Saudi Arabia: Fiscal Consolidation Resumes

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- Lower government spending has decreased medium-term fiscal vulnerabilities to lower oil prices.
- As the PIF is taking a leading role in public investments, capital expenditures in the budget have declined significantly.
- Following an estimated decrease of 3% in 2019, further reduction in spending is envisaged for 2020-2022.
- The authorities' ability to balance the budget by 2023 is now more likely with public debt remaining below 30% of GDP.
- However, if oil prices drop to $50/bbl, the deficits would remain large and the debt-to-GDP ratio could exceed 40% by 2023.
- Despite fiscal headwinds, non-oil growth is expected to remain solid at 2.7%, supported by monetary easing.

We are encouraged by the improvement made in expenditure management, including major reduction in fuel subsidies and streamlining inefficient capital expenditures. Gasoline prices are now being adjusted quarterly in line with international benchmark prices. The recent reforms to strengthen government procurement have helped to improve the efficiency of public spending.

NARROWER FISCAL DEFICIT THAN EXPECTED

Preliminary estimates by the authorities put actual spending in 2019 at SAR 1048 billion, well below the budgeted SAR 1106 billion (Exhibit 1). While defense spending exceeded slightly the budgeted amount due to the ongoing Yemen war, this was more than offset by lower capital expenditures. The PIF (the SWF) is now taking a leading role in public investments The increase in revenues in 2019 despite lower oil prices mainly reflects the special oil dividends transfer from Aramco. As a result, we have revised our estimate of the fiscal deficit for 2019 from 6.2% to 4.7% of GDP.

We have also lowered our forecast for the fiscal deficit for 2020 from 7.5% of GDP to 6.6% in 2020. This still represents a widening compared with 2019 due to lower oil revenues. The 2020 budget announced on December 9, sets expenditures at SAR 1020, which is 2.7% lower than the preliminary estimates for 2019. Given the recent OPEC + agreement, and as the Jizan refinery became fully operational, we expect oil production to increase slightly in 2020, following a decrease of 3% in 2019. Based on oil revenues included in the 2020 budget and our assumption of crude oil production, we estimated the oil price assumption in the 2020 budget at $60/bbl.

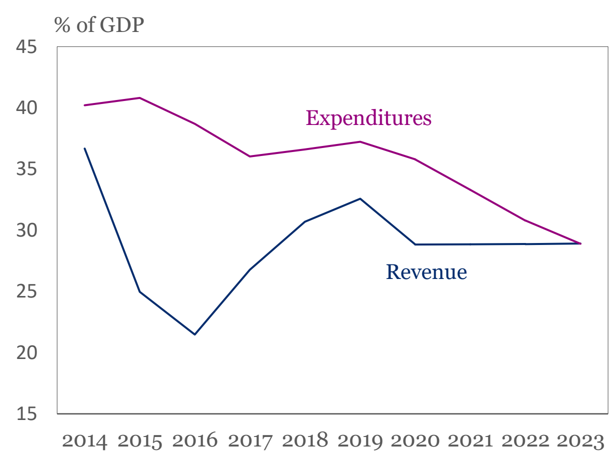
The focus of spending remains on security, education, health, and social services. The wage bill will be restrained as the authorities are containing public sector employment, and capital spending will continue to decline. With the glimmer of hope that the war in Yemen could come to an end in 2020, military expenditures (a fifth of the budget) have received a lower allocation. Infrastructure spending also has a decreased allocation.

Exhibit 1: Medium Term Fiscal Framework
SAR billion, unless otherwise indicated

	2018	2019	2020	2021	2022	2023
Revenues	905	917	822	858	896	936
o/w: Oil revenues	611	602	502	515	531	547
Expenditures	1079	1048	1020	990	955	936
% change	16.1	-2.9	-2.7	-2.9	-3.5	-2.0
Budget balance	-174	-131	-198	-132	-59	0
% of GDP	-5.9	-4.7	-7.0	-4.5	-1.9	0.0
Brent crude, $/bbl	71.7	64.0	60.0	61.2	62.4	63.7
Oil production, mbd	10.33	9.85	9.93	10.03	10.13	10.23

Source: MOF and IIF

Exhibit 2: Fiscal adjustment underway could balance the budget by 2023.



Source: MOF and IIF

BALANCING BUDGET BY 2023 IS FEASIBLE

Our view now is that the fiscal trajectory is much more secure than a few months ago given the efforts underway to restrain spending, and assuming that oil prices remain slightly above $60/bbl (Exhibit 2). However, significantly lower oil prices than assumed in our baseline scenario would lead to large deficits, causing the government debt-to-GDP to exceed 40% by 2023 (Exhibit 6, page 3).

In that case, the authorities would need to cut further some of their planned spending for 2020-2023, including reducing the size of the civil service by not replacing retiring employees. The wage bill accounts for 47% of total spending, one of the highest among emerging economies.

DECLINE IN FISCAL BREAKEVEN OIL PRICES

We estimate an Brent oil price of $77/bbl to balance the budget for 2020, as compared with $80/bbl in 2019. The fiscal breakeven oil price for next year is based on the following assumptions: (i) a 2% increase in non-oil revenues; (ii) a decrease in government spending of 2.7%; and (iii) no change in volume of oil exports. We expect the fiscal breakeven oil price to continue its decline through 2023 (Exhibit 3), supported by adjustment in current spending and non-oil revenues. Non-oil revenues could increase significantly if the VAT rate is raised gradually from 5% in 2019 to 9% by 2023. We expect the government to continue tapping foreign debt sources at very competitive rates to finance the fiscal deficits.

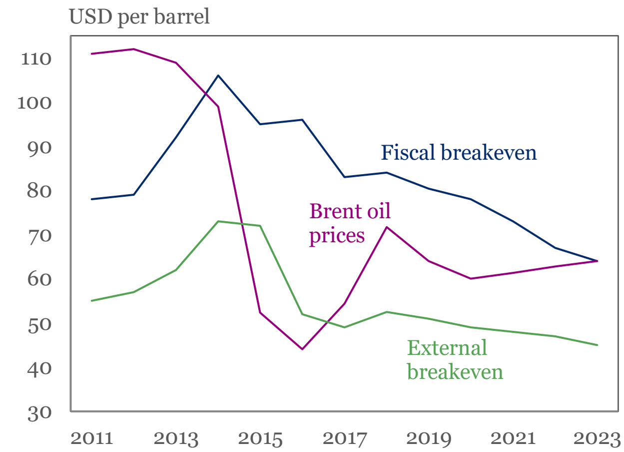
DEBT WILL REMAIN BELOW 30% OF GDP BY 2023

Authorities are committed to keeping the public debt-to-GDP ratio below 30% over the medium-term, but this could be challenging, particularly if oil prices decline well below $60/bbl. Public debt has risen from 6% of GDP in 2015 to 23% of GDP in 2019. If government expenditure continues to decline modestly through 2023, as highlighted in the kingdom's medium-term fiscal framework, and if oil prices remain slightly above $60/bbl, then the debt to GDP would stay below 30% by 2023. To keep public debt below 30% of GDP, additional expenditure cuts and nonoil revenue measures would be required if oil prices fall significantly below $60/bbl in the next few years. An early resolution of the conflict in Yemen could remove some pressure on the budget and bring achievement of fiscal targets closer in reach. While there is limited information regarding the debt profile, debt service is not burdensome since government debt is rising from a very low base. We estimate the debt service at about SAR 25 billion, equivalent to 1% of GDP in 2020.

SOLID NON-OIL GROWTH

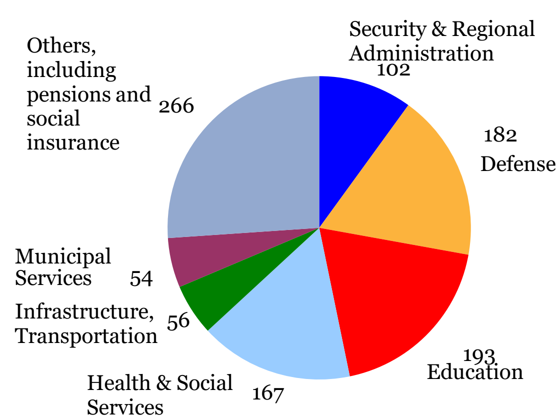
Despite a tighter budget in 2020, we expect non-oil real GDP growth to remain solid at 2.7% in 2020 driven by further recovery in private sector activity, which will be supported by interest rate cuts (Exhibit 5). The PMI rose to 58.6 in November (the highest in four years), and point of sale transactions, a proxy for retail sales, continue to expand. Credit growth picked up to 3.5% yoy in October 2019, with a recovery in lending for construction and manufacturing. We expect overall real GDP to shift from a contraction of 0.3% in 2019 to a growth of 1.9% in 2020, as crude oil production is projected to increase slightly. The contraction in 2019 is mainly due to the decline in crude oil production of 4.5% in the context of OPEC+ agreement and the September attack on Aramco's oil facilities.

Exhibit 3: We expect fiscal breakeven oil prices to decline from $80/bbl in 2019 to $63/bbl by 2023.



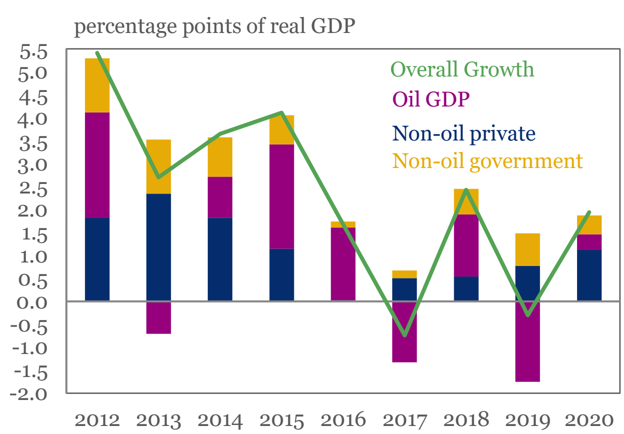
Source: MOF and IIF

Exhibit 4: Composition of the 2020 budget, *in billion SAR*



Source: MOF and IIF

Exhibit 5: Growth will by driven by the non-oil private sector.



Source: IIF

Exhibit 6: Illustrative two scenarios of main macroeconomic indicators.

	2016	2017	2018	2019	2020	2021	2022	2023	2024
	Baseline Scenario: Oil prices at $60/bbl in 2020 and remain constant in real terms afterwards								
Oil Exports, $ billion	136.6	170.7	229.5	195.5	184.5	190.1	195.8	201.7	207.8
CA balance, % of GDP	-3.7	1.5	9.0	5.5	3.3	3.0	2.7	2.3	2.0
CA balance, $ billion	-23.8	10.5	70.6	41.4	25.3	24.0	22.3	20.3	18.2
Fiscal deficit, % of GDP	-17.2	-9.2	-5.9	-4.6	-6.5	-4.1	-1.5	0.0	1.6
Fiscal deficit, $ bn	-111.1	-63.6	-46.5	-34.9	-52.7	-32.7	-12.4	0.0	14.1
Government debt, % of GDP	13.6	17.2	18.9	23.5	26.1	29.3	29.7	28.3	25.7
Brent Oil Prices, $/bbl	44.0	52.2	71.7	64.0	60.0	61.2	62.4	63.7	64.9
GDP, $ billion	644.9	688.6	786.5	753.9	762.7	795.6	830.1	866.7	906.7
	Low oil price scenario: Oil prices drop to $50/bbl in 2020 and onstant in real terms afterwards								
Oil Exports, $ billion	136.6	170.7	229.5	195.5	153.7	158.4	163.2	168.1	173.2
CA balance, % of GDP	-3.7	1.5	9.0	5.5	-1.3	-1.7	-2.0	-2.3	-2.6
CA balance, $ billion	-23.8	10.5	70.6	41.4	-9.7	-12.5	-15.8	-19.2	-22.9
Fiscal deficit, % of GDP	-17.2	-9.2	-5.9	-4.6	-10.0	-7.5	-4.8	-3.2	-1.6
Fiscal deficit, $ bn	-111.1	-63.6	-46.5	-34.9	-75.6	-56.6	-37.9	-26.4	-13.9
Government debt, % of GDP	13.6	17.2	18.9	23.5	30.5	36.9	40.3	41.6	41.5
Brent Oil Prices, $/bbl	44.0	52.2	71.7	64.0	50.0	51.0	52.0	53.1	54.1
GDP, $ billion	644.9	688.6	786.5	753.9	726.3	758.1	791.4	826.8	865.6

Source: IIF