجلس الأعمال السعودي الأمريكي

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USSBC Economic Brief
Preliminary 2021 Budget & GDP Review

Overview

The Ministry of Finance recently released both its official second quarter 2020 GDP report and preliminary budget statement for the 2021 fiscal year. Saudi Arabia's Q2 GDP totaled SAR564 billion ($151 billion) as lockdowns and travel restrictions hampered both manufacturing and service activity. The government expects full-year 2020 GDP to fall 3.8 percent before rebounding 3.2 percent in 2021, consistent with World Bank estimates. While the budgets for 2021 and 2022 have remained in line with prior expectations, including a continued commitment to prominent Vision 2030 reform programs, the 2020 fiscal deficit is expected to reach SAR298 billion ($79.5 billion) compared to a budgeted SAR187 billion ($49.9 billion) due to lower revenues and increased spending. The global pandemic led to widespread economic restrictions and a sharp fall in oil demand that bottomed during the second quarter. Saudi Arabia lifted most business lockdowns in late June and has been gradually easing international travel restrictions.

Brent crude is expected to average $42 per barrel during the fourth quarter according to the Energy Information Administration (EIA) and the recent VAT hike could prolong a full recovery in consumer spending in the near-term but boost non-oil revenues in the long-term. Compared to last year's budget statement, 2021-22 government revenue and spending forecasts remain unchanged though the makeup is expected to be different amid lower oil revenues, increased VAT revenues, and the potential for additional economic stimulus through SAMA or the National Development Fund. Signs of economic recovery are evident as consumer spending remains above pre-COVID levels following the VAT increase and non-oil private sector activity has returned to growth in September. Consumer demand could still be challenged in the short-term as the pandemic caused a spike in digital point-of-sale transactions, but digital sales have trended lower after the economy reopened and VAT was raised. Vision 2030 programs including housing and privatization programs, along with a slate of Public Investment Fund-led initiatives are expected to play a leading role in the economic rebound.

Q2 GDP & Economic Activities

Saudi Arabia's economy contracted 7 percent YoY during the second quarter as virus containment measures were in full effect and global oil prices slumped. Arab Light crude averaged just $28 per barrel

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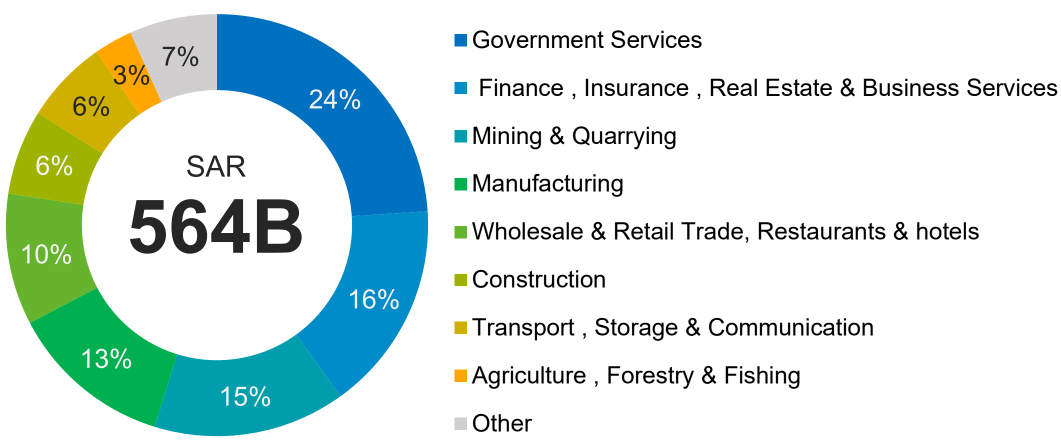
during Q2 as domestic and international travel collapsed and industrial activity slowed down substantially. Our previous economic brief in July covered the effect of lower oil revenues on Q2 spending and revenues. The government drew down its reserve assets by a further 5 percent during April and expanded debt issuances in domestic and international markets. The non-oil sector contracted 8.2 percent while the oil sector contracted a lesser 5.3 percent. The government instituted an array of stimulus and financing support programs (outlined in our COVID-19 Policy Response brief) to support the private sector. As lockdowns were in full effect, private sector GDP, which totaled SAR302 billion ($81 billion), fell more than 10 percent. Government services accounted for 24 percent of GDP in Q2, following by Finance, Insurance, Real Estate & Business Services (16 percent), Mining & Quarrying (15 percent), and Manufacturing (13 percent). Crude petroleum and natural gas activities accounted for 96 percent of Mining & Quarrying GDP.

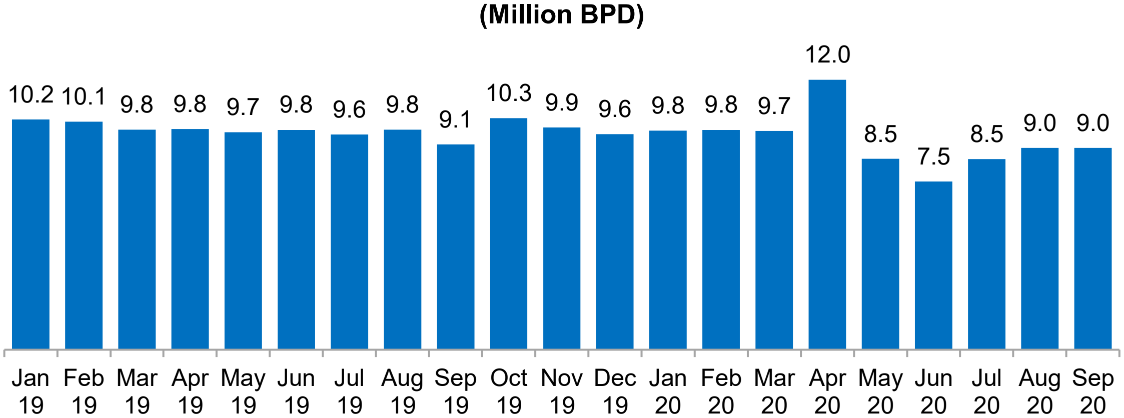
Saudi Arabia Q2 GDP Contribution by Sector



Source: GAStat

Oil exports were down 62 percent in the second quarter, confirming the impact on Q2 revenues covered in our May brief. Saudi Arabia and Russia led OPEC+ to remove an estimated 10 percent of the world's oil supply from the market to support prices through the end of 2020. As a result, Saudi Arabia pumped 8.5 million bpd beginning in May and unilaterally lowered production a further 1 million bpd in June. By

Saudi Arabia Average Crude Production
(Million BPD)

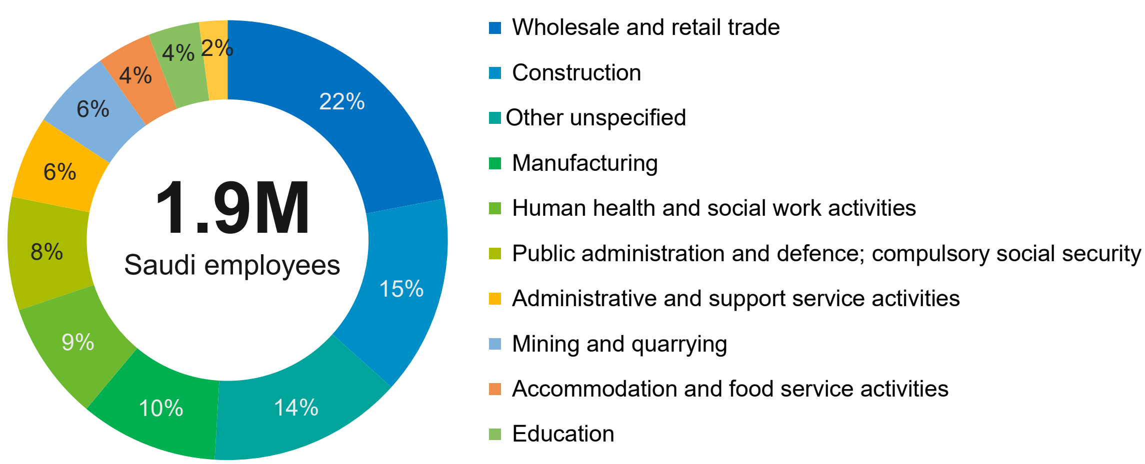


Source: OPEC

comparison, Saudi oil production averaged 9.8 million bpd during 2019. The labor market was also adversely affected by COVID-19 lockdowns in Q2. The unemployment rate jumped to 15.4 percent, up from 11.8 percent at the end of Q1 as the economic impact of COVID-19 lockdowns led businesses to cut workforce levels. Saudi unemployment had declined or remained flat in each quarter since Q1 2018. The labor force participation rate for Saudis rose from 46 percent to 49 percent in Q2, driven by a large increase in Saudi female labor force participation which reached 31 percent in Q2 from 26 percent in Q1.

The sectoral trends in Saudi Arabia's labor market largely mirrored those seen internationally; employees in the service sector were most likely to receive social insurance support, followed by construction and manufacturing employees. Most sectors saw a decline in both Saudi and expatriate workers in Q2. Shortly after the VAT increase to 15 percent in July, the government announced it would extend the SANED unemployment insurance program which included 60 percent wage subsidies for Saudi private sector workers and the lifting or postponement of VAT and other fees for private businesses.

Saudi Private Sector Employment by Economic Activity



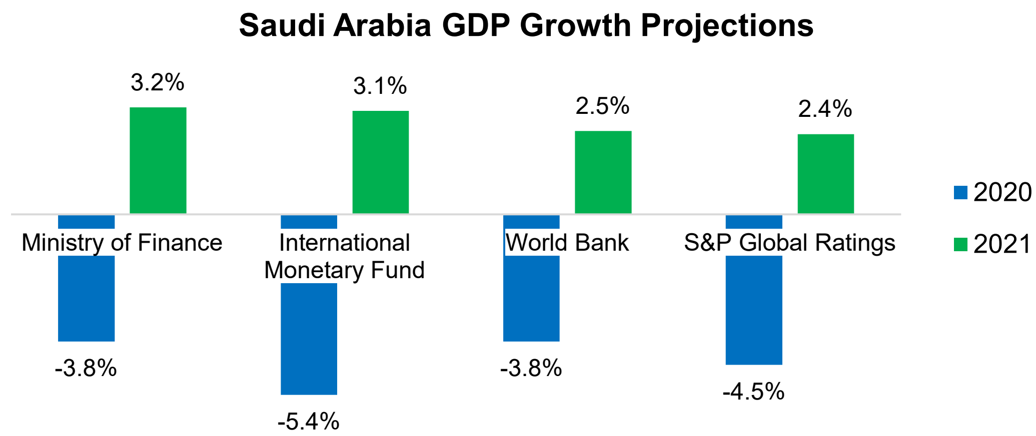
Source: GAStat, GOSI

GDP & Budget Outlook

With most lockdowns being lifted in late June and international travel restrictions gradually being lifted through end of the year, the Saudi economy is now in a recovery phase. The Ministry of Finance has kept its fiscal outlook for 2021 and 2022 largely in line with previous figures with the primary adjustment in the recent preliminary budget statement being made to the government's 2020 finances. Revenues are expected to decrease 8 percent in 2020 from forecasted levels while spending will outpace budgeted levels by 5 percent. As a result, the 2020 fiscal deficit is expected to reach SAR298 billion ($79.5 billion), or 12 percent of GDP. The government expects the deficit in 2021 and 2022 to remain at budgeted levels, totaling 5.1 percent and 3 percent of GDP, respectively.

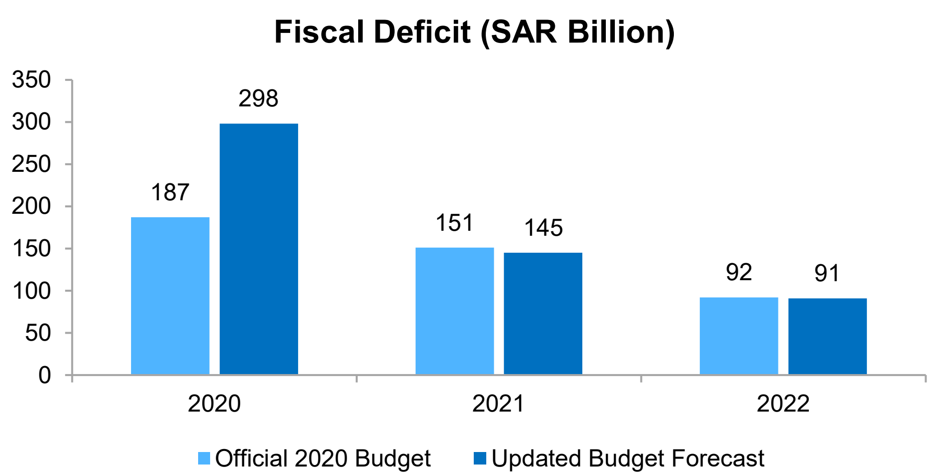
In H2 2020 and 2021, the Saudi economy is expected to return to growth, though uncertainty regarding the global containment of the ongoing pandemic continues. The differences in the pace of recovery is highlighted by the range of estimates from leading international institutions. Compared to the Ministry of Finance's estimate of a 3.8 percent contraction in 2020, the IMF (October WEO) expects a deeper 5.4

percent GDP contraction followed by a 3.1 percent rebound in 2021. The World Bank's estimate for 2020 matches the Ministry of Finance's expectation for 2020 but forecasts a slower 2.5 percent GDP recovery in 2021.



Source: Ministry of Finance, IMF, World Bank, S&P Global Ratings

The Ministry of Finance has highlighted the need for "sufficient flexibility" in public finances to deal with the materialization of risks that include a viral resurgence. On the spending side, the Saudi government tapped 10 percent of its foreign reserves during March and April to finance the National Development Fund and the Public Investment Fund to address immediate economic needs, but is expected to hold reserve assets totaling SAR1.7 trillion ($453 billion) going into 2021. Leading global credit rating agencies, mostly recently S&P Global Ratings, have affirmed the Saudi government's strong fiscal and net asset position to pursue additional debt financing as needed.



Source: Ministry of Finance

The preliminary budget statement indicates government spending is expected to decline 7 percent in 2021 to reach SAR990 billion ($264 billion), the same amount budgeted pre-COVID. Spending will be steadily reduced through 2023 while revenues are not expected to return to 2019 levels until 2023. This fiscal trajectory would allow Saudi Arabia to bring its budget deficit under 1 percent by 2023. Both the 2021 and 2022 deficit-to-GDP forecasts are nearly identical to Saudi Arabia's initial 2020 budget forecasts. Public debt is expected to grow in line with previous MoF forecasts from SAR854 billion in 2020 (34.4 percent

GDP) to SAR1,029 billion (31.8 percent of GDP) by 2023. The Kingdom raised its debt ceiling to 50 percent of GDP in March but is not expected to reach that level in the coming years.

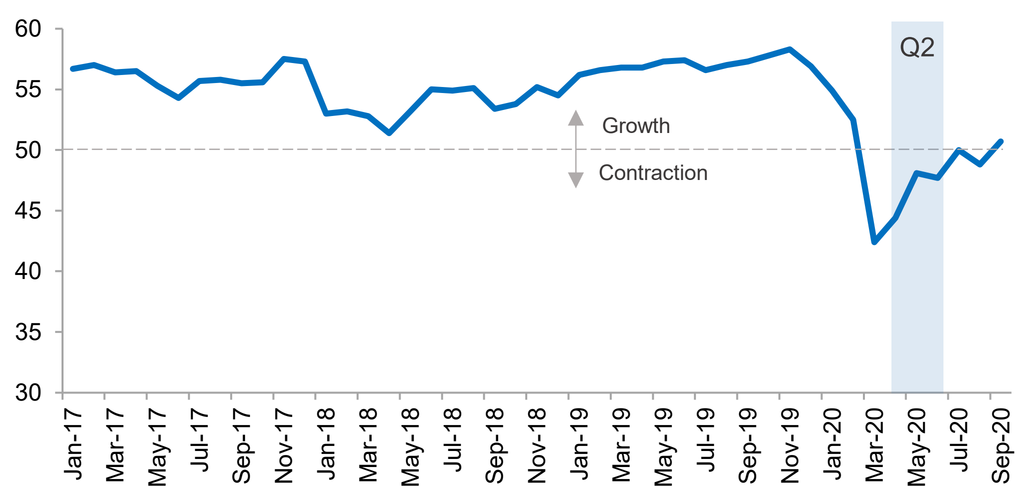
Fiscal Projections (SAR Billion)

	Actual	Estimate	Projections		
	2019	2020	2021	2022	2023
Total Revenues	927	770	846	864	928
Total Expenditures	1,059	1,068	990	955	941
Budget Deficit	(133)	(298)	(145)	(91)	(13)
as percent of GDP	4.5%	12.0%	5.1%	3.0%	0.4%
Debt	678	854	841	1,016	1,029
as percent of GDP	22.8%	34.4%	32.9%	33.4%	31.8%

Source: Ministry of Finance

Non-oil revenues will be supported by the VAT increase in the medium-term, though the immediate effect has led to a spike in inflation. Consumer prices rose 6.2 percent YoY in August with food & beverages (+13.5 percent), household equipment & furnishings (+8.4 percent), and transportation (+8.2 percent) prices leading other sectors. Point-of-sale transaction data suggests consumer spending surged ahead of the VAT hike but cooled off afterward. We expect this effect to continue through H2 2020 as the effect of the VAT increase makes its way through the economy. The recovery of the non-oil private sector is evident as IHS Markit's PMI business survey indicated a return to growth in September for the first time since February. September's PMI reading rose to 50.7 points from 48.8 points in August. Firms noted that the impact of the VAT increase had softened as cost inflation eased to a marginal pace. However, the labor market remains subdued and will be a key driver of Saudi Arabia's economic rebound moving forward.

Saudi Arabia Purchasing Managers' Index



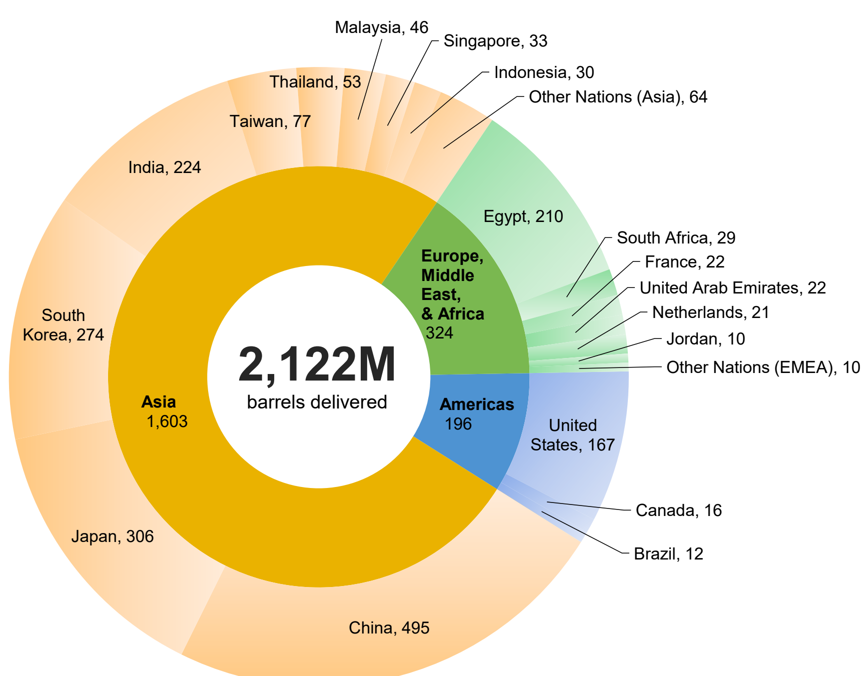
Source: IHS Markit

The oil market's recovery is largely dependent on both oil demand recovery stemming from a reduction in COVID-19 cases and the policy responses by respective governments to address containment of the virus. A global resurgence in COVID-19 cases will prolong policies such as business lockdowns and travel restrictions that would keep oil prices low and put additional pressure on OPEC+ to support the market with continued production caps. A second round of lockdowns may also permanently shutter higher cost producers across the shale industry in the U.S. The number of operating oil and gas rigs in the U.S. has reached 269 rigs compared to 848 operating at this point last year.

A lesser than expected second wave of infections, successful vaccine distribution, and more flexible policy responses instead would lead to a quicker rebound in oil demand. However, prices are likely to remain low due to the elevated oil stockpiles coupled with higher cost producers increasing production as global demand rises. The EIA forecasts monthly Brent spot prices will average $42 per barrel during Q4 2020 and will average only $47 per barrel in 2021. Under the OPEC+ agreement, Saudi Arabia's production is limited to 8.99 million bpd until the end of 2020, and then rises to 9.495 million bpd in January 2021. Saudi Arabia has signaled it may seek to delay the output increase until the end of Q1.

Oil demand from East Asia, the top export destination of Saudi crude, has recovered at a faster rate than other regions and appears to have also had a lower penetration of COVID-19 which would support a quicker rebound in revenues. However, both OPEC and the International Energy Agency (IEA) expect 2021 oil demand to reach 97 million bpd which would fall short of 2019 demand levels by 3 percent. While the oil market's recovery is crucial for Saudi Arabia's fiscal strength, the diversification of the economy beyond hydrocarbons remains a top priority of the government.

Saudi Crude Oil Deliveries YTD* (Million Barrels)



Source: Refinitiv
*Through October 2020

In Focus: The Public Investment Fund

The Public Investment Fund (PIF) is now the 10th largest sovereign wealth fund in the world with SAR1.5 trillion ($390 billion) in assets under management, according to the SWF Institute. The value of PIF's assets has more than doubled since the launch of Vision 2030. PIF's broad domestic and international investment portfolio is aimed at growing emerging sectors (entertainment, tourism, AI, renewable energy, fintech), facilitating foreign investment, localizing the military and manufacturing sectors, guiding Saudi Arabia's megaproject pipeline, and supporting an array of other reform programs. In a post-COVID world, the PIF will be a leading force that will drive economic diversification through the transformation and growth of the Kingdom's non-oil industries.

The Saudi Real Estate Finance Company (SRC), a wholly owned subsidiary of the PIF has injected liquidity into the housing market through the introduction of asset backed mortgage securities, which provides a streamlined channel that will offer investment opportunities in the secondary market. SRC recently agreed to purchase over SAR3 billion ($800 million) in mortgages from the Public Pension Agency and established a new real estate subsidiary, 'Roshn', to facilitate public-private partnerships in meeting the local demand for housing. As the construction sector recovers from a slowdown in activity as explained in our Q2 Construction Contracts Awards Report, the government has indicated it will move forward with large-scale tourism and entertainment megaprojects. Through its subsidiaries, PIF has contributed to the creation of more than 88,000 jobs in the construction sector. The PIF is the sole stakeholder in NEOM, the Red Sea Development Company, Qiddiya Investment Company, and Amaala. These projects are expected to create hundreds of thousands of jobs across construction, manufacturing, tourism, and other adjacent sectors in the coming years.

In addition, development programs across tourism, energy, manufacturing, and entertainment will provide more opportunities for private sector participation. PIF announced recently a SAR3.8 billion ($1 billion) boost to JADA "Fund of Funds" for SME access to capital through venture capital and private equity firms. PIF subsidiaries Elm and Tabadul (digital services, logistics), TAQNIA (technology development and investment), SALIC (agriculture, agribusiness), NUPCO (procurement, medicines), and numerous others will continue to drive non-oil sector growth and support private sector growth in the years ahead.

Vision 2030 Initiatives

The preliminary budget statement for 2021 indicates the Kingdom is doubling down on a commitment to achieving the goals outlined in Vision 2030. Capital spending cutbacks in 2020 necessitated some Vision 2030 programs be delayed amid business inactivity and international flight suspensions, while others have seen an acceleration of progress. The government's preliminary budget statement highlighted that the Housing Program reached 67 percent of the 2020's approved budget by mid-year as new residential mortgages surged in Q1, dipping briefly during COVID-19 lockdowns in April and May, and then surged again at the end of Q2 and through Q3. The government recently announced it would forgo the 15 percent VAT for property sales, keeping it at 5 percent as the Kingdom pushes for increased home ownership rates.

Saudi Arabia has also moved ahead with its Vision 2030 privatization program, selling off its flour milling sector during the pandemic. The initiative, led by the government-owned Saudi Grains Organization (SAGO) and the National Center for Privatization, marks one of the first sales of Saudi Arabia's state-owned assets. The first two of four total companies were sold for SAR2.8 billion ($740 million). In light of the current economic situation, the Ministry of Finance has stated that Saudi Arabia will consider the sale of assets not previously considered for privatization, including the education and healthcare sectors.

As international travel is expected to resume in 2021, Saudi Arabia plans to resume issuances of tourism visas after opening its doors to foreign tourists for the first time in September 2019. Saudi Arabia forecasts that tourism will contribute 10 percent to GDP by 2030 by liberalizing tourism regulations, improving Hajj and Umrah facilities, developing more robust infrastructure around existing UNESCO and other cultural sites, and constructing large-scale tourism megaprojects through Public Investment Fund-led companies. Other programs highlighted in the Ministry of Finance's preliminary budget include Quality of Life (sports, healthcare, culture) and the Financial Sector Development Program (capital markets, SME private sector growth, mortgage markets).