Domestic Demand Remains Strong

- Domestic demand in the Kingdom remains very strong, driven by a booming projects market and firm consumption growth. Following a comparatively soft patch in Q3, the non-oil economy is picking up pace again, thanks in part to an acceleration in central government spending. We expect non-oil GDP growth to reach 5.1 percent this year and 5.2 percent in 2024 (Figure 1).

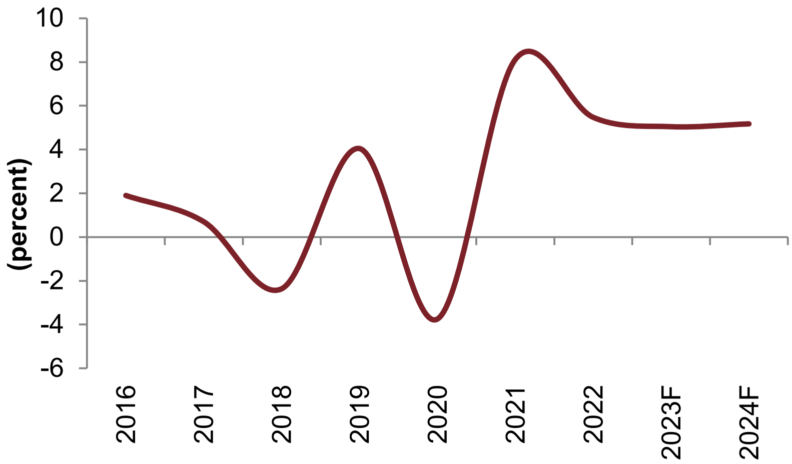
- Government spending should remain brisk in 2024 as interim Vision 2030 targets begin to loom. We see a small pick-up in oil prices next year, but in any case the government has indicated that it is comfortable running moderate fiscal deficits in the next few years (see our *2024 Budget Report*). The PIF and NDF are also likely to provide additional capital to help ensure that V-2030 project targets remain on track.

- Shortages of labor (both skilled and unskilled), higher raw materials' costs, and tight liquidity are constraining some project activity. Labor bottlenecks should be gradually overcome as wages adjust upwards, and lower interest rates in 2024 should see liquidity conditions improve somewhat. That said, the sheer number of projects in execution means increased competition for scarce inputs, and probable cost overruns.

- OPEC Plus has deepened its production cuts. Output is now scheduled to be reduced by an aggregate 2.2 million barrels a day (mbpd) from January 2024, based on June 2023 quotas. However, this includes Saudi Arabia's current 1 mbpd cut, which has been extended to Q1-24. Indeed, we think this cut will be extended again to H2-24, meaning that oil GDP is likely to contract further in 2024.

- The fiscal position has been buoyed by the addition of "performance-related" dividends from Aramco. These should help limit the fiscal deficit to around 2 percent of GDP this year, and see it narrow to less than 1 percent of GDP in 2024.

Figure 1: Solid growth expected for non-oil GDP



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Global backdrop:

The global economic outlook has improved as the US Fed signals that its tightening cycle is at an end.

The global economic outlook has improved. In the US the chances of a so-called soft landing have risen, with consumer price inflation now down to just over 3 percent even as unemployment remains near historic lows. The Federal Reserve has indicated that it has finished its interest rate hiking cycle, and that rate cuts are likely in 2024. The main area of global weakness is China, with concerns around deflation, rising youth unemployment and a stricken property sector at the forefront of analysts' minds.

We expect 100 bps of rate cuts in 2024.

We think the Fed will begin cutting rates from the middle of next year, with 100 basis points in H2 and a further 100 bps in H1-25. This will leave the Fed Funds Target Rate at 3.5 percent for the upper bound. SAMA is set to follow in lockstep, meaning that the Reverse Repo will also be cut to 3.5 percent by mid-2025. This will be passed on to Saudi interbank rates, though they will also be influenced by local credit demand, which is likely to remain very firm.

Oil prices remain under pressure with fears that OPEC Plus will not be able to reduce output significantly.

Meanwhile, oil prices have sagged in the face of weak European demand, worries about potential Chinese demand and robust non-OPEC supply. A glut of light crude (such as Brent) in all of the major demand centers is also weighing on prices. Traders are concerned that the recent OPEC Plus announcement of further cuts (to be instituted in January) will not amount to very much given that they are "voluntary" and based off June quotas, which many countries were already struggling to reach.

We think these fears are overdone and prices in 2024 should also be supported by weakening US output growth and a general boost to commodities as rates are cut.

In fact, we think OPEC Plus will follow through enough to allow a significant tightening of balances in Q1-24. We also think US shale output growth is set to slow quite sharply next year and with additional Chinese stimulus set to be deployed, we think oil prices will catch up with the broader rally in commodities prices. Product demand—such as for gasoline—also appears healthy and should receive a further boost from US monetary easing. This in turn will keep demand for heavy crudes, such as Saudi Arabia's, in vogue.

All told, we think Brent will rally to reach an average of $89 per barrel (pb) next year, up from an estimated $84 pb in 2023. Saudi Arabia's main export crude should continue to trade at a premium over Brent of $2-$3 pb. Looking out to 2025, we expect prices to remain firm given a more supportive demand backdrop. Interest rates should still be on a downward track in 2025, lending support to global economic activity. US output should also continue to slow, creating a drag on non-OPEC output growth. These broad trends should help lift Brent to an average $90 pb. Yet the overall energy transition will remain intact, pointing to longer-run oil price weakness.

Oil activities:

Saudi crude and refinery output is down sharply this year.

Saudi crude production averaged 9.7 million barrels per day (mbpd) in the year to November, around 8 percent lower than the same period last year, with Q3 alone declining by 18 percent year-on-year. Meanwhile, latest available data from Joint Organizations Data Initiative (JODI), show that refinery output eased by almost 8 percent year-on-year in the year to October. This fall is greater than we had expected, and probably relates to economic weakness in Europe, which is the Kingdom's main market for oil products. This has led us to revise down our estimate of the change in 'Oil Activities' GDP to negative 8.3 percent this year versus negative 7.5 percent previously (Figure 2).

A further fall in crude output is likely in 2024 as the Kingdom's cuts are extended.

Looking into 2024, production is expected to fall again. We think the Kingdom's production cuts will be rolled over to include the whole of H1-24, meaning that production is likely to average 9.4 mbpd, which would be 2 percent down on 2023 (Q1-23 output was relatively high). There is no reason to think that demand for Saudi products will pick up meaningfully next year, given European economic weakness and capacity constraints in China. This means that Oil Activities GDP is set for a further decline, though at negative 1.8 percent it will be milder than this year's contraction. Moreover, crude production should edge up in H2-24 to reach 10.3 mbpd by end-year, with a full-year gain in 2025 approaching 10 percent as global economic activity rebounds.

Non-oil activities:

Non-oil GDP growth dipped in Q3, but it should accelerate again in Q4 as government spending picks up. We expect real non-oil GDP growth of 5.1 percent this year.

Despite lower oil prices and higher interest rates, the Saudi non-oil economy performed well in the year to Q3, with GASTAT data showing 'Non-oil Activities' output rising by an average 4.7 percent, year-on-year. This came despite significantly softer activity in Q3, when the year-on-year rate eased to 3.5 percent. This is also captured in our non-oil private sector composite index (Figure 3).

Moreover, the GASTAT data showed a sharp downward revision for Non-oil Activities GDP in Q2, which is now pegged at 5.3 percent growth versus 6.1 percent earlier. While we expect growth to pick up again in Q4—in line with traditionally strong government spending—the revision to Q2 (and historical data) and the relatively weak reading for Q3 have led us to cut our overall non-oil GDP growth estimate for this year to 5.1 percent, from 5.9 percent previously.

Investment growth should accelerate in 2024 given the push to deliver interim Vision targets.

Looking into 2024, domestic activity will be boosted by an acceleration of Vision 2030 project-rollout as 2025 interim Vision Realization Programs (VRPs) deadlines begin to loom. An added tailwind comes from Expo 2030, which Saudi Arabia is hosting. Naturally the Construction sector will be a major beneficiary of the giga-project push. Against this, housing construction will remain a drag, with developers unwilling to proceed in an environment of weak demand. This should begin to change as interest rates fall in H2-24.

Surging wages and other input costs mean that project cost overruns are almost inevitable.

The downside of such a vigorous giga-project market is rising cost pressures. These are most visible in surging wages and the rising costs of rebar and copper. Supply should respond to wage and price signals but project cost overruns seem inevitable.

Figure 2: Oil GDP is expected to see a slight decline in 2024 (year-on-year)

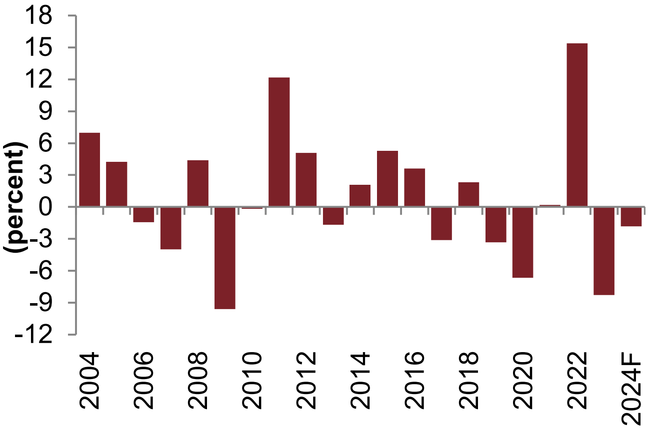
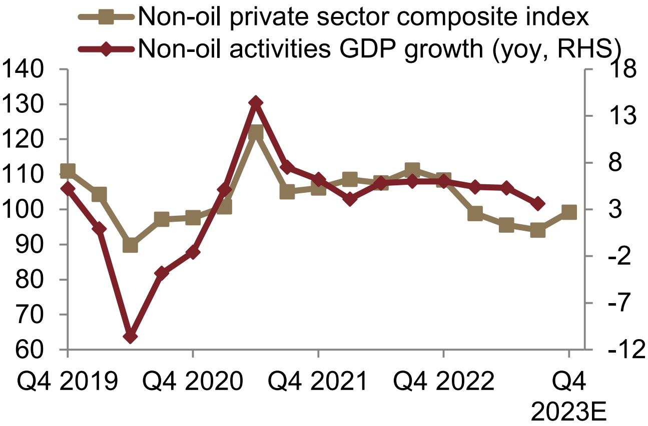


Figure 3: Non-oil growth should accelerate in Q4-23 thanks to higher government spending



The expected decline in interest rates in H2-24 should give a fillip to housing demand.

While giga-project construction will capture most of the attention, non-oil activity will be buttressed by a further expansion of Wholesale and Retail Trade, which has seen impressive growth over the past few years. This sector grew by a real 6.9 percent in the nine months to September, year-on-year. We expect consumer spending to see higher growth rates in H2 2024, based on our expectations of lower interest rates (and ongoing female labor force entry). Lower rates will encourage a shift back towards house purchases (away from rentals) and associated spending on goods such as 'furniture', 'electronics' and 'building materials'. On the supply side, ever more hotels, restaurants and entertainment options are expected to be rolled out, catering to both Saudis and another large influx of religious pilgrims from abroad (Figure 4).

Elsewhere, Non-oil Manufacturing should stage something of a recovery in 2024. The sector has been hit by weakness in China's demand for petrochemicals (Figure 5). More positively, Kingdom-focused non-oil manufacturing capacity is likely to be augmented next year.

The central government's fiscal stance has loosened and there should be a pick-up in domestic investment from the PIF and NDF. This indicates that non-oil GDP growth of at least 5.2 percent is in prospect next year.

The central government's fiscal stance will also remain supportive. The 2024 budget indicates that the government is now prepared to tolerate moderate fiscal deficits, while PIF- and NDF-balance sheet deployment is likely to be increasingly Saudi-focused. Thus, we see non-oil GDP growth reaching 5.2 percent in 2024, with a further acceleration in 2025 as the push to meet VRPs intensifies.

<u>Fiscal:</u>

The central government's fiscal position is manageable and is likely to remain so in 2024 with an expanding tax take and modest gains in oil income supporting overall revenue. The outlook has also been significantly improved by Aramco's commitment to pay "performance-related" dividends, worth an estimated SR150 billion next year.

Government oil revenue has received a significant boost from Aramco's commitment to pay "performance-related dividends". These are worth SR75 billion to the government this year, and are scheduled to double in 2024.

Oil revenue was down 24 percent year-on-year in the nine months to end-September, dragged lower by weakening prices and production cuts. Prices have been volatile in Q4, but are unlikely to exceed Q3 on average. And with production essentially unchanged, oil revenue is likely to remain flat in quarter-on-quarter terms. But with the inclusion of the special dividends (worth SR75 billion this year), oil revenue should come in at around SR731 billion. For 2024, the outlook balances slightly lower average output with higher prices, but the inclusion of a full year of special dividends should boost the oil take to SR792.

Figure 4: Spending on hotels is robust
(POS transactions)

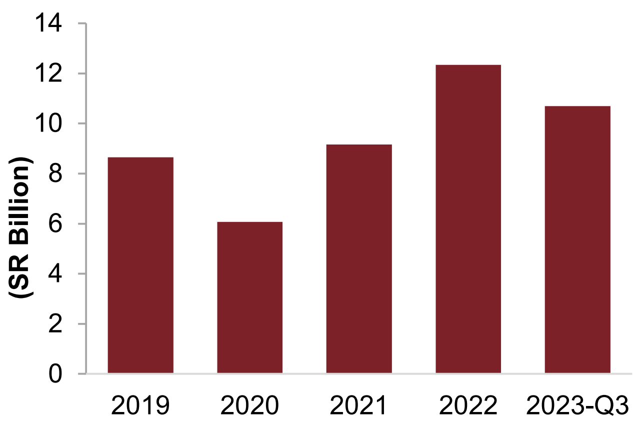
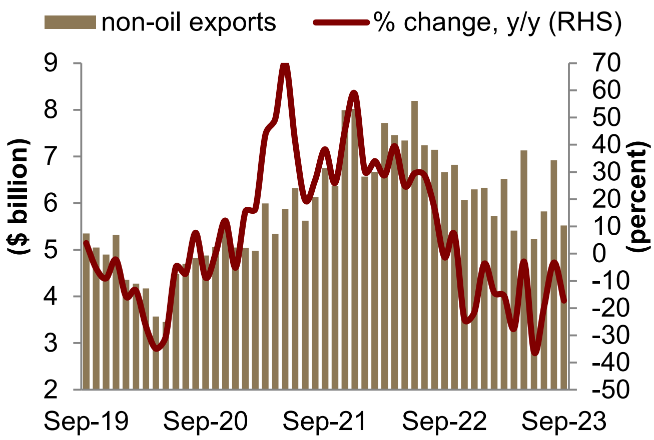


Figure 5: Non-oil exports have struggled



Non-oil revenue should continue to climb in line with a growing take from VAT and other taxes.

Non-oil revenue rose 22 percent year-on-year in the year to Q3 2023. All segments within non-oil revenue showed increases, but the driver was an 18 percent gain from VAT revenue. The upward trend should continue in 2024 assuming further growth in tourism inflows and retail offerings. Additional gains from taxes on foreign firms are also in prospect as the Regional Head Quarters program takes effect.

Government spending was up by 12 percent in the first nine months of 2023, year-on-year.

Government expenditure was up 12 percent year-on-year in the year to Q3 2023, supported by a 21 percent rise in capex as the central government pushed on with a number of infrastructure projects. This push was the main reason why 'use of goods and services' (i.e. procurement) surged by 25 percent. The main element of current spending remains 'compensation of employees' (44 percent of total expenditure), which was up 5 percent, likely driven by the need to find skilled labor in a tight market.

The Kingdom's year-to-Q3 2023 fiscal deficit stood at SR43.9 billion. The MoF recently outlined that the fiscal deficit is expected to hit SR82 billion (2 percent of GDP) in full-year 2023. This is plausible as it implies a spike in Q4 spending, which would be in line with historical trends.

Spending is likely to remain firm given project cost inflation (among other things). But the deficit should narrow thanks to a full-year of Aramco's special dividend payments.

The government's budget indicates that spending will fall slightly in 2024. We doubt this cut will happen, and expect instead a 4 percent gain in spending, with considerable upside risk given looming project targets and rising costs. Nevertheless, a full year of Aramco's performance dividends will boost the overall position, allowing a deficit of just 0.6 percent of GDP.

Current Account:

Our current-account outlook is essentially unaltered. We expect a surplus of some 2.9 percent of GDP in 2023, supported by the usual trade surplus and a strong showing from tourism inflows.

Surging tourism receipts have helped to offset a downturn in non-oil exports.

Import demand has not been quite as vigorous as we were anticipating earlier and we have nudged down our full-year spending forecast (though it will still mean double-digit percentage growth). Export earnings are set to be somewhat lower than we were expecting given oil price softness and a weak showing from petrochemicals exports to China. Some offset is provided by softer-than-expected workers' remittances outflows, possibly reflecting the allure of high savings deposit rates in-Kingdom. The most eye-catching recent development is tourism inflows, which gained 120 percent in the second quarter, year-on-year, and are expected to more than double for the year as a whole.

Next year is likely to see the smallest trade surplus since 2020. However, invisibles earnings should be enough to keep the current account in surplus.

We see another year of strong import growth in 2024 (both capital and consumer goods). With oil earnings little more than steady, the trade surplus is expected to ease to around $62 billion, from $91 billion in 2023 and $221 billion in 2022. This would be the smallest such surplus since 2020.

Tourism inflow growth might be impacted at the margin by heightened regional political tensions, though the core religious pilgrim cohort is likely to remain unfazed. Somewhat weaker savings rates might see remittances outflows pick up again in H2. All this means that a current account surplus of around 1.4 percent of GDP is in prospect.

Interest rates, liquidity and credit:

Deposit growth has eased below 10 percent, year-on-year, and banks have slowed the rate of private sector lending accordingly.

Broad money and lending growth have moved in tandem in recent months. Percentage growth rates are strong by historical and peer-country standards, but they are now below double digits (year-on-year) and credit supply is currently struggling to keep up with project demand.

The broad measure of money supply (M3) was up by almost 9 percent, year-on-year in October. This reflects a striking 39 percent gain in time & saving deposits—lured by historically high savings rates. However, the flipside was a 1.4 percent fall in demand deposits. As such, the share of demand deposits in M3 declined from 60 percent in 2022 to 49 percent in October. As well as higher savings rates, burgeoning spending opportunities are pressurizing demand deposits.

Credit to the housing sector has softened appreciably in line with higher mortgage rates. This should begin to reverse next year.

Turning to assets, bank lending to the private sector eased to 9.3 percent growth, year-on-year, in October—the lowest rate since 2020. Banks are keen to ensure that credit growth does not outstrip deposit growth, though higher interest rates have also weighed on demand. Likewise, growth in credit to the public sector is on a downward track (20 percent year-on-year in October from 67 percent a year earlier). That said, credit to the public sector is still only 5 percent of total bank credit (Figure 6).

Net new private credit growth continues to vary sharply between sectors. 'Real estate' has seen weaker growth rates as higher interest rates have sapped demand for mortgages and softened construction demand. Credit for 'construction' as a whole has been firm given the ramping up of giga-project activity (though project credit demand is beginning to outstrip supply). Credit for 'wholesale and retail' activity has continued to grow robustly given significant structural tailwinds.

Looking ahead, this trend of cooling private credit growth is likely to stay in place for H1 2024, given that we expect no cut to SAMA's policy rate until H2. From then on we expect a revival in mortgage activity and a pick-up in purchases of home-related products and services. Overall, next year's changing interest rate environment should see some shift from time & savings back to demand deposits.

Figure 6: Bank Credit to Public and Private Sectors (year-on-year change)

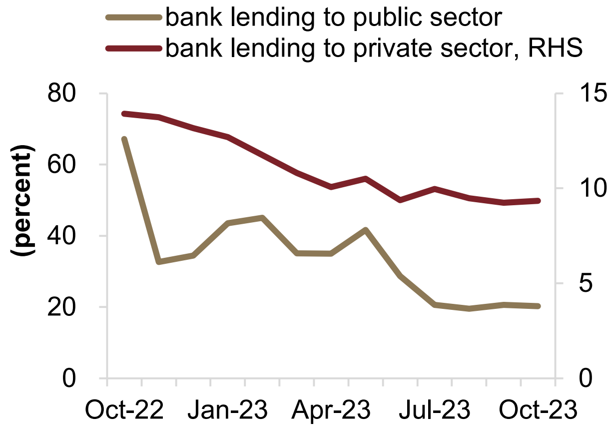
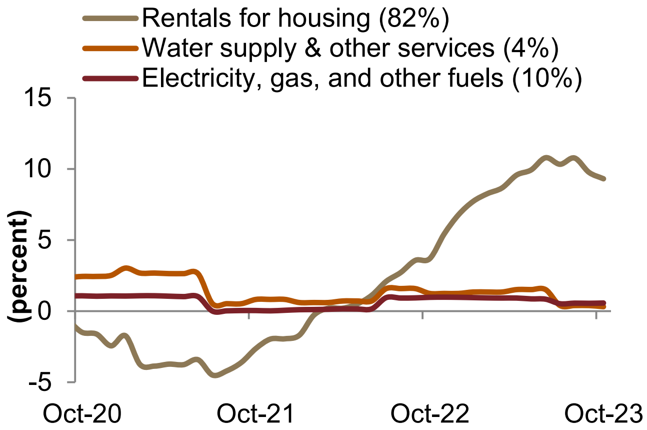


Figure 7: Rentals for housing have likely peaked in recent months (year-on-year change)



Inflation:

Consumer price growth has been weakening. This trend is likely to stay in place next year as food prices continue to soften.

Consumer price growth has been softening since June, with year-on-year inflation easing to just 1.7 percent in November. The main area of weakness was 'food and beverages', which dipped into negative territory for the first time in September before edging back up in October. Transport, too, has seen recent price weakness. Upward price pressure has come from 'housing and utilities', with sub-group 'rentals for housing' still showing significant rises amid high demand. This was despite recent data showing prices have likely peaked (Figure 7). Brisk rental demand is a by-product of high mortgage rates, with many Saudis opting to rent rather than buy, for the moment at least.

In 2024, 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 in H1 2024, given the high interest rate environment and the ongoing influx of expatriates. Rental growth should begin to ease in H2 as interest rates come down and house purchases pick up again. Yet overall rental demand in the Kingdom is likely to remain firm given the robust levels of non-oil growth anticipated in the coming years.

Domestic demand should remain firm however, and categories associated with home ownership should see growth in H2-24.

Stronger demand for home ownership in H2 2024 should create positive spillovers for related sectors such as 'furniture', 'electronics' and 'building material', all of which have been held in check by weak housing demand (Figure 8). At the same time, we expect sectors such as 'transport' and 'hotels and restaurants' to see gathering demand as the tourist offering expands and deepens.

Taken together, the above trends have led us to reduce our inflation estimate for 2023 from 2.6 to 2.3 percent. For 2024 we now see average price growth of just 2 percent, from 2.2 percent previously (Figure 9).

Risks to the forecast:

Near-term risks center on oil prices, which could come under renewed pressure if the US economy was to tip into recession.

The near-term risk to the economic outlook centers on any sharp and sustained fall in oil prices. The US economy has had to endure an almost unprecedented degree of financial tightening over the past year or so, and this could yet tip it into recession. With the Eurozone also struggling, a US recession could have serious implications for oil prices even as OPEC Plus cuts further.

Figure 8: POS in October
(year-on-year change)

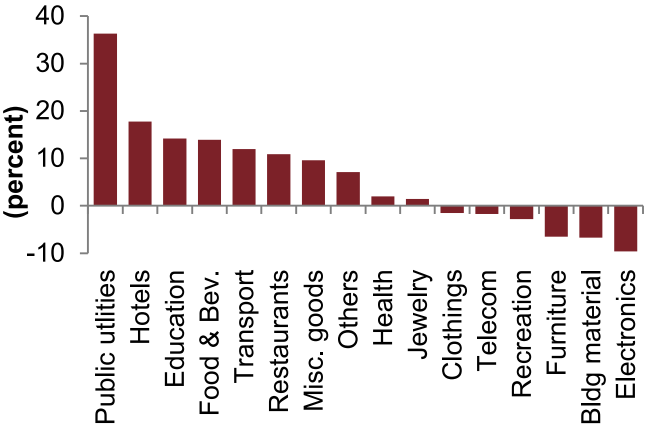
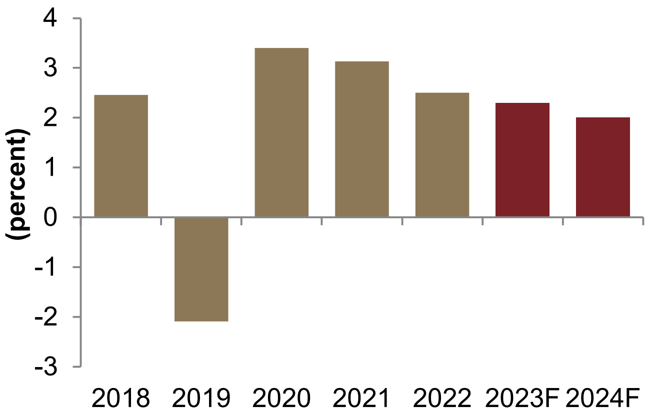


Figure 9: Inflation Outlook
(year-on-year change)



That said, we think the Saudi economy is well-placed to deal with any period of soft prices given the debt “headroom” enjoyed by the central government, along with the strength of the PIF and NDF’s balance sheets. We also note from the 2024 budget the MoF’s willingness to run moderate fiscal deficits. This is a signal that capital spending will not be shut off in the event of an oil price correction.

The medium-term risk is financing. The banking sector is near the limits of what it can provide to the private sector (bar the issuance of additional bonds) while foreign portfolio and direct investment inflows remain subdued. Again, however, the risk is mitigated by the comfortable debt metrics that the sovereign (and semi-sovereigns) enjoy. The appetite to exploit this advantage will presumably rise as market interest rates begin to come down.

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	3,852	4,032
($ billion)	715	847	839	734	869	1,108	1,027	1,075
(% change)	7.4	18.4	-0.9	-12.4	18.3	27.6	-7.3	4.7
Real GDP (% change)								
Oil	-3.1	2.3	-3.3	-6.7	0.2	15.4	-8.3	-1.8
Non-oil activities	3.0	-2.4	4.1	-3.7	8.1	5.5	5.1	5.2
Government activities	0.3	3.9	1.7	-0.6	1.1	4.6	2.8	2.7
Total	-0.1	2.8	0.8	-4.3	4.3	8.7	-0.5	2.3
Oil indicators (average)								
Brent ($/b)	54	71	66	42	71	104	84	89
Production (million b/d)	10.0	10.3	9.8	9.2	9.1	10.6	9.6	9.4
Budgetary indicators (SR billion)								
Government revenue	692	906	926	782	965	1,268	1200	1301
Government expenditure	930	1,079	1,059	1,076	1,039	1,164	1275	1326
Budget balance	-238	-173	-133	-294	-74	104	-75	-26
(% GDP)	-8.9	-5.5	-4.2	-10.7	-2.3	2.5	-2.0	-0.6
Gross public debt	443	560	678	854	938	990	1024	1103
(% GDP)	16.5	17.6	21.6	31.0	28.8	23.8	26.6	27.4
Monetary indicators								
Inflation (% change, average)	-0.8	2.5	-2.1	3.4	3.1	2.5	2.3	2.0
SAMA Reverse Repo (%, year end)	1.50	2.50	1.75	0.50	0.50	4.50	5.50	4.50
External trade indicators ($ billion)								
Oil export revenues	170	232	200	119	202	327	244	245
Total export revenues	222	294	262	174	276	411	308	310
Imports	135	137	153	138	153	190	217	248
Trade balance	87	157	108	36	123	221	91	62
Current account balance	10	72	38	-23	44	151	30	15
(% GDP)	1.5	8.5	4.6	-3.1	5.1	13.6	2.9	1.4
Official reserve assets	496	497	500	454	455	460	441	456
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	31,219	31,955

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